

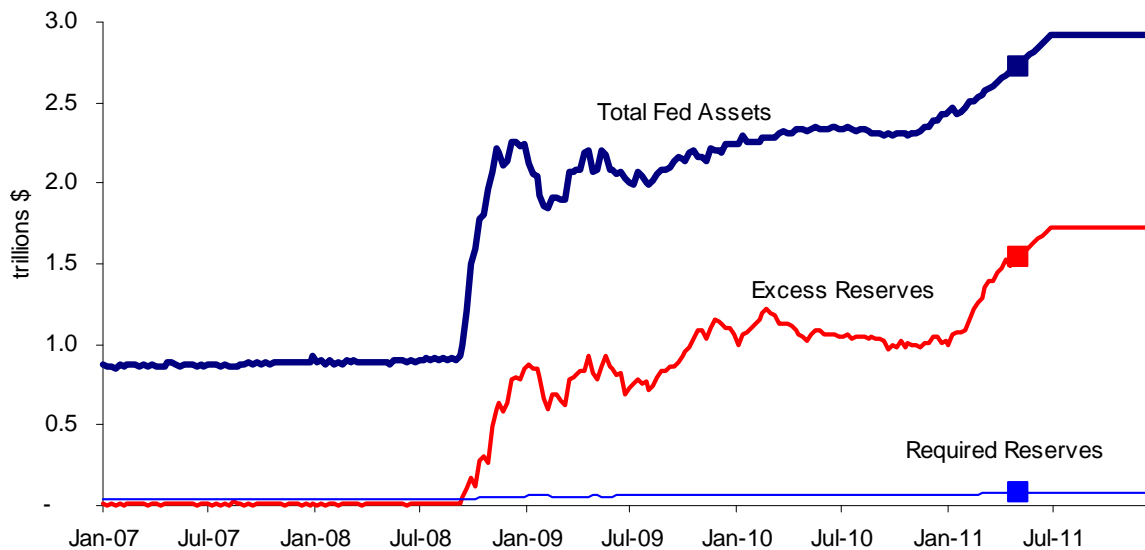
May 10, 2011

# Fed Not Printing; Global Market Implications

We think QE2's impact on the economy, markets and inflation has been exaggerated. This creates several important market opportunities in coming months as QE2 ends and the debt limit gets resolved.

- QE2 has been treated as a powerful monetary stimulus akin to money printing. Proponents of this view cite Fed Chairman Bernanke's 2002 observation that central banks can stop deflation by printing money, dubbed Helicopter Ben. Financial market moves over the last six months enhanced this interpretation of QE2 through record dollar weakness, inflation in developing countries, equity market gains, a commodity bubble and equity underperformance in many developing countries.
- QE2 isn't money printing and isn't very powerful in its current form. To achieve its balance sheet expansion, the Fed pays an above-market interest rate to commercial banks for extra deposits at the Fed and discourages private sector credit through strong regulatory scrutiny of bank balance sheets. The result has been a rise in excess commercial bank reserves equivalent to the Fed's balance sheet expansion.

## Fed Assets and Excess Reserve (last obs. May 4, 2011, estimated to Dec 31, 2011)



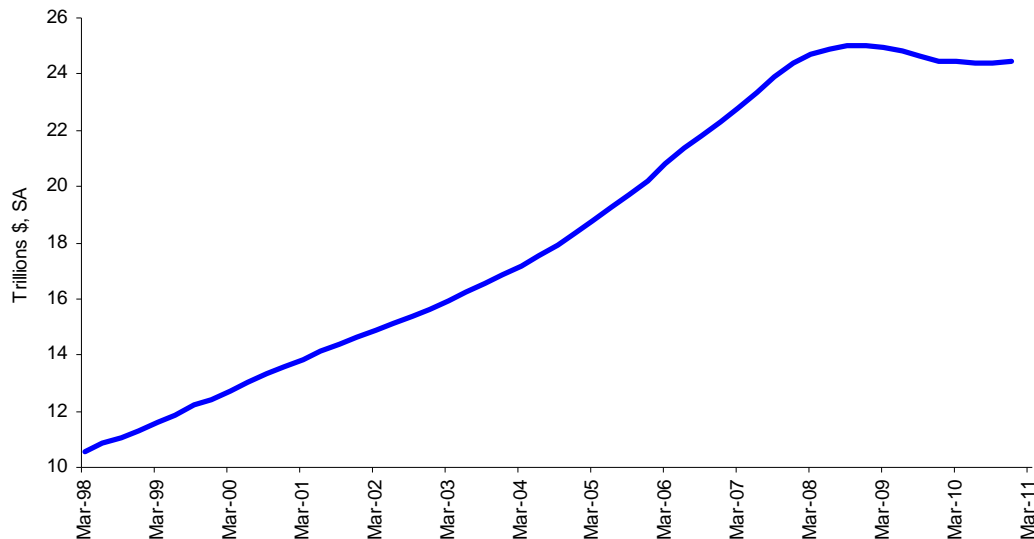
Source: Federal Reserve; Encima Global

- The commodity spike and the squeeze on Treasury bonds got overdone in part due to the view that the Fed's QE2 was a new form of printing money that would create a near-term crisis. QE2 has caused substantial distortion in credit markets and artificially depressed the dollar, but we don't think this creates the near-term crisis that's assumed in high gold and commodity prices and low Treasury bond yields.
- **The market implications are: 1) the completion of QE2 shouldn't be contractionary; we think equities will go up, a sigh of relief, not down as some have argued; 2) similarly, bond yields should rise as worries about post-QE deflation subside; the threat that the debt limit might stop Treasury issuance during the Fed's final QE2 purchases has squeezed yields down, but we think the 10-year Treasury yield may reach 4% toward year-end on evidence of 3% U.S. growth and over 3% CPI inflation; 3) global non-commodity-linked emerging markets (like India and China) should do well after underperforming during the QE2 fascination.**

### QE2 Isn't Money Printing

Since banks aren't lending against their deposits at the Fed, there's been little transmission from QE2 to private sector credit growth or to the economy. This explains the anomaly of a Fed balance sheet expansion but relatively weak nominal economic growth. Usually, a bigger Fed balance sheet means more money in the private sector economy and added growth and inflation. Not this time.

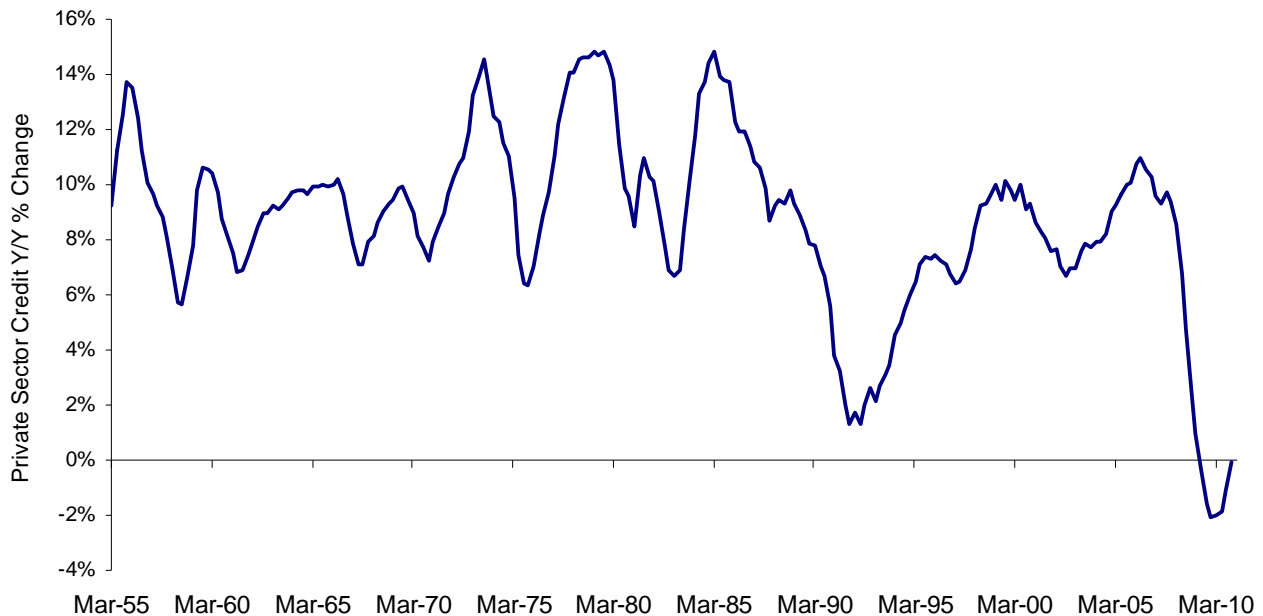
### Private Sector Credit (\$ trillions, last obs. Q4 2010)



Source: Federal Reserve; Encima Global

- The lack of private sector credit growth fundamentally distinguishes the current monetary policy from previous inflationary monetary policies in which the Fed and bank regulators accommodated dollar weakness and higher prices with credit growth. Private sector credit has been contracting (in part due to mortgages) both in nominal dollar terms...

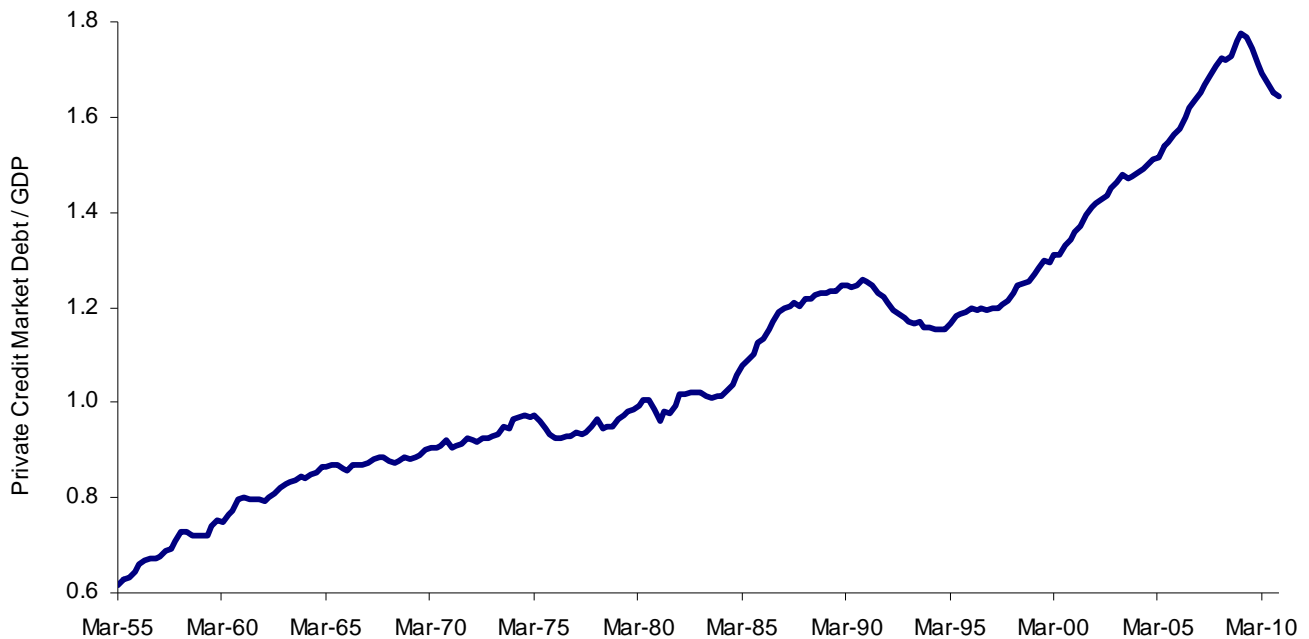
### Private Sector Credit Y/Y (last obs. Q4 2010)



Source: Federal Reserve; Encima Global

- ...and relative to GDP. This phenomenon of shrinking private sector credit is more like the 1990s (strong dollar, falling commodities) than the 2000s (weak dollar, rising commodities.) One characterization of inflation is too much money chasing too few goods. We don't think that's happening now in part because QE2 is not adding to private sector credit.

## Private Sector Credit / GDP (last obs. Q4 2010)



Source: Federal Reserve; Bureau of Economic Analysis; Encima Global

- Rather than crediting QE2 itself, we attribute most of the market activity since the 2010 QE2 process to 1) confusion about QE2, which would be powerful if excess reserves were lent; 2) trend-following behavior when liquidity is plentiful; and 3) the existence of plentiful liquidity from factors other than QE2 – strong corporate cash flow in part due to underinvestment; and foreign central banks keeping interest rates too low in order to avoid currency appreciation, but generally not rationing credit as tightly as the U.S.
- We think most of the rise in U.S. equities since the 2010 QE2 process can be attributed to strengthening U.S. economic growth after the 2010 soft patch, strong corporate profits, the December deal on tax cuts in which each party got its wish list and small business hiring.

This is not an argument for QE2. We've been critical of QE2 on the grounds that it expands the Fed's mandate to include economic growth (the rationale for QE2), inserts the Fed into equity market performance and creates an overhang of Fed bond holdings that could distort monetary policy for years.

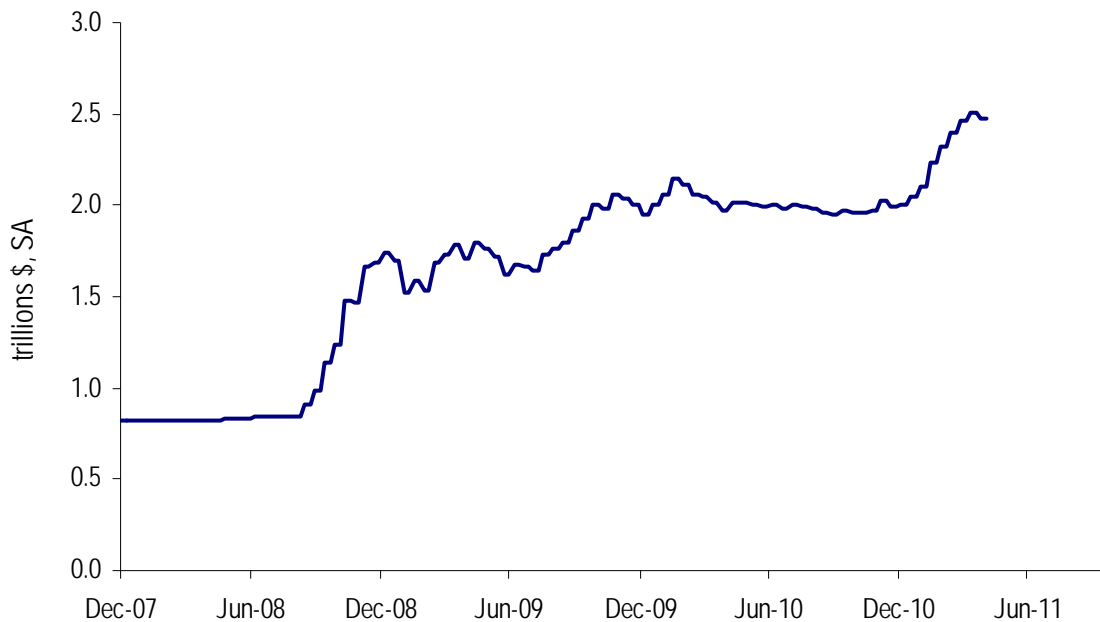
- We expect inflation to rise further due to dollar weakness, high commodity prices and regulatory costs, but we think financial markets have gone a step too far, pricing in the idea that the Fed is printing money and that QE2 is providing powerful monetary stimulus that will be missed when removed.

- This misinterpretation of QE2 is hard to quantify. Part of dollar weakness and the rise in gold and other commodities is due to the near-zero Fed funds rate and the Fed's history of devaluing the dollar. We also credit confusion about QE2, ETFs, momentum-trading and, to an extent, valid concern about future Fed policy (like QE3 or another year of near-zero Fed funds rate.) We note the difficulty in pricing commodities during periods of excess of liquidity and social unrest. Because commodities don't have earnings, an ROI, a PE multiple or a relative asset value, their value is heavily influenced by momentum, speculation and the value of the dollar (which is mostly speculation about monetary policy and the Fed's willingness to accommodate dollar weakness and inflation.) The rise of ETFs has further widened the range of prices that might be correct for a given commodity –fashionable commodities are worth more because investors pay more. The price of gold fell by over 50% from September 1980 through March 1982 as monetary policy changed and the value of the dollar doubled.

Given the shift in the banking system from price-based credit allocation to rationing-based credit allocation, we don't think money supply has much connection to the economic and inflation outlook.

- Monetary base (the M0 money supply) includes the Fed's excess reserves and has been rising rapidly in line with the Fed's balance sheet. It's not inflationary because it's not being transmitted into the private sector.

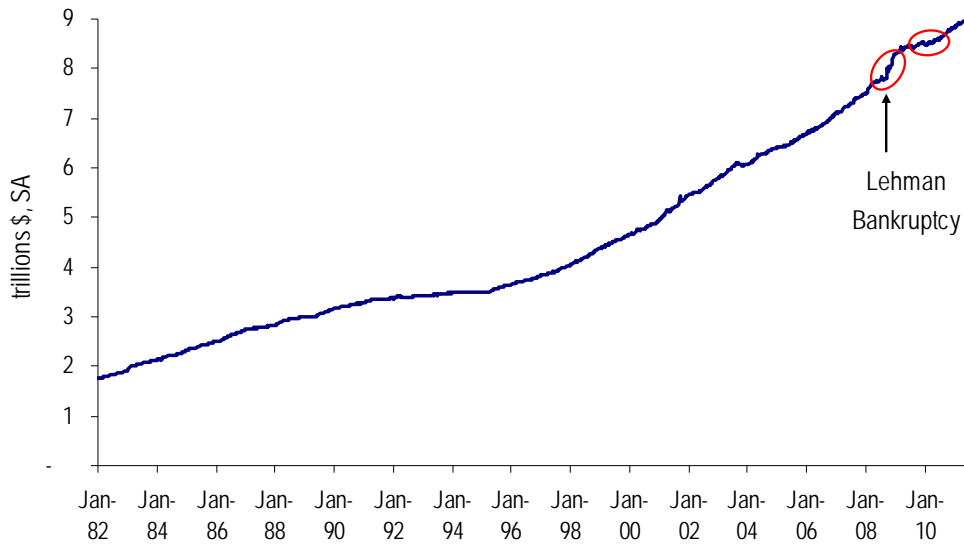
### M0 (last obs. April 25, 2011)



Source: Federal Reserve; Encima Global

- M2 money supply surged after the Lehman bankruptcy as the Fed allowed money creation, but reverted to a normal trend.

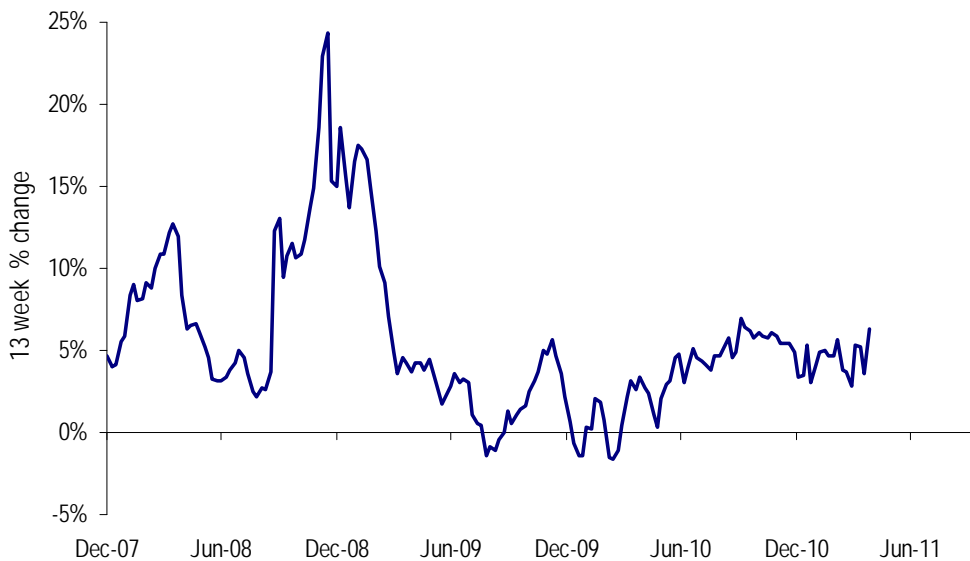
### M2 (last obs. April 25, 2011)



Source: Federal Reserve; Encima Global

- M2 money supply growth is running at roughly a 6% annual rate, versus 3.7% nominal GDP growth rate for the first quarter.

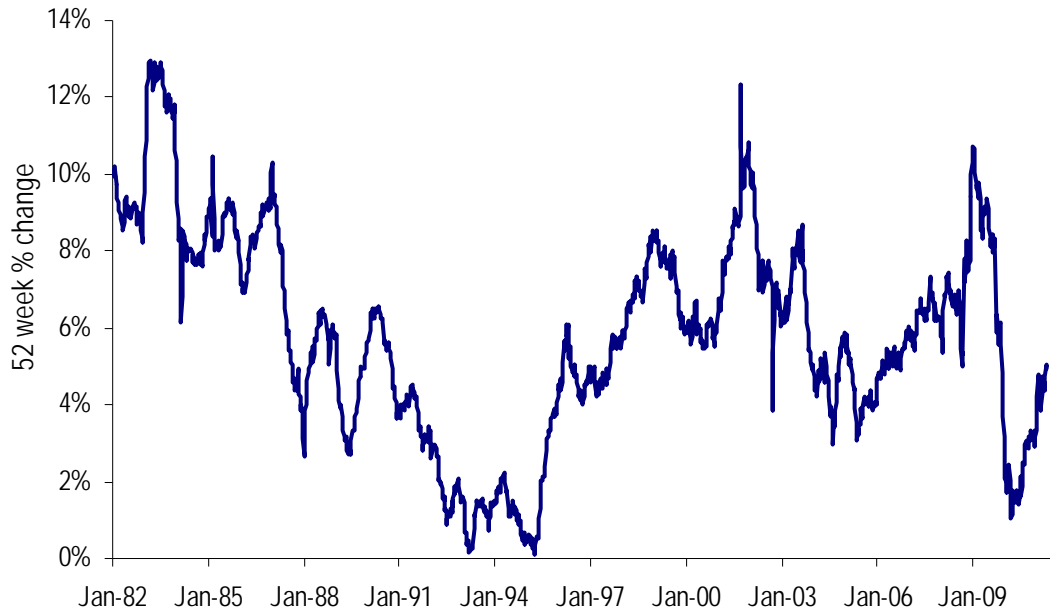
### M2 13 week % change annualized (last obs. April 25, 2011)



Source: Federal Reserve; Encima Global

- On a year-over-year basis, M2 money supply growth is running at 5%, versus 3.9% nominal GDP growth yoy.

**M2 Y/Y (last obs. April 25, 2011)**



Source: Federal Reserve; Encima Global

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