

Heath Hightower

From: Mike Minter [mminter@finsyn.com]
Sent: Wednesday, June 15, 2011 2:26 PM
To: Heath Hightower
Subject: Financial Synergies Article - The End of Quantitative Easing?

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June 15, 2011

Dear Heath,

What exactly is quantitative easing (QE)? It's when a central bank (the Fed) shifts the focus to expanding its balance sheet through the purchase of longer-term securities rather than targeting short-term interest rates. With rates near zero already, quantitative easing may be the only tool the Fed has left. So they inject the banking system with cash, increasing the quantity of reserves held by commercial banks - this in turn creates liquidity. Logistically it goes like this: The Fed purchases treasury bonds (or sometimes mortgages or other agency debt) from the commercial banks and credits their accounts with reserves. The bottom line is the resulting increase in reserves provides banks with an opportunity to lend more. QE hopefully fosters an environment of economic growth by increasing inflation expectations, reducing real rates, and creating asset (i.e. stocks, commodities) inflation. The depth at which the Fed has utilized this tool is unprecedented, so the long-term consequences of these actions are unknown.

It all sounds good in theory, but QE hasn't worked exactly as planned. There's no doubt that QE has been good for the stock and commodities markets, but it hasn't gotten the banks lending again. Recent reports from the Federal Deposit Insurance Corp. (FDIC) show that bank lending declined again in the first quarter of this year. In fact, total bank lending has declined nearly 9 percent since March 2008, according to analysis by the Investigative Reporting Workshop at American University. Many of these banks were still trying to recover from losses from the housing collapse (which left them with toxic assets), and simply weren't healthy enough to start lending again until they got their balance sheets in order. And the bank regulators were telling them to "build their capital cushion." So most of this injected cash has bolstered cash reserves and found its way into other investments such as the stock and commodities markets, but hasn't spurred any lending. Banks do want to lend, but they are as unsure about where we are headed as you and me. You cannot have job growth, wage inflation or business expansion if the banks aren't lending and consumers aren't spending.

Consumers are in the same boat. Most Americans' biggest asset is their home - and the value of that asset has been dramatically reduced, so they don't feel confident increasing their spending. For most people, much of their perceived buying power comes from the value of their home (although this is probably not wise).

Make no mistake, most American companies and financial institutions are in good shape - they now have solid balance sheets and an abundance of cash. They're just gun shy about putting it to work because of so much uncertainty surrounding the economy, future taxes and financial regulations.

The second round of quantitative easing (QE2) is set to end on June 30, 2011, but the latest economic numbers don't look great. The official unemployment rate is still 9.1% and GDP grew at an annual rate of just 1.8% in the first quarter. Most economists are revising their 2011 GDP growth forecasts to between 2.5% and 3.0%(1). Last week, Ben Bernanke (Fed Chief) gave a speech to a group of bankers in Atlanta and made the following statement - "the economy is still producing at levels well below its potential; consequently, accommodative monetary policies are still needed." He went on to say, "overall, the economic recovery appears to be continuing at a moderate pace, albeit at a rate that is both uneven across sectors and frustratingly slow from the perspective of millions of unemployed and underemployed workers." Not exactly inspiring, but the numbers don't lie.

Bernanke is not worried about inflation in the near-term. With no real significant increase in core inflation (core inflation excludes energy and food prices) the Fed won't feel pressured to raise rates. I know, I know, - to the average American this core inflation number is a joke. Minus food and energy? Are you kidding! *As far as I know, I still have to drive my car and put food on the table.* But this is how your government sets inflation targets. My point here is that even though Bernanke has indicated there will not be a QE3 - never say never. Admittedly it is unlikely, but this administration has proven that it will do whatever it takes to keep this recovery from halting. We are in a slow recovery, but why would we expect otherwise? This wasn't your typical recession. We are coming off of the worst economic downturn since the Great Depression. It's likely that government intervention kept this country from a complete and total financial collapse, but at some point we have to stand on our own two feet again.

As all seasoned investors know, long-term perspective is the key to success. Trying to time the market or predict its future fluctuations has proven to be a fool's errand. We've already seen a pullback over the last month (probably in anticipation of the end of QE2 and some disappointing economic numbers). But the long-term ramifications of more artificial capital may be worse than a temporary decline.

Sincerely,

Mike Minter, CFP[®], CFS
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Important Disclosures

(1) The Wall Street Journal

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