CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

November 17, 2010

The Launch of QE2

In the first week in November came the elections and the Fed's announcement of its new round of 'quantitative easing'. The policy had been well foreshadowed in speeches by Fed members, widely anticipated in financial markets, and strongly criticized from many sides.

This letter considers aspects of the policy and offers an assessment of its effects on investment markets.

By

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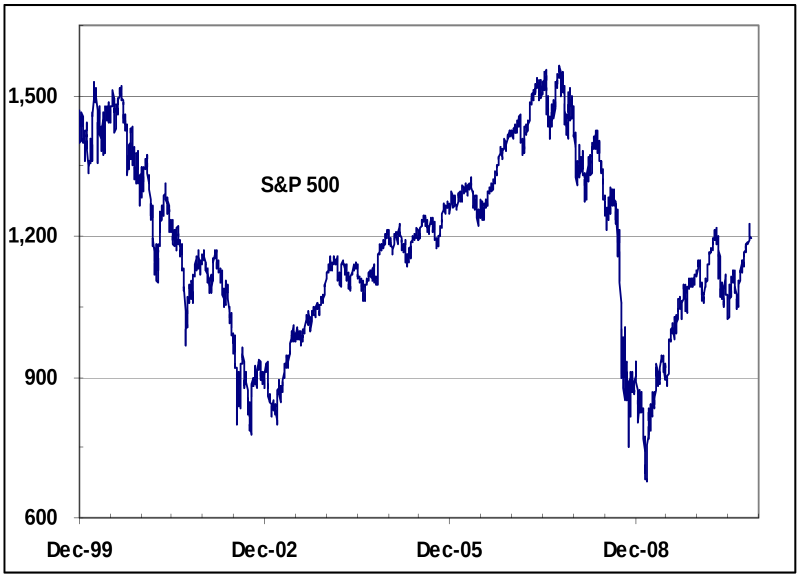
The Federal Reserve Board recently announced its plans for further monetary policy support for the economy and clarified those plans with some specificity. The Fed typically conducts its monetary policy by lowering short-term interest rates in times of economic weakness and financial system stress, and by raising short rates to dampen economic activity and/or inflationary pressures. The present risk of deflation, terribly high unemployment, and weak economic growth cry out for help from the Fed, but the option of lowering rates is not available now, the Fed having cut rates essentially to zero two years ago. Thus it employs what is referred to as 'quantitative easing', whereby it purchases assets with funds it creates. (The Fed owns the printing press that makes dollars.) At the worst of the financial crisis after the collapse of Lehman Brothers in September 2008, the Fed tripled the size of its balance sheet to about $2 trillion, by purchasing mortgage-backed and US treasury notes and bonds.

The economy faltered in the summer, in response to which the Fed announced that, as it received principal repayments for the mortgage-backed securities it holds (about $30 billion per month), it would invest the proceeds in Treasury notes and bonds, thus maintaining the level of assets on its balance sheet. In a speech in August, Ben Bernanke, the Fed Chair, reported that the Fed was actively considering new purchases of treasury debt. After the regular meeting of its Open Market Committee on November 3rd, the Fed announced the broad terms of its second round of quantitative easing, now widely referred to as QE2. It will continue the monthly treasury bond purchases of $30 billion related to the mortgage-backed securities, and will supplement that by buying about $600 billion more between now and June. Last week the New York Fed announced that the Fed will purchase $109 billion of treasuries with maturities from 5.5 years to 10 years.

It goes without saying that the Fed's actions are unprecedented, but the ideas are not new. Bernanke first put forward these ideas in a speech in November 2002, about which I wrote in *Core Comments* of January 23, 2003, a copy of which I send along with this letter. The predicament in which the Fed finds itself and the US economy is characterized by high unemployment, abnormally low levels of bank lending, inflation at about 1% and probably falling, and a political environment in which Federal and local government actions to stimulate the weak economy are largely out of the question. Although the Fed has various tools to fight deflation, as Bernanke wrote in 2002, these tools would almost certainly be more effective if co-ordinated with fiscal actions involving spending and taxation policy by the federal government. The Fed has probably determined that, in this political environment, it must fight

Bernanke's Op Ed piece may be found at http://www.washingtonpost.com/wp-dyn/content/article/2010/11/03/AR2010110307372.html

deflation and the weak economy on its own. It has determined to buy a very large quantity of treasury bonds--more than will be issued over the coming months--in an effort to lower interest rates and increase asset prices. The $600 billion to be created in coming months will slosh around the globe, raising prices of many assets and, most likely, decreasing the value of the dollar against many other currencies. In an Op Ed piece in the Washington Post on November 4, Mr. Bernanke discussed his goals. A link to the article and a passage from it may be found to the left.



The Fed has two mandates: to maintain maximum employment and to foster price stability. The threat of deflation (falling prices) and the high level of unemployment demand ameliorative action. Strident criticism in the media and from many politicians complicates the Fed's work; one consequence may be that the Fed will attempt less than needed, so as to avoid arousing Congressional opposition to its independence. The ultimate success or not of these actions is unknowable now. A separate question is whether or not the Fed *should* engage in this type of monetary policy. These questions are interesting to us as citizens, but they are outside the scope of Core's work for you. Our job is to assess the likely consequences of the Fed's actions on investment assets and to make appropriate investments.

Bernanke writes: "This approach eased financial conditions in the past and, so far, looks to be effective again. Stock prices rose and long-term interest rates fell when investors began to anticipate the most recent action. Easier financial conditions will promote economic growth…. And higher stock prices will boost consumer wealth and help increase confidence, which can also spur spending. Increased spending will lead to higher incomes and profits that, in a virtuous circle, will further support economic expansion."

Consistent with Mr. Bernanke's explicitly stated goals for QE2, we may expect higher prices for stocks. Indeed, many investment assets have rallied significantly since August when Bernanke and other Fed members began to discuss QE2. The dollar has fallen, not an explicitly enunciated goal, but not an unwelcome outcome. For the next six months, as this round of quantitative easing unfolds, it is reasonable to expect stocks, commodities and REITs and similar assets to rise in price. Because money flows freely round the globe, it is almost certain that a meaningful portion of the newly-created dollars will find their way into bonds and stocks of the developing economies, contributing to higher prices for these assets.

Very recent economic reports, including employment and manufacturing activity, have been better than those in the late spring and early summer. The Fed's actions may add a bit of oomph to all this, but consumer spending remains very poor, suggesting that the forces of deleveraging--less spending and more saving by wary consumers--are still strong. These will necessarily restrain the economy. The Fed has a tough fight before it.

After increasing our equity and commodity investments in September, we recently made some further changes. We sold our very long-term treasury bond positions and made an investment in an exchange-traded fund holding treasury bonds with maturities of 7 to 10 years. These are within of the range the Fed's QE2 purchases. We sold about half our very successful gold investment and bought silver with the proceeds. Gold has attracted buying as the anti-paper currency investment. We expect gold and silver both to rise further in price. There are fears that deficit spending and quantitative easing will lead to hyper-inflation. To our thinking, this is bunk, but we recognize the demand for precious metals, well-founded or not. In the last week, many assets that had risen steadily since late August have begun to trade down. We may use some of our cash reserves for new investments in weeks ahead.

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