

## A QE2 PRIMER

**December 2010**

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On August 27th Federal Reserve Chairman Bernanke signaled a second round of quantitative easing in an attempt to fulfill its dual mandates of pursuing low unemployment and price stability. Long before the details were made public, a firestorm of rhetoric was unleashed here and abroad criticizing the program and the Chairman. Even over a recent weekend a group of 21 conservative economists and investment managers published an open letter asking that the program be ceased. Notes from the last Fed meeting show that policymakers also disagreed on the possible ramifications of this plan. Now that the program has been initiated to affect monetary policy, we can begin to evaluate its impact. Fiscal policy, controlled by Congress, remains mired in the political grinder.

### **What is QE2?**

The Fed Chairman stated that the program would comprise the purchase of large amounts of Treasury securities. This was similar to the even larger program used during the financial crisis dubbed Quantitative Easing (QE1). The current program was labeled Quantitative Easing 2 or QE2. In QE1 – started in November 2008 - the Fed focused on purchasing mortgage-backed securities (MBS). Now they will focus on purchasing Treasury issues. These outstanding Treasury instruments were originally sold to the public in exchange for cash reserves. The Federal Reserve will now buy these issues, injecting reserves back into the banking system. Assets on the Fed balance sheet will increase. Then, at some point in the future, the Fed will attempt to execute an exit strategy, gradually selling these assets from its balance sheet and draining reserves.

The program details were announced on November 3, 2010. The Federal Reserve Bank will buy \$600 billion of U.S. Treasuries, or \$75 billion for each of the next eight months, until June. The Bank will concentrate in the 2.5 to 10 year maturity range, but will buy out to 30 year maturities. Additional Treasury issues may be purchased with principal payments from the MBS's purchased in QE1. Including the MBS reinvestment program, total potential purchases under QE2 could rise to \$900 billion by next summer. The Federal Reserve emphasized that they reserve the right to modify or terminate the program.

### **What are the Fed's objectives?**

The Fed hopes to lower intermediate to longer term interest rates and borrowing costs, which should help home owners to refinance and smaller business to gain more access to credit. It should also push investors seeking higher returns into riskier assets, supporting the prices of stocks and corporate bonds. In turn higher asset prices should help build confidence. This confidence should flow through to consumers and businesses creating a healthier economy that supports higher levels of employment. The Fed's mandate for price stability has been used to justify the attempt to create a higher level of inflation, squashing the fears of deflation. It is thought that Chairman Bernanke seeks an inflation target of 2.0%. Although the Fed emphasized that a weaker U. S. dollar was not an objective, this by-product could make U. S. exports more price competitive, stimulating foreign sales and domestic manufacturing.

### **Will QE2 work?**

Supporters of QE2 such as James Bullard, St. Louis Fed President, feel strongly that the increase of credit in the combined central bank and commercial banking system during QE1 supported higher spending on goods and services, and led to higher asset prices. This helped to avert an even worse deterioration than we saw in the recent credit crisis and recession. Therefore, according to QE2 supporters, it should work this time. Supporters of the move state that if the economy continues to grow slowly, the injection of liquidity by the Federal Reserve and lower interest rates should strengthen the expansion and help guard against the dreaded "double dip" recession. In a recent commentary, Paul Kasriel of Northern Trust showed that "money printing" or "debt monetization" grew at a median rate of 7.5% from 1954 through 2009. During 2009 we saw the first annual period during which "money printing" actually declined. If the Fed releases \$600 billion of central bank credit between now and June 2011, Federal Reserve and commercial bank credit will have grown by 5.2% for the eight months and 5.6% year-over-year. Unless additional reserves are created, the increase will be in line with historical norms. Monetization is more "normal" than we would like to believe or think is healthy.

### What could go wrong?

Much of the possible success for quantitative easing is based on economic theory, most of it untried. The chorus of criticism is widespread and loud. It tends to center on the monetization of debt and flood of currency that could lead to high inflation and the continued debasement of the dollar. Many critics also say we are in the proverbial “liquidity trap”, where substantial injections of liquidity and lower interest rates fail to stimulate economic growth, but lead to higher inflation and commodity prices, further decreasing purchasing power. Offsetting the QE2 effect are deleveraging businesses and consumers who remain reluctant to increase demand for products and services. Critics also fear that a continued low level of interest rates will further weaken the U.S. Dollar, festering trade retaliation and a move away from the dollar as a currency of choice. Low levels of interest rates also fail to cleanse the system of over leveraged businesses and individuals mired in uneconomical situations, extending marginal and irrational uses of capital. These critics remind us that virtually every problem period in our economic history occurred after a period of easy credit and sustained high levels of debt.

### What has happened so far?

It is early in this program to glean meaningful conclusions. The “front running” of the Fed is just beginning to dissipate as hedge funds that positioned themselves after the August 27th announcement subsequently unwound many of those trades. Yields on 5, 10 and 30 year Treasuries moved sharply lower on the heels of the original announcement of intent in August, yet have moved higher since the statement of details on November 3. Domestic equity markets have benefited as intended with stocks up almost 15% since the original announcement. Mixed economic releases in recent weeks have led some Fed officials and proponents of the program to say that continued weakness justifies the path begun by the Federal Reserve. But global economic tensions have increased significantly. Criticism rains in from abroad of our increasing level of debt and its monetization, the Fed move to keep interest rates artificially low and the world wide effects of a weaker U. S. Dollar.

### How will this affect investment opportunities and our strategy?

The debate rages on, but QE2 is being implemented. The accommodative monetary policy should help bolster our economy and offset waning fiscal stimulus. Our economy continues to begrudgingly strengthen with corporate earnings steadily recovering and employment slowly firming. Sustained economic growth is the elixir that can avert the effects of the dreaded “liquidity trap”, kick-start job growth, firm up the housing market, give the Fed the latitude to consider the phase-in of an exit strategy and begin to stabilize our currency. We must remember that unless the Federal Reserve shifts their strategy, they will likely win the battle to increase asset prices and keep interest rates lower in the short run. Signs of higher inflation in the intermediate to long run are not yet on the horizon. But a pervasive fear of inflation is healthy as we work to rebuild financial strength. We continue to monitor global economic trends as we may be seeing the beginning evolution of a new playing field in international trade and currency policy. This does not yet change our current strategy which is looking for stronger corporate earnings to drive fairly valued stocks higher, generating more attractive returns than in fixed income.

**Lawrence B. Whitlock, Jr., CFA**  
Managing Director

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