

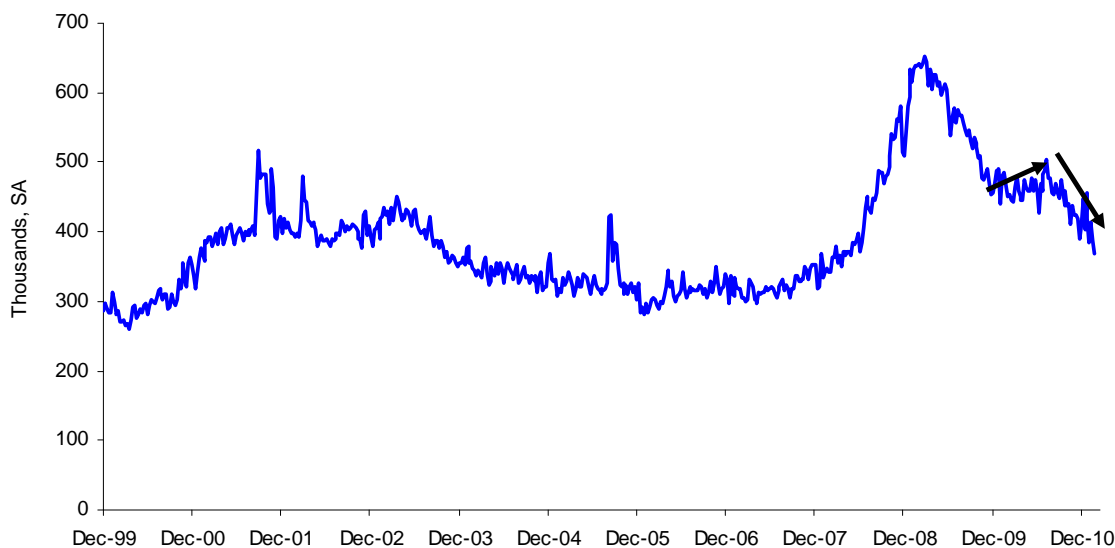
# QE2 Not Justified: What If Bernanke Stops Buying?

The U.S. expansion has built strength since the second quarter 2010 soft patch. There was more evidence of that in this morning's February employment data. Though the Fed is not yet winding down its bond purchases, we think it should. It's worth reviewing the implications of a less dovish Fed, most of which are positive for the growth outlook.

## U.S. Expansion Strengthening; QE2 Not Justified

- Initial jobless claims have been a good indicator of the economy's acceleration, worsening in the first half of 2010 and then beginning a steady decline on August 13, 2010. In the week ending Feb 26, initial claims fell to 368,000, pushing them below the post-2000 average.

## Initial Unemployment Claims (last obs. February 26, 2011)



Source: Department of Labor; Encima Global

- Commodity prices hit new post-crisis highs again yesterday. They were already rising when Chairman Bernanke floated the idea of QE2 at Jackson Hole in August 2010. ISM price indexes are showing sharp increases in prices paid by purchasing

managers. We note the deeply lagging nature of CPI, core CPI and the core PCE deflator and the Fed's pattern of delayed responses to inflation problems.

### CRB Futures Index (last obs. March 2, 2011)



Source: Commodities Research Bureau; Encima Global

- Equity markets have closely tracked jobless claims, falling when claims rose and rising when claims fell (though the Fed can argue that QE2 caused the equity gains.) Jobless claims are one of the best economic indicators because they are based on state filings, not a survey, are not subject to major revisions, and reflect small businesses as well as large. They began improving in mid-August 2010, with the equity upturn starting at the end of August.

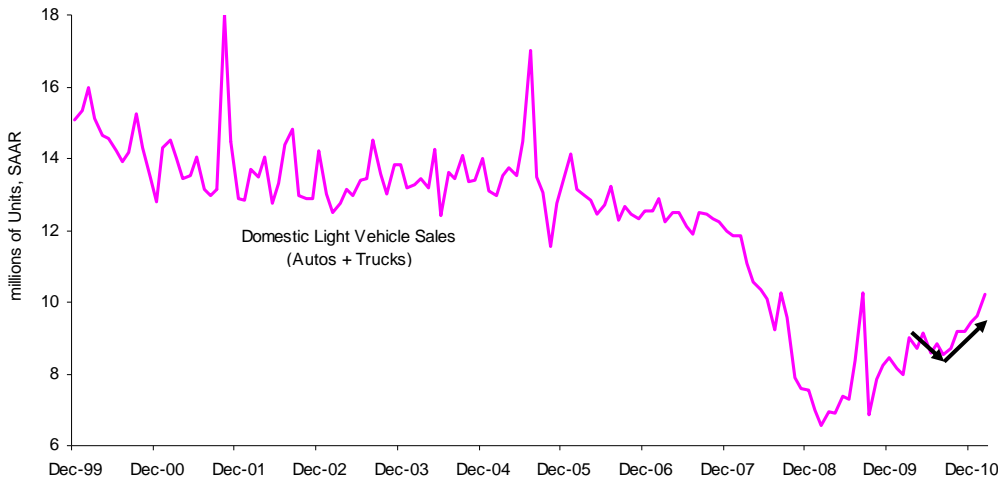
### S&P 500 (last obs. March 2, 2011)



Source: Wall Street Journal; Encima Global

- Auto sales fell from March 2010 through August and then began a strong uptrend, tracking jobless claims (the Fed can argue that it tracked equities which were responding to QE2). **Growth in auto sales is now running 37% annualized** (December-February unit sales versus September-November sales seasonally-adjusted annual rate.)

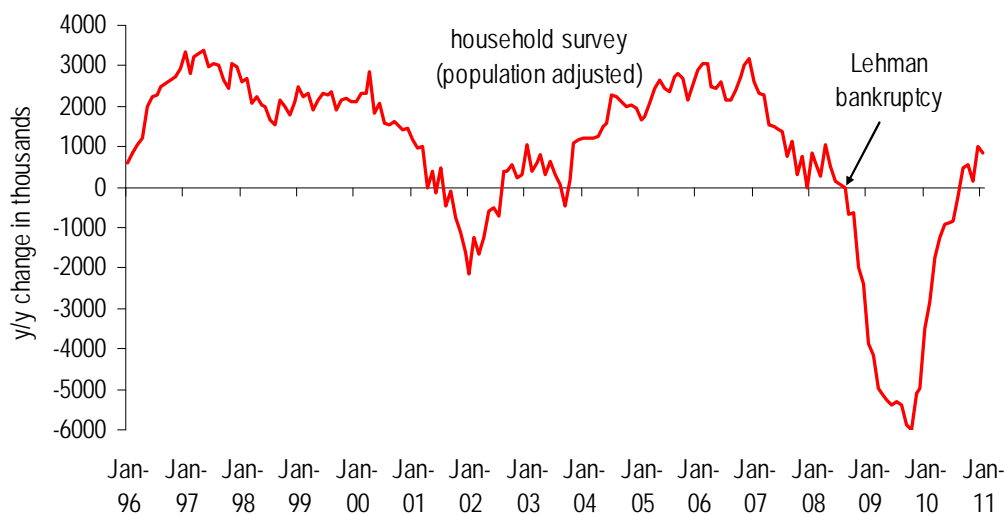
### Auto Sales (last obs. February 2011)



Source: Bureau of Economic Analysis; Encima Global

- In February, the household employment survey, the more sensitive survey in picking up inflection points because it includes new businesses and small businesses, showed another strong 250,000 gain on top of January's 589,000 gain (population adjusted, see our February 4 and February 7 pieces on the strength in the population-adjusted survey.)

### Annual Growth in Household Employment (last obs. January 2011)



Source: Bureau of Labor Statistics; Encima Global

## Time to Get Monetary Policy Back on Track

Our view is that current monetary policy is extreme and would only make sense if we were in an all-out panic that endangered the financial system. The Fed should not now be forcing a near-zero Fed funds rate -- it blocks interbank markets, hurts savers, isn't necessary, pushes capital abroad, gooses commodities, and harms the free-market capital allocation process that is critical to high-quality, long-term growth.

- We don't think Fed Chairman Bernanke should have floated QE2 in his August 2010 Jackson Hole deflation speech. The economic acceleration was already underway. The speech provided two long months of pre-buying of Treasury bonds by Wall Street costing taxpayers billions when the Fed started buying at inflated prices in November. Chairman Greenspan gave a Jackson Hole deflation speech in August 2002 which set the stage for years of bad Fed policy (1% rates into 2004 followed by limited hikes and weak financial regulation as capital fled the weakening dollar and over-leverage became routine.)
- With the economy, commodities and equities strengthening, the Fed should not have embarked on Treasury purchases in November, especially not based on the rationale in the Chairman's November 4 Washington Post oped that "lower mortgage rates will make housing more affordable and allow more homeowners to refinance. Lower corporate bond rates will encourage investment." (Neither goal was achieved. AAA corporate yields have risen by 40 basis points, 30-year conventional mortgages by 60 basis points).
- **Fed asset purchases are setting a major, harmful precedent for future Fed policy – years from now, slow economic growth could justify trillion dollar Fed asset purchases designed to increase stock prices so equity owners will consume more.** Even when the Fed finally unloads its bonds, the precedent will create uncertainty and distort financial markets for decades, slowing private sector growth.

## What If Bernanke Stops Buying Bonds?

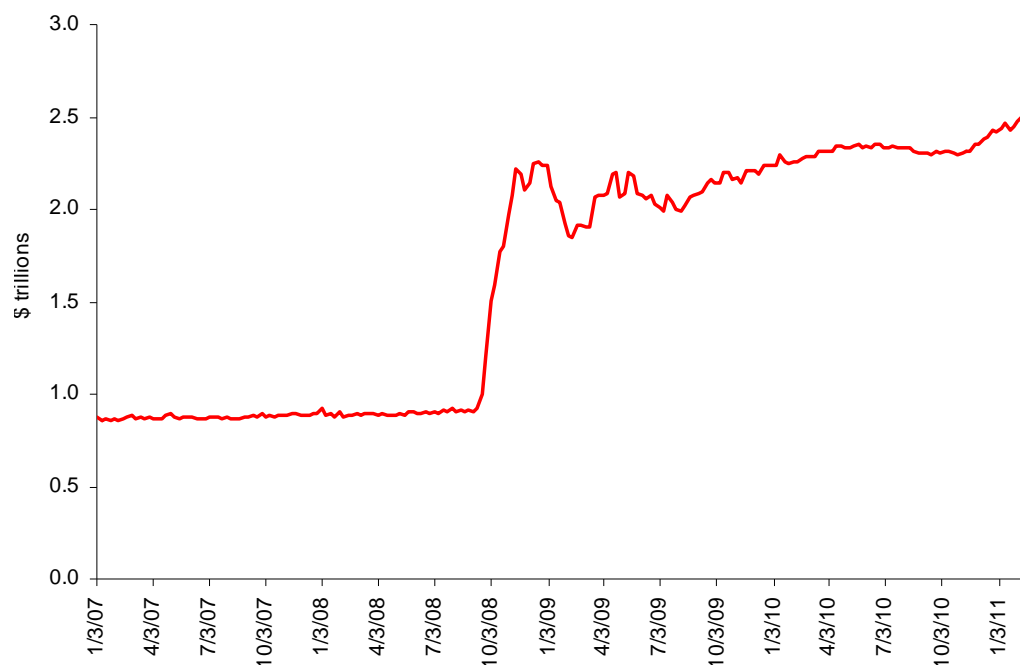
If the Fed stops bond purchases short of the \$600 billion announcement, we think **the economic and market impacts will be positive, not negative. It should be easy for the Fed to communicate the wind-down.**

- The Fed can gracefully exit QE2 by claiming credit for the economic acceleration. "Mission accomplished."
- The Fed could use about the same communications concept as in June 2004 when it surprised financial markets by hiking interest rates by 0.25% to 1.25%. In the June 2004 statement, the FOMC said: "The Committee believes that, even after this action, the stance of monetary policy remains accommodative and, coupled with robust underlying growth in productivity, is providing ongoing support to economic activity."

The evidence accumulated over the intermeeting period indicates that output is continuing to expand at a solid pace and labor market conditions have improved. Although incoming inflation data are somewhat elevated, a portion of the increase in recent months appears to have been due to transitory factors.”

- World bond markets are deep. There should be no particular difficulty when the Fed stops buying bonds. We disagree with the view that bond yields would rise. The yield on Treasuries is set by inflation, growth, currency expectations, confidence in the central bank and returns on other assets, not by the existence of a committed buyer. Treasury yields are tightly arbitrated to agency yields, corporate bond yields, bund yields and the universe of financial assets. Fed purchases have been sizeable relative to the flow of Treasury bonds, but aren't sizeable relative to the universe of competing instruments.
- Like the overhang of federal debt, the legacy cost of \$2.5 trillion in Fed assets is harmful but probably not so great as to stop the expansion. In effect, the Fed is now a combination of a monetary policy organization and a highly leveraged repository of bonds (like a SIV). As Bernanke explained to Congressman Paul Ryan at a recent hearing, the Fed will make profit on these positions unless the Fed funds rate goes up a lot; and if it goes up a lot, it will probably be due to fast growth, which, for overall government accounts, would more than offset losses on the Fed's bond speculation.

### Federal Reserve Total Assets (\$ trillions, last obs. February 23, 2011)



Source: Federal Reserve; Encima Global

- The increasing Fed ownership of bonds has added to the risk that the Fed will resist rate hikes due to the conflict of interest with its own portfolio. This has contributed to the increase in gold and commodity prices and long-term bond yields since the Fed started buying bonds. **We think there will be a global sigh of relief when the Fed stops its extreme measures.** Commodities would probably soften some (we can hope), but most countries around the world, including the U.S., are worried about inflation and would consider a QE2 wind-down as a distinct positive.
- **We think Treasury bond yields would stabilize if Bernanke floated a QE2 wind-down. Gold prices would probably decline. The dollar would strengthen some against the euro (though rate hikes are the more important variable.) Credit spreads would stop their narrowing. Equities might take a short-term pause, but we think they would quickly focus on the improvement in growth prospects that led the Fed to stop its purchases.**

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