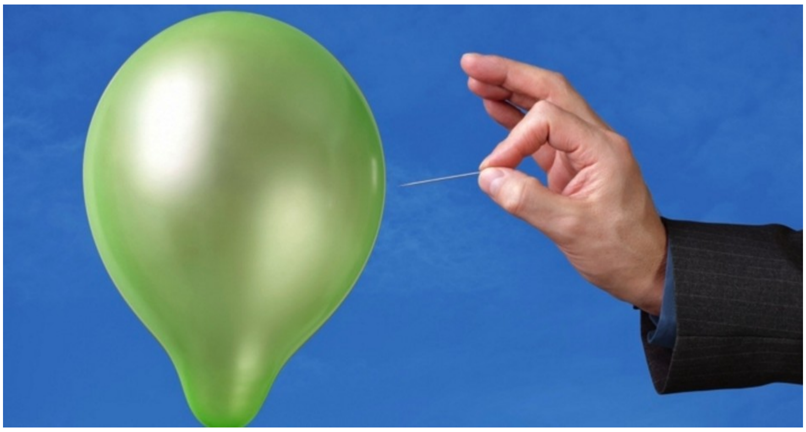
Written by Bob Adelmann on June 13, 2013

Central Banks' Bubble Bursting, Sending Markets Down Worldwide



When the Japanese stock market lost more than six percent of its value on Wednesday in a massive sell-off, pundits jumped on the move to try to explain what happened, and what it all means. Evan Lucas, a market strategist at IG Markets, wrote:

> The storm clouds are building: the Dow has just suffered its first three-day losing streak for the year, the Chicago VIX [fear] index has climbed further; Europe is sliding off its highs; China is slowing down faster than expected, and the BOJ [Bank of Japan] is holding [off] on additional stimulus action.

Hans Goetti, chief investment officer at Finaport, explained why:

> We've been living in an environment where economically speaking, bad news was good news because bad news meant more monetary stimulus. The rally that we have had over the past one-and-a-half years has been mainly driven by central banks and now the punch bowl is about to be taken away.

Two analogies are often used to describe the actions of the Federal Reserve in the United States as well as other central banks around the world: the punch bowl, and the drug addict. Each is helpful in explaining the addictive nature of easy money (or alcohol or drugs) and the inevitable withdrawal that takes place when the stimulus is removed.

According to Austrian school business cycle theory these declines in markets are the inevitable consequences of an expanding money supply, sold as the answer to fighting a recession. Low interest rates, Keynesians believe, help to stimulate borrowing and investment which works to reverse the economic downtrend and get things moving again. There are numerous flaws in this theory, including not knowing just how much new money needs to be printed, or when to stop. The problem is simple: Central bankers don't know the answer to either question and as a result are unprepared for the consequences, or even to recognize them while they are occurring.

What's being reported are those consequences. On Wednesday, the Dow Jones Industrial Average (DJIA) rose by more than 100 points early in the day, reversed course and dropped 260 points, ending the day down 126 points, capping its first three-day losing streak in 2013. Similar losses were recorded by the S&P 500 Index and the Nasdaq, while the "fear index" (the CBOE Volatility Index) spiked over 18 (five points above where it usually trades).

In the last 30 days the Dow has lost 500 points while the S&P 500 has broken through support levels, and put-call ratios (another measure of risk of a sell-off) have been rising. Market breadth (stocks rising in price compared to those falling) has gone negative as well. International bond fund investors are redeeming shares at a rate not seen since the start of the Great Recession.

It's happening because there are whispers that the punch bowl might be taken away, perhaps sooner than later. Since November 2008, when the Fed introduced its plan to fight the Great Recession with plans to expand the money supply by $600 billion, it has continually added new money to the economy until the total now exceeds $3 trillion. But that fades in comparison to the expansion by central banks world-wide, estimated at more than $12 trillion since 2007.

This was aided and abetted in Japan by the program called "Abenomics," a gigantic Keynesian program of new money creation named for its primary instigator, Shinzo Abe, the current prime minister of Japan. This huge expansion of the money supply initially served to weaken the Japanese yen sufficiently to make Japan temporarily more competitive in world markets. This in turn drove the moribund Nikkei 225 to highs not seen in decades, topping out in May at 15,943. On Thursday the Nikkei 225 index closed at 12,445, a decline of 22 percent, well into bear market territory. The FTSE (London's equivalent of Wall Street's S&P 500 Index) topped out at 6,876 in May, and ended the day at 6,304, a decline of more than eight percent, while shares of the Brazilian Total Return Index topped out at 34,664 in May and ended the day at just 28,655, a decline of 17 percent in less than a month.

The dominoes continue to fall, according to John Nyaradi, writing in the *Wall Street Journal's* Marketwatch:

> **Domino #1**: Apple Computer was the first domino to fall as it reached an all-time high of more than $700/share in September 2012, only to fall to an interim low of $390 in April 2013. Recently, the stock has enjoyed a tepid rally but still remains firmly locked in bear market territory, down more than 35% from its September high. Viewed as a bellwether of the tech sector and a prominent player in the S&P 500, Apple was the first domino to fall.
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> **Domino #2**: In a long-term bull market until October 2012, gold has been variously viewed as the "barbarous relic," the only "true" currency and the ultimate "safe haven" against both currency collapse and runaway inflation….
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> Recently, however, the luster is off the precious metal, and gold has been a falling domino, to say the least. Peaking at $1800/oz in October 2012, gold has fallen to interim lows of $1362/oz in April 2013, a stunning six-month decline of 24%.
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> **Domino #3**: Another "safe haven" and the ultimate "no risk" investment, United States Treasury bonds are starting to wobble and could become the third domino to fall. The value of 30-year Treasury bonds has plummeted 8.9 percent between May 1 and June 7 alone, and this has more than troubling ramifications for important things like the real estate market, corporate profits, interest on the national debt and the future of U.S. equity prices.
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> This is a colossal domino, and its fall would be a major game changer across the entire spectrum of global financial assets.
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> **Domino #4:** The real estate sector has been the one really bright spot in our ongoing mediocre economic recovery, but now even it seems at the cliff's edge and ready to take a tumble. The iShares Dow Jones U.S. Real Estate ETF fell 9.3 percent between May 21 and June 7.

Whether Wall Street becomes **Domino #5** (or **#6** after Japan) will likely become clear over the next weeks and months. It's not being helped any by Fed Chairman Ben Bernanke who just announced that he won't be attending the annual Jackson Hole Conference in August, due to a "personal scheduling conflict." This is the first time a Fed chairman has missed this confab in 25 years.

Regardless, the pins are lined up for a major correction, a reflection of central banking's determined move to flood the world economy with digital currency without regard for those nasty unforeseen consequences that are now surfacing. It may be that Bernanke is doing his disappearing act just in time.

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