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The whys and wherefores of QE3

For the institutional elite of American finance, money is literally free. Federal funds change hands at 10 basis points, the one-month Treasury bill at two basis points. In the repurchase, or repo, market, the lending rate on general collateral stands at five basis points, that on certain named, or “special,” collateral at less than zero percent. The dollar exchange rate sits near record lows, the dollar-denominated gold price at a nominal high. In a functioning free-market economy, money is no more free for the taking than are neckties or movie tickets. Yet, almost 30% of the respondents to a poll conducted by UBS a few weeks back said they anticipate a third round of so-called quantitative easing. Maybe our economy isn’t so functional or so free.

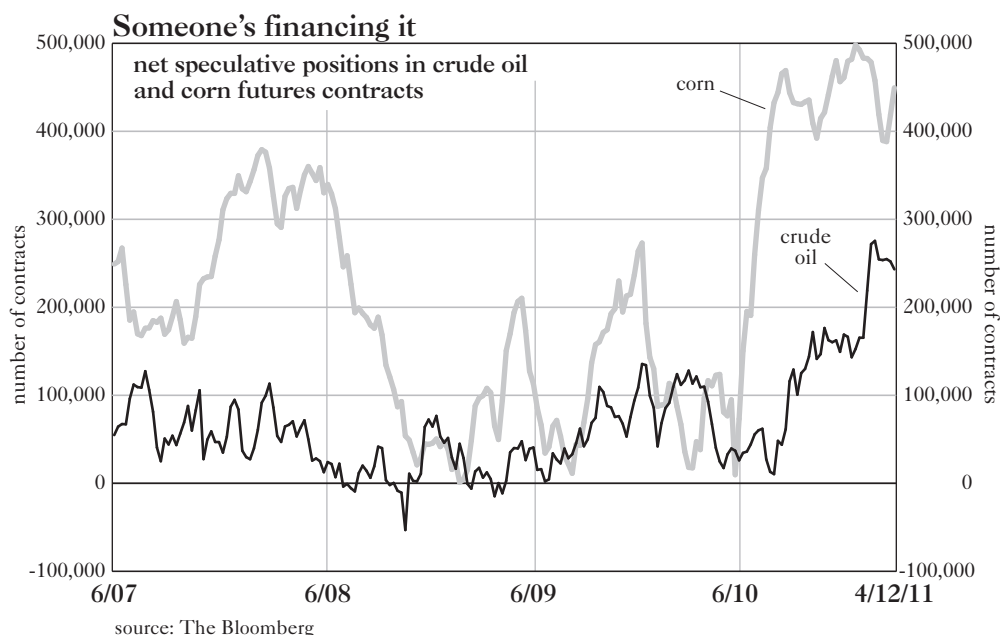
QE3 is the subject at hand, a topic as speculative as it is timely. In preview, we count ourselves among the expectant 30%. To its congressionally directed dual mandate—stable prices and full employment—the Bernanke Fed has unilaterally added a third. It has undertaken to make the markets rise. The chairman himself has more than once taken credit for the post-2008 bull market (on one such occasion in January, he reminded the CNBC audience how far the Russell 2000 had come under Fed ministrations). Could he therefore stand idly by in the face of a new bear market? Byron Wien, vice chairman of Blackstone Advisory Services, went on record the other day predicting a summer swoon in stocks following the scheduled winding down of

QE2 in June. Let us say that Wien is right, and that, furthermore, drooping stocks are accompanied by sagging house prices and a weakening labor market. Bernanke was hard put to explain why he chose to let Lehman go while acting to save Bear Stearns. He would be harder put to explain why he chose to implement QE1 and QE2 but, in another hour of need, refused to launch QE3.

A different Fed—a *Grant's* Fed or a Hoisington Fed, for instance—would cease and desist quantitative easing this very minute. Van R. Hoisington, eponymous chief of Hoisington Investment Management Co., Austin, Texas, is out with a new critique of the Bernanke program. “If the objec-

tives of Quantitative Easing 2 (QE2) were to: a) raise interest rates; b) slow economic growth; c) encourage speculation and d) eviscerate the standard of living of the average American family,” his colleagues and he write in their first-quarter report, “then it has been enormously successful.” The third point, especially, speaks to the prospects of QE3, we think. Sooner or later, gravity turns speculative markets into investment markets. When this transformation next occurs, the Fed will confront the need to bail out the innocents it had previously bailed in. Hence, QE3.

The first phase of Federal Reserve dollar conjuring began in November 2008, and it didn’t stop until March

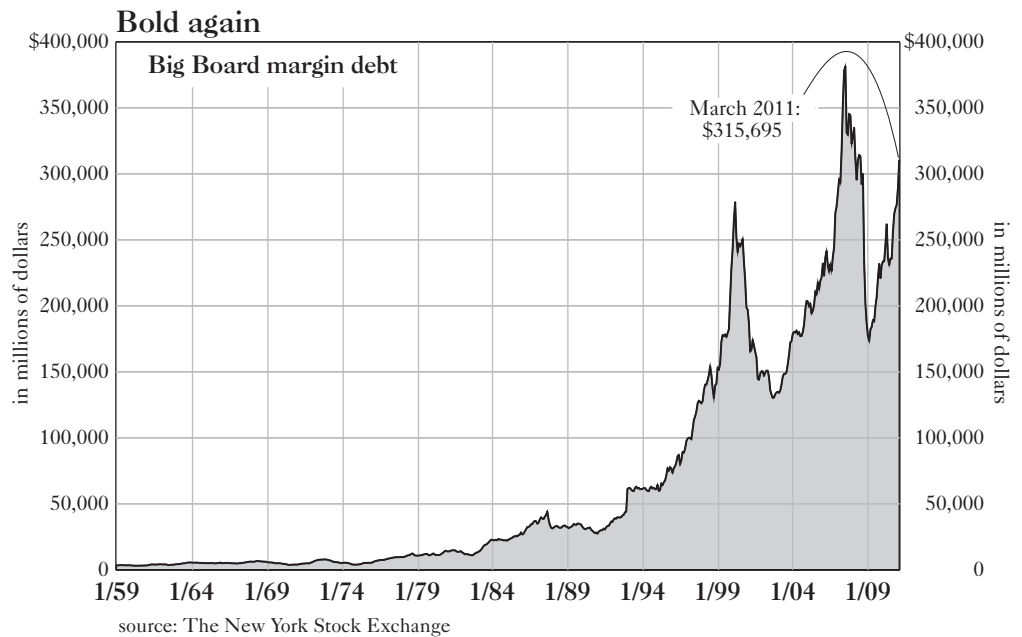


2010. Over those 16 months, the Fed's balance sheet grew by 5.8%, as the S&P 500 jumped by 36.4% and the dollar-denominated gold price by 35.1%. As for the nation's economic pulse, it slightly quickened. Best of all, observe the Fed's apologists, there was no reprise of the Great Depression. On those terms, QE1 was a rousing success.

We say "dollar conjuring"; some will object that "conjuring" is what modern central banks do. The Fed and its ilk purchase earning assets with money they create for the very purpose. However, QE is no ordinary conjuring trick. In the 10 years ended in 1951, the Fed pegged the three-month Treasury bill rate at three-eighths of 1% and the long bond rate at 2½%. But the Ben Bernankes of their day, Marriner Eccles and William McChesney Martin, were only doing their duty as they saw that duty. They pegged interest rates to facilitate wartime borrowing (and, after the war, to prevent the kind of jump in interest rates that had shocked the novice Liberty Bond buyers after World War I). Eccles, in particular, seemed to have it in for bull stock markets. He cut short one in 1937, another in 1946. Besides, in those days there were forms to respect. As the dollar was lawfully defined as a weight of gold (\$35 to the ounce), one could conjure only so many pieces of green paper.

The Martin Fed exulted in its newfound independence from the Treasury after the famous 1951 Fed-Treasury Accord. The Bernanke Fed appears to be exulting, still, in its independence from the gold standard, the last vestige of which ended in 1971, 40 years ago this summer. Like its World War II-era predecessor, the 2011 Fed is pegging money-market interest rates at close to zero. Unlike the Martin Fed, however, the Bank of Bernanke has set out to manipulate America's risk appetite. It means to herd the public into stocks and corporate bonds and out of government securities, so speeding financial and economic recovery. "The portfolio balance channel" is the clinical name for this monetary mind game.

Successful though it was at cheapening the dollar in terms of stocks and gold, QE1 failed to deliver vibrant growth or full employment. Be-



sides, the Fed had chosen to pursue its policy by buying mortgage-backed securities. Perversely, the still-weak economy gave long-term interest rates a downside push. Lower mortgage rates meant a faster gait of mortgage refinancing, which meant that the Fed's MBS portfolio began an unplanned and, from the vantage point of monetary management, disadvantageous shrinkage. At the annual Federal Reserve cookout and barbeque in Jackson Hole, Wyo., on Aug. 27, 2010, Bernanke sketched the outlines of what turned out to be QE2.

"[A]s the pace of economic growth has slowed somewhat," the chairman explained, "longer-term interest rates have fallen and mortgage refinancing activity has picked up. Increased refinancing has in turn led the Fed's holding of agency MBS to run off more quickly than previously anticipated. Although mortgage prepayment rates are difficult to predict, under the assumption that mortgage rates remain near current levels, we estimated that an additional \$400 billion or so of MBS and agency debt currently in the Fed's portfolio could be repaid by the end of 2011.

"At their most recent meeting," Bernanke continued, now all but drawing a picture, "FOMC participants observed that allowing the Federal Reserve's balance sheet to shrink in this way at a time when the outlook had weakened somewhat was inconsistent with the Commit-

tee's intention to provide monetary accommodation necessary to support the recovery." A month later, David Tepper, chief of Appaloosa Management, was on CNBC correctly anticipating that, unless the economy picked up, the Fed would re-launch QE. "Then what's going to do well?" he rhetorically asked. "In the near term, everything." And so it came to pass.

Speculation has particularly flourished, as the Hoisington-produced indictment notes. Thus, from the date of Bernanke's Jackson Hole speech to the present, the S&P 500 has climbed by 23.3%, gasoline by 65.9% and the Goldman Sachs Commodity Index by 43.7%. Open interest is setting records in corn and crude oil. "Commodity and stock price movements are susceptible to a myriad of demand/supply factors that include cartels, war and weather," as Hoisington observes. "But the speculation created by QE2 suggests financial players are aiding and abetting the normal price movements." Gold and silver make exemplary cases in point. You can blame ethanol for the corn pop and revolution for the oil spike. The cause of the updraft in the precious metals would seem to begin and end with the world's central banks. Understandably, people have come to doubt paper currencies.

Before the Monday break, share-price volatility, as measured by the VIX index, stood at a post-2007 low,

while New York Stock Exchange margin debt registered post-crisis highs. Of course, modern financial leverage takes many forms. One would expect zero-percent funding costs to facilitate ramp-ups in derivatives activity. And, indeed, ventures Rod McKnew, editor of "Beyond the Numbers," a professional bulletin on monetary matters, the invisible funds rate has done just that. The \$1.4 trillion in excess reserves now apparently lying fallow at the Federal Reserve banks, he and we venture, are not quite inert. They finance something, even if we're not quite sure what.

To the Dean Witter Distinguished Professor of Finance at the Graduate School of Business at Stanford University, Darrell Duffie, we posed this question: Can excess reserves serve as collateral for futures and derivatives transactions? "Yes," he replied. "Acceptable collateral is a matter of private contract, but reserve deposits [are] virtually always acceptable." It would be interesting to know the views of the Federal Reserve on this matter, but neither the Federal Reserve Bank of New York nor the Federal Reserve Board in Washington returned our calls. In any case, the piling up of these immense redundant balances is stimulatory in ways both seen and unseen.

Hoisington hates QE2, McKnew hates QE2 and we hate QE2. We will go further. The founders of the American central bank would hate it,

too. The 1913 Federal Reserve Act was intended to prevent a recurrence of the Panic of 1907 by dispersing and decentralizing banking assets. At fateful, all-too-frequent intervals, the sponsors of the legislation believed, America's deposits wound up making mischief in the New York broker-loan market rather than financing enterprise and agriculture in the hinterland.

Rep. Carter Glass, Democrat of Virginia—the "father of the Fed," as history styles him—gave a talk in New York in October 1913 entitled, "The opposition to the Federal Reserve Bank Bill." In it, the chairman of the House Banking and Currency Committee tore the hide off the city bankers who would selfishly thwart progress. Glass was a gold-standard man with a populist's abhorrence of concentrated financial power.

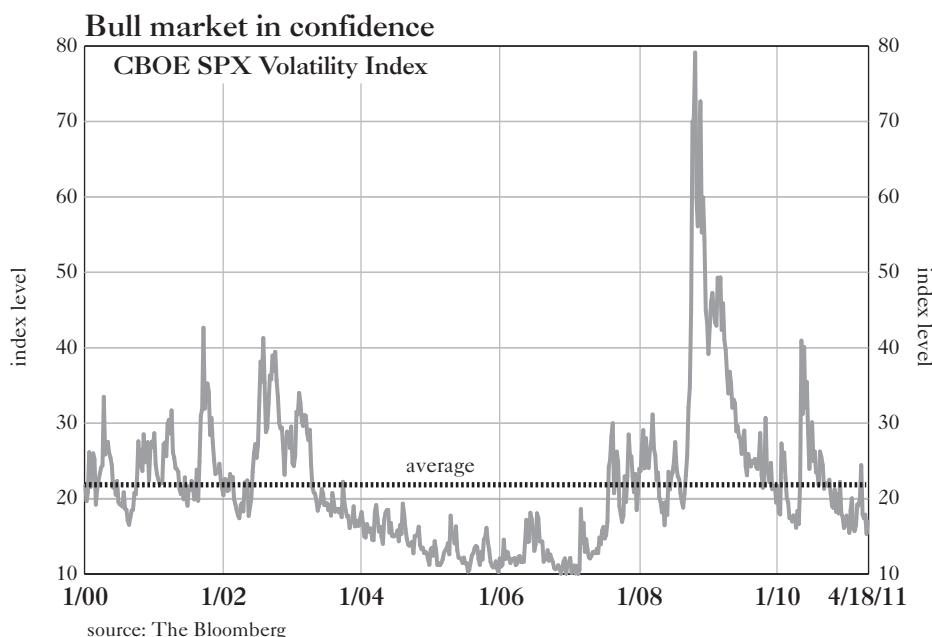
"Under existing law," Glass declared, "we have permitted the banks to pyramid credit upon credit, and to call these credits reserves. It is a misnomer. They are not reserves, and when financial troubles come and country banks call for their money with which to pay their creditors, they find it invested in stock-gambling operations. There is suspension of payment and the whole system breaks down under the strain, causing widespread confusion and almost inconceivable damage. The avowed purpose of this bill," Glass continued, "is to cure this evil, to withdraw the reserve funds of the

country from the congested money centers and to make them readily available for business uses in the various sections of the country to which they belong."

This redistribution of deposits, Glass assured the audience, would occur only gradually. But the obstructionists wouldn't accept those assurances. "They do not want existing arrangements disturbed; they are willing to perpetuate a defective, unscientific system sanctioned by law but condemned by experience and bitterly offensive to the American people," Glass continued—"a system which everybody knows encourages and promotes the worst description of stock gambling."

Glass seemed not to know the word "investing"; for him, "gambling" was the all-purpose investment gerund. A worshipful admirer of Woodrow Wilson, the Virginian shared his president's conviction that the nation's banking resources were under the control of just a dozen willful men. Congress must break up this "money trust," as the Dimons, Blankfeins and Moynihans of 1912 were collectively stigmatized. Still, you could depend on Glass to stand up for old-time religion in the matter of the currency itself. It pleased the lawmaker just how many layers of protection insulated the new Federal Reserve notes. Gold, for one thing; self-liquidating commercial loans, for another; and the double liability of the stockholders of the national banks (and of the regional Federal Reserve banks, too), for a third. If, in those days, a nationally chartered bank became insolvent, the stockholders got a capital call. They deserved it, the lawmakers and judges of the time reasoned. After all, it was their bank that failed, not the government's.

Maybe the father of the Fed would deny paternity if he were returned to life to confront the consequences of his legislative achievement. Instead of Wilson's dozen willful men, the 2010 best-seller about financial concentration named a baker's dozen ("13 Bankers" was its title). Not much net progress seems to have been made toward the democratization of finance over a full century. In 1911, the 20 largest New York City banks controlled 43% of New York banking resources—but New York



City controlled just 22% of the nation's. In a widely quoted speech a couple of months ago, Thomas Hoenig, president of the Federal Reserve Bank of Kansas City, pointed out that, in 1999, the five largest American banking organizations controlled \$2.3 trillion in assets, or 38% of the grand total. Now the top five—Bank of America, JP Morgan Chase, Citigroup, Wells Fargo and Goldman Sachs—control \$8.5 trillion, or 52% of the sum. Woodrow Wilson never saw a money trust like the one brought about through the succession of crises

ending in ever more radical federal interventions. As for the double-liability feature of the national banking system, it was erased in 1935.

No monetary system protects against booms and busts. We humans can't seem to help ourselves. However, unchecked money printing in conjunction with the socialization of risk has brought this country to a more precarious position than Carter Glass ever dreamed of. And now, perversely enough, still greater feats of money printing likely await us. Good luck to the Fed—better luck to the rest of us!



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