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The Fed's Monetary Policy Sequel

Why QE2 May Not Live Up to the Hype

Earlier this summer, we asked whether we were on the road to recovery or relapse. Since then, our assessment of the data has not led us any further toward answering this question. Our WCA Composite Conditions Index™ remains stuck in neutral with a reading near 50.

Nevertheless, two important developments have occurred since then. First, the Federal Reserve's 180° about-face from exit strategy planning to another round of asset purchases underscored the deteriorating momentum in the recovery seen earlier this year. The program involves the injection of new money into the banking system via the purchases of government debt, despite earlier pledges by the Fed not to monetize the government's debt. Second, the mid-term elections have the potential to reduce government deficits to below trend, while offering little offsetting incentive to stimulate private investment.

We believe that the next several quarters will be strongly affected by how effective the Federal Reserve's asset purchase program is in promoting recovery, and the extent to which fiscal changes are factored into perceptions about economic growth and profits.

Before tackling the issue of what the mid-term elections might mean for investors, I would like to first try to tackle the issue of the Federal Reserve's latest effort to further bolster bank reserves, and to prod investors toward greater risk-taking through threatened currency devaluation. While most policymakers, bankers, and investors see the Fed's actions during the crisis as good steps, there are important differences between those actions and now. The program, which has been euphemistically dubbed *Quantitative Easing II,* or simply *QE II,* thus runs the risk of disappointing a global audience of onlookers who are hopeful for a repeat performance of QE I.

The Fed Buying More Assets

The Federal Reserve's monetary easing program was announced in late August and was designed to lower interest rates, help avert deflation, and help restore full employment. However, some interest rates have been moving up, and borrowing costs for mortgages are largely unchanged. Both the 10 and 30-year Treasury bond yields are higher now than when the program was announced in August, and the average mortgage rate has only declined by about 0.1% from the announcement of the program. While there has been some modest improvement in the rate of weekly job losses, the related weakness in the foreign exchange value of the U.S. dollar has begun to place a burden on our trading partners, thus jeopardizing progress made toward recovery in those countries. Not surprisingly, there is mounting discord among bankers and finance ministers, and the threat of reprisals is growing with each passing week. Should Ireland, Greece, or Portugal move closer toward default, the cries for protectionist measures, currency controls, and competitive devaluations will grow louder and may preclude additional rounds of asset purchases later on.

Markets may be overestimating the size and effectiveness of quantitative easing based on currency and stock market moves since the plan was announced in August. According to William Dudley, New York Federal Reserve Board President, a $500 billion program of asset purchases by the Fed would provide stimulus approximately equal to a 0.5-0.75% rate cut. If that is true, then the $600 billion asset purchasing program that the Fed announced last week would equate to a rate cut of as much as 0.90% ($600/500 billion times 0.75%).

What sort of change would that imply for stocks and the dollar? For this, we turn to a Federal Reserve model that attempts to measure the cause and effect of rate changes on equities and the dollar.[1] That model suggests that a 0.9% cut in the federal funds rate should translate into an 8% rise in stock prices and a 2% decline in the dollar. However, since the program was announced in August, the S&P 500 has risen by twice the predicted 8% amount (actually rose 15%) and the dollar has declined by four times the predicted amount (actually fell by 8% on a trade-weighted basis).

Based on this math, it seems that markets have already discounted the fullest imaginable measure of asset purchases by the Fed at this time. By focusing only on assumed positive and short-run benefits, the market is ignoring potential longer-term costs that may follow from further asset purchases.

We can hardly blame the Fed for pursuing their present tack, however. Aggregate credit in the private sector continues to contract, government deficits are likely to shrink, thus deflation is still in the cards. The Fed believes whole heartedly (as we do) that the predominant monetary force in the economy is debt liquidation and deflation, rather than debt accumulation and inflation. Moreover, the Fed is attuned to (as we are) market-based indicators as validation of their policies. So we are sure that the Federal Reserve was watching the deterioration in risk assets during the spring and summer months, along with the ongoing push by households to reduce leverage by paying or defaulting on debt. Households paid off more debt than they took on last quarter by -$309 billion — a record falloff despite record low interest rates.

[1] Aggregate Disturbances, Monetary Policy, and the Macroeconomy: The FRB/US Perspective, *Federal Reserve Bulletin*, January 1999

We can't be surprised by their actions either. Way back in 2002, Ben Bernanke who was not yet Chairman of the Federal Reserve laid out in a speech before the National Economics Club a plan for making sure deflation does not happen in the United States. In it, he outlined specific steps that he felt the Fed should undertake should deflation become a threat.

These steps included:

1. Directly lowering short-term interest rates to 0% via open market operations.
2. Indirectly lowering long-term interest rates via a pledge to keep short-term rates low for an "extended period."
3. Announcing specific ceilings for specific yields and specific assets, and enforcing those ceilings through a program of ongoing asset purchases.
4. Expanding the list of eligible securities for asset purchases beyond Treasuries to also include private securities, government agency debt, and even foreign bonds of foreign governments.
5. Enacting policies designed to lower the foreign exchange value of the dollar (not stated directly for political reasons, but clearly intimated in the speech).

The first four of the steps have been employed directly, and the last is being employed indirectly. It is important to recognize that the depreciation in the foreign exchange value of the dollar has been generally cheered by equity markets so far, as equity markets have been inversely correlated with changes in the exchange value of the dollar. The hope is that the lower value of the dollar will stimulate export demand, thus extending the recovery.

However, the short-run positive effects of easy money and weak dollar policies can produce unwanted longer-run consequences, especially when those policies are pursued in isolation. Currently, we sense that the Federal Reserve's desire to quantitatively ease is not shared by other central banks — notably Germany and several other emerging economies who are implementing far more hawkish policies of their own to tamp down inflation.

What sort of consequences might arise?

First, these policies fail to account for the burdens it places on other nations. Greece, Ireland, Spain, and Portugal, who again are seeing signs of stress in their internal finances, are confronted with weak growth, and a real possibility for a dip back into recession in 2011. These four countries have a combined Gross Domestic Product (GDP) of $2.25 trillion, and this GDP is down 0.5% on a year-over-year basis through the most recently reported quarter. An additional drag on GDP would be caused by a stronger Euro. A stronger Euro, in turn, would be the flipside of a weak dollar associated with additional Fed asset purchases. By no means will other countries accept being put upon by United States monetary policy, especially when a strong currency creates an impediment to their own recovery.

Second, if it becomes understood that the foreign exchange value of the dollar is being deliberately undermined, then direct investment flows coming into the United States will be undermined. Over the long run, discouraging such investment will hurt rather than help grow business investment and employment, and can ultimately raise the cost of borrowing.

Third, while low interest rates help debtors, they hurt those needing a safe source of income. Those especially include retirees and defined benefit pension funds who rely on such income to meet basic living needs and obligations. Additionally, by cutting interest rates to savers, it undermines the accumulation of a pool of savings that can become a valuable source of "fuel" for the economy's eventual recovery. A higher savings rate may be necessary to offset the very low rate of savings in the years before the recession. The improved liquidity position of households that comes from higher savings and earnings on those savings is a net positive toward recovery. Since consumers are typically impatient to spend, and since they are not likely to borrow and spend until they restore balance sheet health via savings to a level that they are comfortable with, then policies designed to retard this savings process will only serve to shallow out and lengthen the period of sub-par economic growth. Additionally, to the extent that households and businesses become concerned about future tax obligations as the result of public sector borrowings, then there is an additional (albeit hard to determine) drag on private consumption as higher expected taxes become part of the private sector's calculus regarding their own well-being.

Lastly, competitive currency devaluations hurt trade. A round of competitive devaluations that circulated around the globe during the 1930s exacerbated the Great Depression and prolonged the downturn. During the 1930s, various nations, including the United States, sought to devalue their currency by abandoning ties to gold. Widespread unemployment enticed governments to seek devaluations to encourage exports and ignite growth. These policies were called *beggar thy neighbor policies* and were generally viewed as unsuccessful because the positive effects of devaluation would soon be counteracted by a corresponding devaluation by trading partners, so that no one nation gained any sustained advantage as the result of embarking on the path of devaluation. The positive effects of uncoordinated devaluation proved mercurial, and sharp fluctuations in currency values created increased volatility in markets, along with a rise in protectionism, more unemployment, and further depression in economic growth. It is not surprising that high global unemployment and the discord in trade paralleled a discord in diplomacy that led to the start of World War II, and eventually to the adoption of the Bretton Woods era following the war. Clearly, beggar thy neighbor policies, currency devaluations, and protectionism were not successful in driving growth in trade and prosperity.

Nonetheless, Ben Bernanke seemed to embrace the idea of currency devaluation as a means to stimulate growth in his 2002 deflation speech when he said:

"Although a policy of intervening to affect the exchange value of the dollar is nowhere on the horizon today, it's worth noting that there have been times when exchange rate policy has been an effective weapon against deflation. A striking example from U.S. history is Franklin Roosevelt's 40 percent devaluation of the dollar against gold in 1933-34, enforced by a program of gold purchases and domestic money creation. The devaluation and the rapid increase in money supply it permitted ended the U.S. deflation remarkably quickly. Indeed, consumer price inflation in the United States, year on year, went from -10.3 percent in 1932 to -5.1 percent in 1933 to 3.4 percent in 1934. The economy grew strongly, and by the way,

1934 was one of the best years of the century for the stock market. If nothing else, the episode illustrates that monetary actions can have powerful effects on the economy, even when the nominal interest rate is at or near zero, as was the case at the time of Roosevelt's devaluation."

This "bubble case" that Bernanke described above as the result of currency manipulation has its adherents in the market today. We have seen sharp rises in commodity prices and high risk assets since the announcement of QEII. Bubbles, by definition, introduce risk, because the market valuation of the asset becomes disconnected from underlying fundamentals. When those bubbles also incorporate debt financing, then systemic risk is not added as the result of the bubble, but multiplied. Although investing in the early stages of a bubble may be rational (as George Soros believes), such activities become inherently more risky with time. So, if markets come to believe that a new speculative bubble will arise from current quantitative easing, then: 1) the Fed's current policy actions are inappropriate, 2) markets will continue to move to extremes of valuations, and 3) future busts that inevitably follow the bubble will further undermine confidence and dampen the longer-run secular potential for sustainable growth.

Time will tell whether the "bubble hypothesis" will play out or not. We find this to be a risky gambit, particularly as: 1) the private sector continues to liquidate debt and 2) the level of debt in the public sector is rising faster than the nominal growth rate of the economy. Without these factors in place, the risk that the Fed's efforts to pursue recovery via bubbles will ultimately prove to be a fool's errand are extremely high.

More likely than embarking on a new bubble, we believe that the QEII "honeymoon phase" is drawing near the end as implementation proves more difficult than the promise, especially since large parts of the rest of the world (and the U.S. electorate) are not invested with the same sense of unanimity and urgency that was apparent when the Fed launched its first round of asset purchases during a time of crisis a couple of years ago.

Conclusion and Tactical Implications

The Federal Reserve is creating more paper reserves in the hope of forestalling any possible bank reserve shortage, and to shift investor expectations in such a way to stoke greater risk-taking. Easy money policies in the past have typically been successful in creating consumer and asset price inflation. However, as we stated above, there are important secular challenges that have not yet been solved, and which raise the possibility that this round of asset purchases may not be successful in delivering the higher asset prices, stable prices, and full employment that the Fed is hoping for. Specifically, high levels of debt and leverage impedes the mechanism of money creation in the economy, and makes the Fed's efforts to inflate much more difficult. In order for us to feel comfortable that the U.S. economy has escaped the secular pull of debt liquidation and deflation, we would prefer to see expansion of credit in the private sector.

So far that hasn't happened. Accordingly, we remain guarded with regard to our secular outlook for sub-par growth with the risk of disinflation and deflation outweighing concerns about reflation and inflation. We continue to watch for improvement in trends regarding private demand for credit and

money as an important factor that might lead us to a more bullish long-run secular outlook.

Our shorter-term cyclical outlook continues to be of the glass-half-full / glass-half-empty variety. Our WCA Composite Conditions Index™ continues to post readings near 50. A reading of 50 indicates that about half of the measurements of data that we find relevant to the selection of stocks or bonds is favoring stocks at this time, while the other half favors bonds. We would be remiss in not pointing out that this "neutral" condition contrasts with more "equity friendly" readings of 80-90, which we saw in 2009 and early 2010. We would also be remiss not to point out that September (the first month after the announcement of the Fed's QEII program) broke the downtrend in our index. The next several weeks will help us determine whether the initial bounce following the August announcement of QEII has legs (requiring the addition of risk assets to portfolios), or whether the initial excitement regarding QEII was premature (requiring further scaling back of risk).

We conclude, based on our various indices, that our tactical asset allocations, which remain near the middle of our strategic ranges, are appropriate at the present time.

Next time, we will tackle the potential impacts on fiscal changes that may be on the horizon as the result of mid-term elections, as this topic deserves separate treatment.

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