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# Giant Free Lunch Risks Stagflation

Equities, gold and bonds all gained today on the view that Japan's small quantitative easing (possible $65 billion in asset purchases) is a precursor to a bigger Fed QE at its November 3 announcement. We don't think bond purchases by either central bank will have much positive impact on the economic outlook, so we're skeptical of each market – equities, bonds and gold.

- Markets are hoping that money will be in unlimited supply for a long time. Other central banks – China, Korea, Brazil – are already redlining their monetary engines in an effort to keep up with the U.S. The proverbial free lunch has pushed Japan's 10-year bond yield to 0.92% and its 20-year bond to 1.7%, while the U.S. 10-year Treasury remains below 2.5%. We think these yields will turn out to be a poor investment and are explained more by market momentum, prospective Fed purchases and unwise Treasury limitations on longer-term bond issuance than by expected returns over the decade.

- We think the Fed may expand its QE profile a bit on November 3 by getting authority from its board to buy some additional Treasuries if needed. The Fed may want to hold back on QE until three key issues are clearer – the aftermath of the November 2 election, the October jobs data (due November 5) and possible Congressional action to stop the year-end tax rate increase (situation might clarify in mid-November.)

We think free money in the face of a weakening dollar and rising gold is a bad idea.

- QE under current circumstances isn't effective. Given regulatory policy, the excess reserves are pushing on a string -- meaning no throughput through the banking system into the real economy. And the flattening yield curve hurts private sector savers more than it helps those few parts of the private sector that can tap into low bond yields.

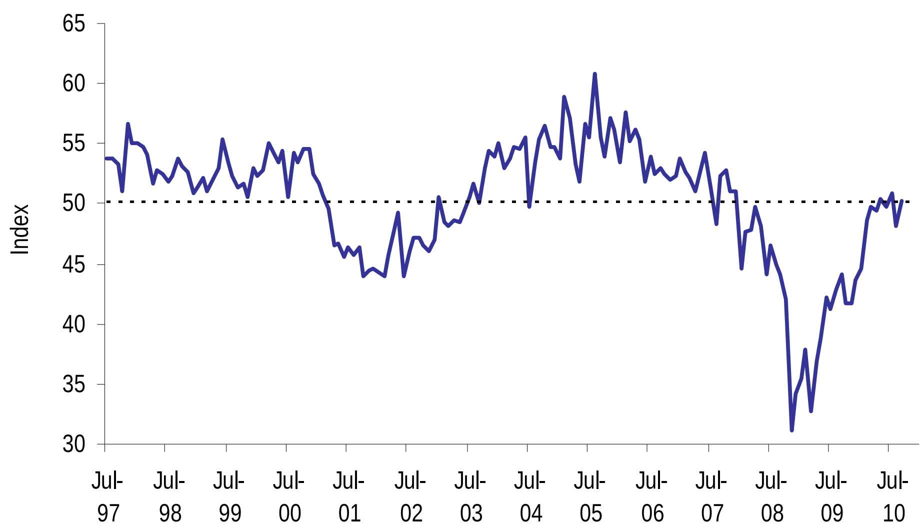
- Artificially holding down interest rates distorts capital flows. The Fed demonstrated this clearly in 2003-2006 with negative real interest rates, achieving a massive transfer of U.S. risk capital abroad and a bubble in U.S. home-building.

- This time the Fed is overseeing a giant transfer of capital from the private sector to the government. The Fed alone will earn over $100 billion this year from private sector savers. An even bigger drag on the private sector comes from the Fed pushing Treasury's interest rates super-low on most of its nearly $9 trillion in marketable securities. And both the Fed and Treasury are taking on huge duration risk by borrowing short-term, adding further cost and risk to the private sector.

Equities celebrated today's above expectation reading on the non-manufacturing ISM (53.2 vs 52 expected and 51.5 in August). However, we think the data is showing more signs of inflation than growth.

- The employment sub-index of the non-manufacturing ISM is still at only 50.2. This level has usually not been high enough for a recovery.

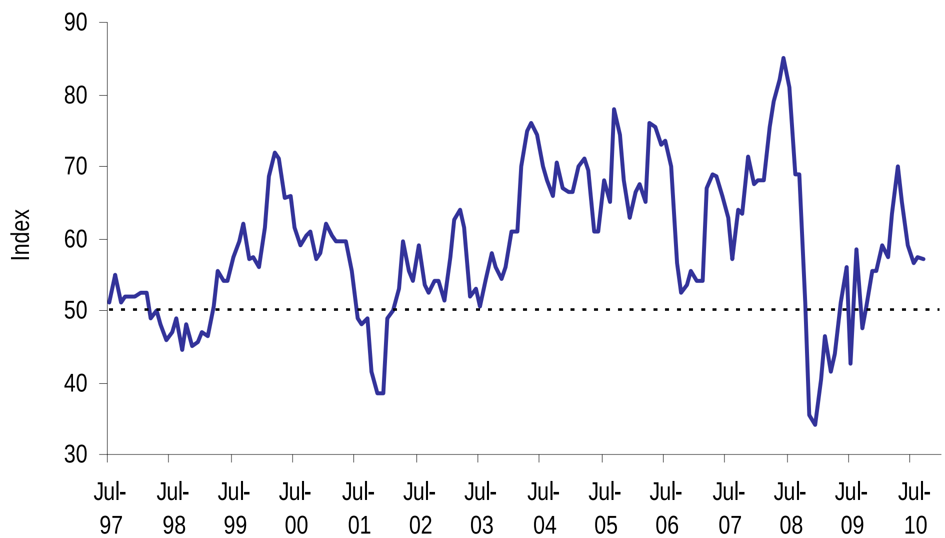
**ISM Non-Manufacturing Employment (last obs. September 2010)**




Source: ISM; Encima Global

- The strongest single component in the non-manufacturing ISM was the 60.1 reading for prices paid (versus 60.3 in August.)

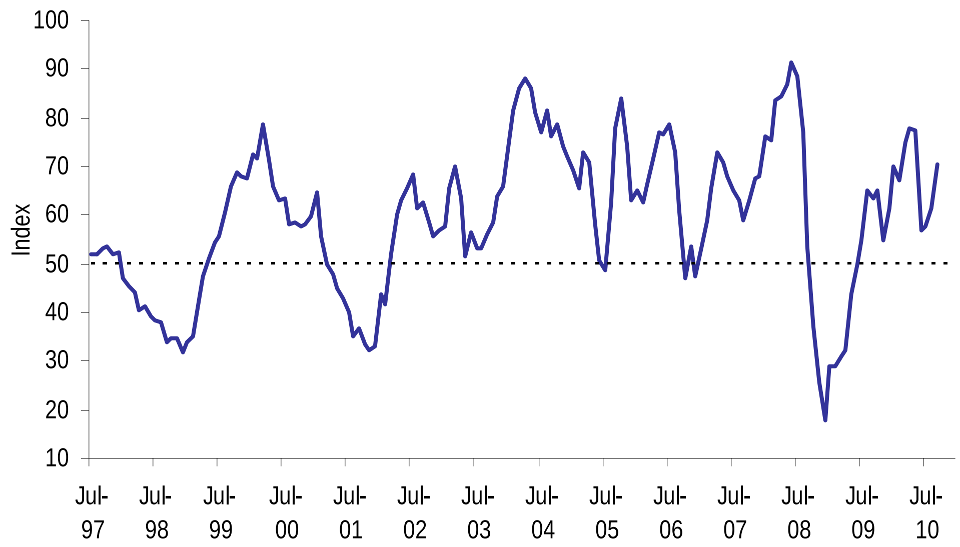
**ISM Non-Manufacturing Prices Index (last obs. September 2010)**




Source: ISM; Encima Global

- Similarly, prices paid was also the strongest sub-index in the ISM manufacturing index reported October 1.  September jumped to 70.5 from 61.5 in August and 57.5 in July.

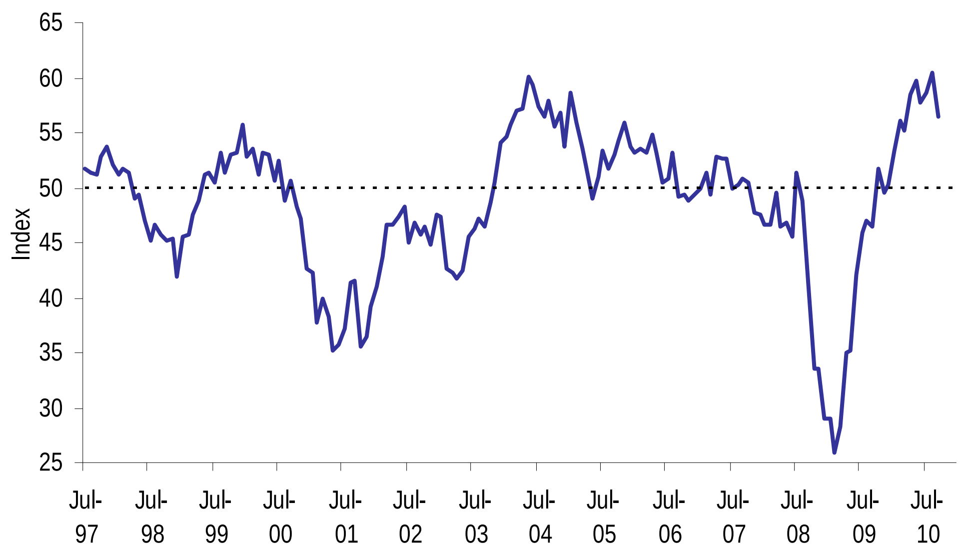
**ISM Manufacturing Prices Paid (last obs. September 2010)**




Source:  ISM; Encima Global

- The employment subindex of the ISM has been stronger, in part reflecting the gains in auto production.

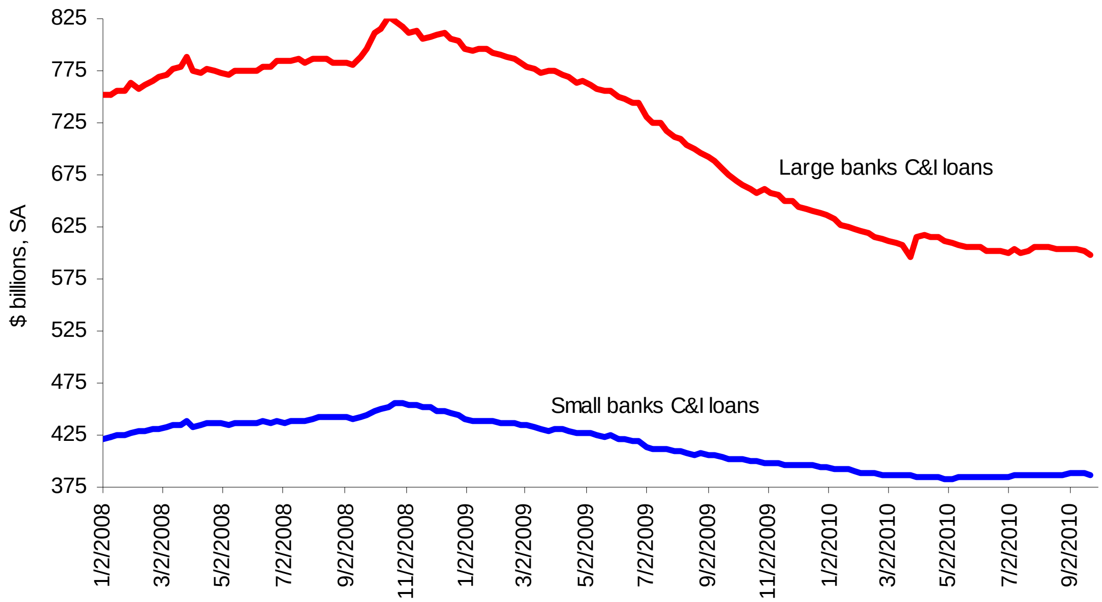
**ISM Manufacturing Employment (last obs. September 2010)**




Source:  ISM; Encima Global

- Despite the Fed's large balance sheet and expressions of concern, shrinkage in bank lending resumed in bank lending in September. Commercial and industrial loans outstanding from large bank loans fell to $598.2 billion on September 22, down from the $605 billion level maintained since May. C&I loans outstanding from small banks fell to $386.2 billion on September 22, having risen some from the $383.3 billion low point in May.

**C&I Loans (last obs. September 22, 2010)**

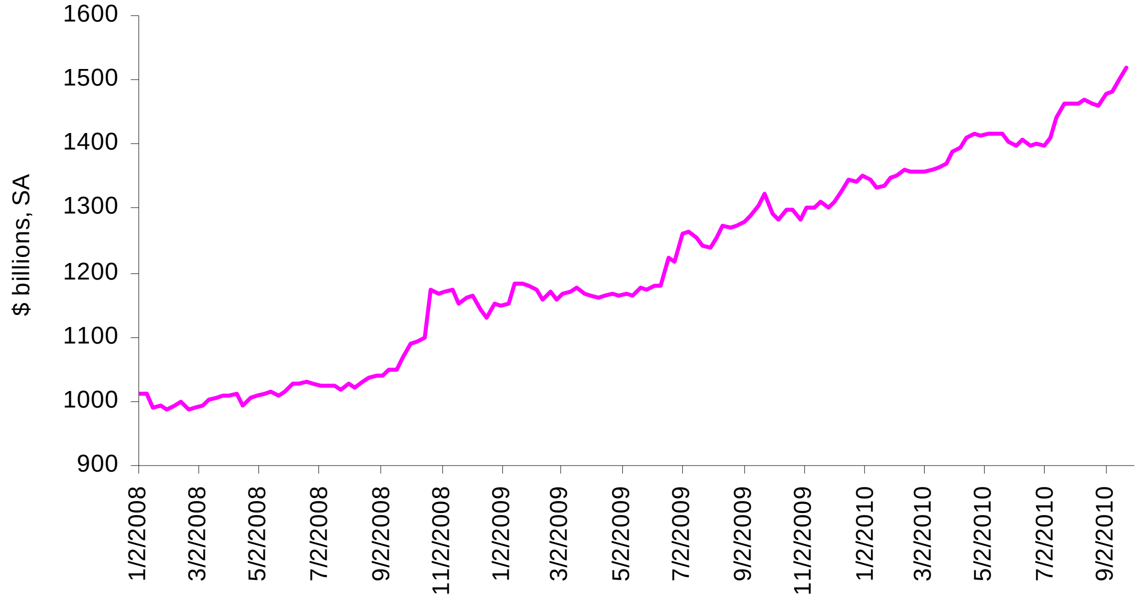



Source: Federal Reserve; Encima Global

- While some of the weakness in C&I loans is due to weak demand for loans, the complexity of the regulatory process is an important factor rechanneling loans from business to the government.

- Bank holdings of government securities rose to a new high of $1.52 trillion on September 22 as banks continued to redirect their lending to the government from the private sector.

**Bank Holdings of Government Securities (last obs. September 22, 2010)**




Source: Federal Reserve; Encima Global

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