Commentary from Bob Browne, Chief Investment Officer

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If they only knew how to spell "banana."

Central bankers and various financial officials around the world have been stepping over each other recently trying to reassert their credibility and toughness. Let no one doubt their resolve and courage, they say. In his highly noted article in the *Wall Street Journal* published on September 25, Federal Reserve Board Governor Kevin Warsh wrote that the "whatever it takes" policy applied to easing the pain of the financial crisis might be the new mantra needed when the time is right to raise interest rates and reverse the various stimulus efforts of the past year. He sent the proverbial cannon ball across the bow of the financial markets as he told us all to prepare for "asymmetric application." Across the globe in the sphere of the currency markets, Japan's new Minister of Finance Hirohisa Fujii was a bit more cryptic, but no less assertive, when he stated on October 3 that "if currencies show some excessive moves in a biased direction, we will take action." Central banker brethren globally are telling us that they will know *how* and *when* to execute the "exit strategy." Knowing what to do, however, is very different from knowing when to do it. Warsh and his colleagues remind me of the little girl who, when asked if she knew how to spell "banana," said, "Yes, I just don't know when to stop."

They might be better off listening to the remarks of their fellow policy-maker, Jean-Claude Trichet, European Central Bank (ECB) president, who said in a September 23 interview with Italian newspaper *Corriere della Sera*, "…we have a bumpy road ahead and that the level of uncertainty remains high.…" In the same interview, he asserted that the fiscal exit "…should be stepped up in 2011," leaving it to his audience to realize that a full year and then some sits between 2011 and now. It is just as well that Trichet takes a cautionary stance at this juncture of the financial crisis. It was his institution, after all, that saw fit to raise official European interest rates one more time in July 2008. This was after the Bear Stearns collapse, after Icelandic banks went into a deep freeze, after credit spreads around the world began their inexorable trend wider, after the housing markets of the United States, Spain and Ireland all started to turn over, and after European equity markets had already fallen 20% in just over six months. Despite all this, the ECB felt it was more than appropriate to raise the cost of capital across Europe one more time. It is this penchant for self-flagellation that has always scared me about the ECB. In the same interview when he refers to the bumpy road ahead, Trichet also reiterated his strong belief in the Group of 20 preamble that stated, "We will prepare our exit strategies and, when the time is right, withdraw our extraordinary policy support." Let's hope their timing is better next time around.

After mixed economic data in the United States and elsewhere – and it was mixed for the week overall but decisively capped by Friday's poor U.S. employment figures – I would caution Warsh and his peers about publicizing (let alone acting on) their fervor for "asymmetric application." As an old bond investor, please allow me to tell you this: the bond market does not like surprises. If at any time you and your fellow Fed governors are thinking about raising interest rates beyond what is already priced into the forward curve (the series of implied future interest rates), please take a breather and go watch a movie instead. This is not the time or the place to prove how tough you are. Besides, no one is going to believe you until you actually do it anyway. So that is the dilemma the world's central banks face. Even if they want to act sooner than the markets expect, the mere act of doing so likely will undermine the very goal of financial system stability. The first act by hedge funds in the wake of stronger-than-expected policy actions likely will be to short the equities of financial institutions across the spectrum. We all know how that story ends. The Fed, the ECB and the Bank of Japan are therefore left to follow the markets. The forward curve, not the central bankers, likely should determine monetary policy next time around.

This is the way it should be. After all, the markets were right to price in stable European rates before the ECB decided to raise them instead. The U.S. debt markets priced in near-zero short-term rates long before the Fed woke up to the necessity. I am not saying that the market is always right. The market, after all, decided at one point that AAA-rated commercial mortgage-backed securities should trade at 0.65% above U.S. Treasuries before changing its mind less than two years later and deciding the correct spread was closer to 15%. Investors do have a nasty habit of extrapolating market trends right over the cliff's edge. In times of crisis, however, the financial markets do a pretty good job of quickly determining the necessary clearing price of capital. Until yield curves around the world steepen dramatically and/or the currency markets start to gyrate wildly, central bankers should feel comfortable they are holding the right course.

This "easy money policy" naturally will benefit some markets and asset classes that do not really need support. Emerging market equities and commodities continue to stand out in our minds as unintended beneficiaries, but this is a consequence to be borne and, quite frankly, enjoyed for now. We continue to look for risk opportunities with sound fundamentals and positive longer-term secular trends. Emerging markets equities and commodities fit the bill. Low interest rates are just icing on the cake.

At some point, a change in monetary policy will be warranted, but for now we are betting on an extended period of low short-term rates in the big three: the United States, Europe and Japan. Until their economies are on a sustained, broad recoverable trend, these policy-makers should keep in mind Warsh's other observation: "…we should maintain considerable humility about optimal policy." Without such humility, they might find themselves saying, "banananana…."
