

SALIDA SPECIAL REPORT

HAS THE FED THROWN IN THE TOWEL ON QE?

AUTHORED BY THE SALIDA CAPITAL INVESTMENT TEAM

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"Gentlemen, we have run out of money. Now we must think."

— Winston Churchill

THE FED'S NON-ANNOUNCEMENT

The Federal Reserve's much anticipated two-day September meeting has now come and gone, with the market being rather less than impressed with the resulting announcement. Over September 20–23, the S&P500 fell 6%, crude oil fell 8%, and copper fell 12%. Even gold bullion plummeted by more than 9%. The U.S. dollar and long-dated treasuries were pretty much the lone gainers.

While an "Operation Twist" program was widely anticipated, what surprised us was the Fed's explicit acknowledgement of a heightened level of risk to the U.S. economy ("significant downside risks to the economic outlook"), but with no announcement of additional money-printing QE. It's fairly safe to say that today's economic prognosis is much more dire than in late 2010 when QE2 came into being. Does the absence of QE3 imply that the Fed is now simply out of "ammunition"?

Of course the Fed touted its Operation Twist program as being an appropriately stimulative measure to boost an ailing economy. In our view, however, the major impact of unconventional monetary policy comes not from the choice of assets being bought, but rather that additional money is printed to do the buying. The new program misses that point, as it does not involve printing any new money. The Fed simply intends to sell shorter term bonds from its inventory (previously purchased under QE2) and use the proceeds to buy longer term bonds. The hope is that this will push longer term yields lower than they would otherwise be. By lowering longer term bond yields, the Fed hopes to achieve two outcomes.

First, by making long term bonds less attractive (i.e. more expensive) to investors, the Fed hopes to encourage risk taking. So while QE1 and QE2 resulted in additional money lifting all boats, this program aims to lift certain boats at the expense of others. So far the market has not really cooperated.

Secondly, by attempting to push down longer term yields, the Fed hopes to reduce borrowing costs for individuals and businesses. However, any potential rate reduction gains accruing to borrowers would have to come at the expense of the banking industry. But with a flatter yield curve and loan default risk rising (on account of recessionary conditions), we think it far more likely that banks resist lowering lending rates materially and instead allow the spread to long-dated treasuries to rise.

So all in all, we expect very little economic impact from Operation Twist and believe it will be quickly forgotten by the market.

Is Bernanke's refusal to announce another round of money printing QE a sign that he's going to allow the economy to restructure with less central bank interference? We suspect not. The short-term result would likely be a very weak economy as we head into an election year. If nothing else, we would expect intense behind-the-scenes pressure from the Obama Administration on the Fed to do something to "help the American people". Such discussions are probably already occurring. One thing we do know — politicians are in the business of trying to get re-elected.

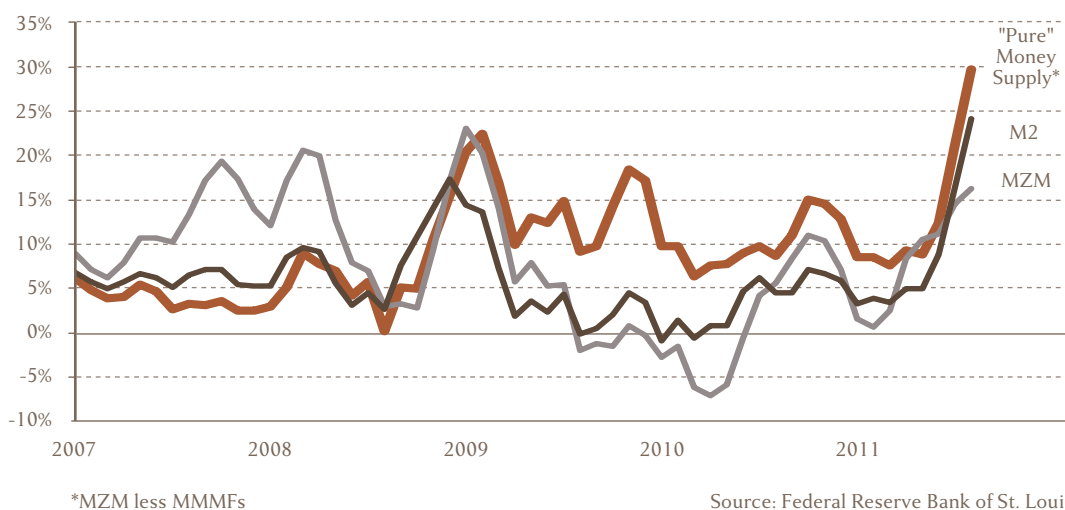
It would also mean that the so-called expert on the Great Depression has thrown in the towel and admitted defeat. Not likely.

Our take? Expect Bernanke to announce a full-blown no-holds-barred money-printing QE₃ by year-end.

U.S. MONEY SUPPLY STILL GROWING ANYWAY?

Despite the absence of an official Fed QE program, U.S. money supply has in fact still grown strongly through the summer months — very strongly indeed. To our surprise, money growth in July and August was higher than at any time during QE₂.

U.S. Money Supply Growth (3-month change annualized)



Perhaps the Fed is now focusing its money printing efforts not on quantitative easing at home, but rather on helping to finance Europe? We can only speculate. But in such case the money growth still occurs — just more clandestinely and without the QE headlines. And that new money still has to go somewhere, and it tends to ultimately find its way into risk asset markets.

On the back of this surge in money supply, we made two mid-August investment calls:

1. We continued boosting our exposure to gold, believing it to be a relative safe haven, and that it would continue to attract inflows as QE3 speculation grew in the face of a renewed U.S. recession. While bullion performed well in 2011 through August, it was hit hard in September, falling a dramatic US\$200/oz in only a 3-day span. Margin hikes by the CME and the Shanghai Gold Exchange, disappointment from the Fed, and rumours of redemption/margin call-driven fund liquidations and European central bank selling took their toll. These factors tend to be temporary in nature. In fact, with much of the developed world now in or close to recession, European sovereign debt concerns intensifying, and Chinese growth appearing to slow, the fundamental backdrop for gold has rarely been more compelling. A bet on bullion is a bet that central banks are about to ramp up money printing — a logical bet in our view. In fact, we feel safer in gold than anywhere else in today's market.
2. We felt that a money growth-fuelled market rally would provide a good bounce to beaten-up energy stocks given the relative resilience of the oil price. Not only did the bounce not occur, but the sector has continued to sell off. Sell off is an understatement — it's been decimated, with the WCAT ETF (a basket of mid-cap energy stocks) falling almost 40% over August and September alone. Our impression is that the sell-off is at least partially driven by forced fund liquidations (i.e. selling to meet margin calls or redemptions). While these factors tend to be temporary in nature and unsupported by fundamentals, we admittedly have less confidence in the short term outlook for the price of oil than we do in gold. It's not \$80 WTI (or \$100 Brent) that has investors spooked — it's the potential for oil to head lower in the near term. And with recessionary conditions spreading, we can't totally dismiss such a scenario. Accordingly, we've now raised our level of hedging in both the energy sector and the broad market.

These two calls have been costly, as the market has moved against us. We still believe that the reasoning was logical, but arguably ill-timed. In hindsight, we underestimated the short term impact of forced selling.

So what happened to the market rally? Where did all the new money go? It would appear that it ran fleeing into long-dated U.S. treasuries at all-time low yields. In fact, from July to September, U.S. 10-year yields dropped from 3.2% to as low as 1.7% and 30-year yields from 4.4% to 2.8%. Stunning moves to say the least.

U.S. Money Supply Growth Rate*	S&P 500 Performance	
	Next 3 months	Next 6 months
< 6%	-1%	-1%
6% – 10%	2%	2%
10%+	6%	12%

July 2011: +21%

August 2011: +30%

-10% (over next 2 months)

-5% (over next 1 month)

* MZM less MMMFs, 3-mth change annualized; data covers period 2003–2011

Source: Federal Reserve Bank of St. Louis, Bloomberg

INVESTMENT CONCLUSION

While we're not fans of money-printing programs (they simply cause an arbitrary wealth transfer and create harmful distortions in the economy), they do tend to have the predictable inflationary consequence of lifting asset prices. And the ability of today's struggling equity and commodity markets to stage a lasting rally at this point is probably dependent on another round of Federal Reserve money-printing QE. Even some kind of resolution to the European debt situation would probably only bring a short-lived bounce. Attention would quickly return to the U.S. economy — which we believe has already entered recession.

With an election year looming, a sputtering economy, and a Fed Chairman who has in the past touted the ability of unconventional monetary policy to cure such economic woes, we believe the announcement will come. If Bernanke needed commodity prices to fall in order to reignite deflation fears — that has now happened. If a falling currency was of concern — the U.S. dollar has now rallied.

True money-printing QE₃ will come — timing is the question.



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