# MV Capital Management Midweek Market Commentary

## Floors, Ceilings and "Kick the Can"

***September 26th, 2012***

We talk a lot about floors and ceilings these days – so much so that readers may be forgiven for thinking that we are carpenters. No – our floors and ceilings are of the electronic variety. Over the past several weeks we have seen the floor in action, with central bankers playing their now-customary role of shoring up support so as to prevent asset markets from falling further. First the ECB got its way when Germany's constitutional court gave a thumbs-up to the European Stability Mechanism. Then the Fed chimed in with QE3, which could be more appropriately be called QE4ever. And in a "hey, what about me?" kind of way the Bank of Japan got into the act with its own new stimulus measures, as noted in last week's Comment.

This week we see the return of the ceiling, in a bit of tiresome déjà vu. Spanish bond yields are sharply up from their levels in recent weeks, Greeks are in the street protesting austerity, oil is dipping below $90 and stock markets are pulling back accordingly. Eagle eyes are trained on upcoming corporate earnings to see if the slow recovery is eating into the corporate bottom line. Gravity, in effect, is in full force.

The market's inability to reach escape velocity and break through the ceiling is in no small part a recognition that the central bank policies put in place so far – including even Draghi's perseverance in getting the ESM through Germany's opposition – have not solved the problems. They have, to use a phrase we have often employed on these pages, just kicked the can down the road yet again.

But is there method in the madness? Is "kick the can" actually a strategy rather than a failure of vision? Maybe. Think about it this way: in its present floor-and-ceiling mode the stock market actually resembles a giant financial option. A basic call option has a floor, which is equal to the price you pay for that option. Your investment will never be less than that floor because the option has only two possible outcomes: to expire worthless; or to increase in value with the appreciation of the underlying asset.

The other thing about an option is that time is an ally. The longer time there is from today until the option expires the more value the option has, all else being equal. Why? Because the more time you give an asset to rise in price, the higher the probability that it will. If I buy an S&P 500 call option that expires next week then there are only a few trading days for the index to rise above the option's strike price. But if the option expires two months from now than there are many more days in which that can happen. Statistically speaking my chances of winning are greater.

So it is for the synthetic floor the world's central banks have put under the stock market. The floor may not be solving actual problems, but it is buying valuable time. Economic cycles come and go, and this anemic growth environment eventually will as well. If we have avoided another market meltdown by the time real growth kicks in again then the floor has been successful. Kick-the-can as a policy approach has worked.

That's a big if, of course. There is already a growing body of doubt that any ongoing stimulus measures will accomplish anything. If investors believe there is no intrinsic value to the floor then the floor goes away and it's watch out below. There are plenty of sharp curves ahead. But if nothing else, time is still probably on our side.

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