



ATLANTIC CAPITAL MANAGEMENT

## WHY QUANTITATIVE EASING CANNOT WORK

And Why We Will Get More Of It Anyway

SPECIAL INVESTMENT RESEARCH REPORT  
June 30, 2010

EDITION 4 **THE NEXT PHASE SERIES**

Written By  
Jeffrey P. Snider, President

## REPORT SUMMARY

The Federal Reserve is preparing the economic battlefield for more heavy artillery. As economic conditions worsen in parallel with liquidity conditions, it becomes more likely that the Fed will introduce and begin implementing a second, larger version of quantitative easing (QE 2.0). Part of that effort is shown in a ridiculous paper from the Richmond Fed's Dr. Kartik Athreya. He argues, I assume with a straight face, that only PhD's in economics can understand such a complex subject, and laymen should not even try. This fits into the overall Fed strategy by saying that the smartest people in the world work at the Fed, so we should stop questioning them and buy in 100% to their brilliant plans. And we should definitely ignore its atrocious track record.

### Part 1 – The Uncertainty Variable

---

A normal functioning economy is a system of transactions that represent a high degree of certainty and value-added. It also represents a self-contained system that needs little interference, enforcing self-correction as needed. However, the more the Fed has intervened (as it views itself more and more capable of economic mastery) the more distorted the natural system has become.

We see that intervention led to the dot-com bust, and the same type of intervention led to the housing bubble. Both policies thwarted the natural arresting mechanisms of the organic economy.

In attempting to “save” the financial system and economy from the 2008 collapse, the Fed has implemented a policy that just creates more distortions. Because of this, it does nothing to address uncertainty, and is doomed to fail.

### Part 2 – Here Comes the Next Wave

---

Rather than focus on the data and reasoning of a coming contraction, we seek to address how a massive QE 2.0 may affect investing. Due to circumstances and adherence to monetary dogma, it is likely that the next version of QE will be much larger and takes the form of direct asset purchases. While it may be limited to US Treasury and municipal debt, we feel it is likely to include direct purchases of equities.

The distortions presented by such an intervention will only create a larger problem with uncertainty. We examine how the current market structure created by the first interventions is playing havoc with funding and investing. From that we can reasonably predict an unfavorable reaction to QE 2.0, including a sharp decline in the prices of stocks.

### Part 3 – Venturing Into the Theoretical

---

As an exercise in forward thinking, we present some conditions that may lead to a successful, sustainable recovery. Because the Fed is acting contrary to laymen's understanding of proper monetary policy, it is creating the uncertainty that will destroy its chances of success. The laymen's understanding is grounded in empirical reality, while the Fed has nothing more than untried theory. Yet it demands complete faith.

In the end, the only way to restore faith and remove the uncertainty that is killing the economy is to restore currency barbarity. Providing some form of intrinsic value to currency is the only way to remove the power of intervention from the same brilliant people that have been creating these bubble crises.

*“By taking away the fool's option of money printing, the discipline that is enforced on companies, individuals, governments and economies will be reassuring in a way that no genius academic plan could ever be.”*

## INTRODUCTION

### WHY QUANTITATIVE EASING CANNOT WORK

#### And Why We Will Get More Of It Anyway

The economy begins to slide back into recession and someone has to do something about it. No one wants to be how biased history has remembered Herbert Hoover. There are really only two choices for the “economic elites”: fiscal policy and monetary policy. Both have been massively deployed to no good economic effect. So what will the elites do?

According to the Fed, I am not qualified to render an opinion. The only people that can advance economic thought are those with PhD’s in economics - the same people that saw the collapse coming and were extremely proactive in resolving it before it got out of hand. Sarcasm aside, that is what the Fed is arguing in piece after piece.

We documented a lot of the Fed’s “academic” stance in our March report. It has been busy making sure that anyone who reads its material knows that the Fed had nothing to do with the housing bubble. Absolutely nothing.

After it rode to our “rescue” in the fall of 2008, it also wants us to know that its policies have been 100% effective and are completely benign. Only conspiracy theorists and the uneducated would think otherwise.

Because of these undesirable opinions the Richmond Fed has put out another remarkable “paper”. Dr. Kartik Athreya says<sup>1</sup>:

“Writers who have not taken a year of PhD coursework in a decent economics department (and passed their PhD qualifying exams), cannot meaningfully advance the discussion on economic policy.”

So we can produce top-ranked investment performance by seeing what the Federal Reserve could not, but in no way can we “meaningfully” add to the discussion of economics.

“The real issue is that there is extremely low likelihood that the speculations of the untrained, on a topic almost pathologically riddled by dynamic considerations and feedback effects, will offer anything new. Moreover, there is a substantial likelihood that it will instead offer something incoherent or misleading.”

Economics is so hard it should be left only to those that have spent their lives in the classroom (a theme we have repeatedly stressed and likely proved is a weakness of



monetary authorities). Dr. Athreya's piece is about economics bloggers, but the real intent is revealed:

“The sophomoric musings of auto-didact or non-didact bloggers or writers is instructive. For those who want to really know what the best that economics has to offer is, you must look here.”

Experience is completely useless as a means to learning about economics – it cannot be self-taught (autodidact) according to Dr. Athreya. It *must* come from the classroom. And, as we have been harping on for several years now, the Fed is full of classroom-trained “economists” that are unwilling and unable to move beyond their obviously flawed models and theories because of their overdeveloped sense of self-worth. Thank you Dr. Athreya for proving our point.

The most troubling aspect of this attempt by the Richmond Fed to reinforce its view of itself is that it is such a “sophomoric” attempt to set up what we believe must inevitably follow the Fed's failure: a second round of quantitative easing (QE 2.0).

The best that economics has to offer is busily readying a much larger package of economic destruction, and the rest of us need to just accept that we cannot possibly comprehend the elegant beauty of it all. I also have very little doubt that the Fed will blame the failure of its policies on the simpleminded people who just did not appreciate the breathtaking virtuosity.

Letting the cat out of the bag, on May 25, 2010, Dr. James Bullard, President of the Federal Reserve Bank of St. Louis, said that there could be more quantitative easing if the U.S got into a bad downturn<sup>2</sup>. The downturn is now upon us and the Fed is preparing the uneducated addlepaters for a second helping of ultimate economics acumen.

As a lesser educated layman I cannot help but remain skeptical. I happen to believe that the autodidactic and nondidactic will not receive this well, and, since that covers 99.9% of the population, it will mean another spectacular failure of theoretical brilliance.

Despite this rather lengthy disclaimer about our lack of ability, we will still attempt to map out just why the smartest people around *cannot* succeed and how their attempts may further distort normal economic functioning.

Someone once said that the definition of insanity is repeating something and expecting different results. That person was obviously never a PhD candidate in economics.

# Part 1 The Uncertainty Variable

Classroom macroeconomics is a top-down system that is preoccupied with the study of incentives. It is doomed to failure without an accompanying analysis of human reaction to both incentives *and uncertainty*. Most people have a sense of the economy that is autodidactic, and that confounds the anthropological understanding that elite economics has limited itself to. The biggest failure of economics as a science is its lack of a psychological variable beyond basic fear. Fear is something that can be understood by even the most socially isolated researcher. But uncertainty is something else.

The majority of us that have a view of economics from a human perspective understand its basic framework as given below:

**FIGURE 1**

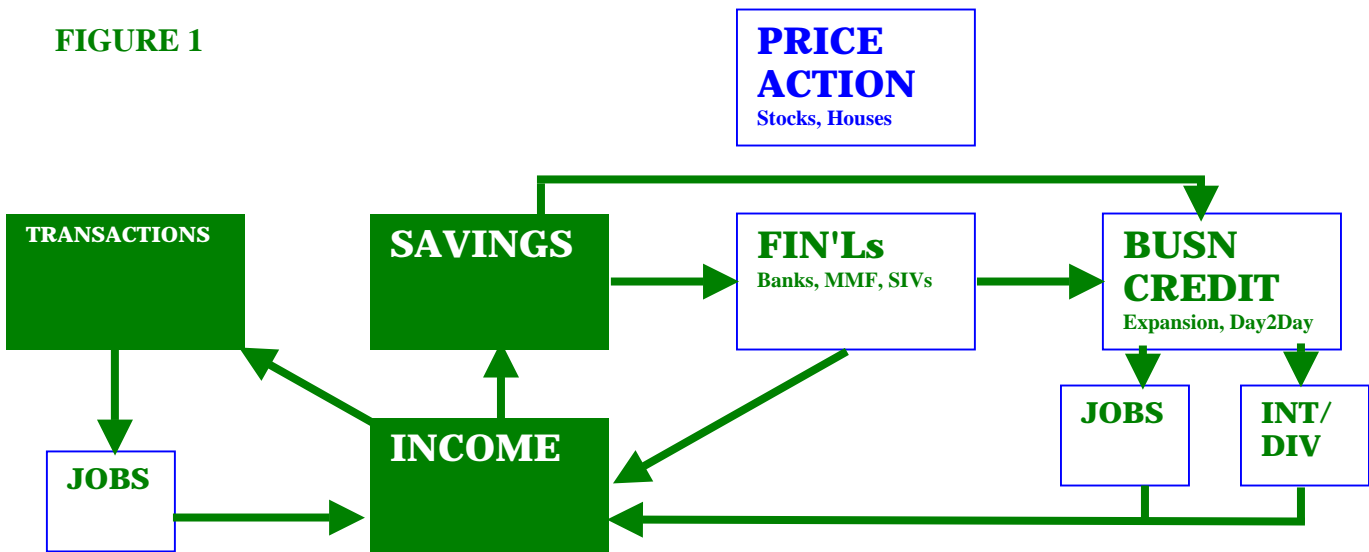


Figure 1 shows how the basic, freely flowing economic model looks. In some places it is overly simplified, but it is the essential core of the combined economy and monetary system. The funding loop at the left represents the organic economy, while the funding loop to the right represents monetary functioning. Each arrow represents funding sources exchanged for value-added goods or services. The lynchpin of both organic loops is income dispersal decisions – the tradeoff between spending and saving (this is true for businesses and households). The value added from spending should be more than the value added for saving to induce spending, and vice versa (incentives).

In this basic framework, the purpose of financial intermediation is to provide value to savers in terms of invested savings. That value is both an expertise (real or imagined) for discerning risks in lending money and as an aggregator for cumulative savings. As the diagram shows, savers can lend directly (government lending is not shown yet, but does account for a lot of savings) through bonds and direct loans but are on their own to determine creditworthiness. This becomes clear by the diagonal line from “Fin’ls” to “Income” representing consumer credit. Without intermediation, consumer credit would not be realistic outside of neighbors lending each other a few dollars.



In addition to having value at every step, the funding side represents certainty (or at least near maximum capacity for certainty, complete certainty is unattainable).

Businesses know what they have to do to access intermediation, or to sell directly to savers. There are not many surprises, and because of established channels, credit seekers know ahead of time the likelihood of success. So much so, funding in this framework can be taken for granted.

For workers, income comes from providing value to employers, whether as a result of existing transactions (left loop) or expectations of future transactions (right loop).

The beauty of this self-contained system is its self-correction. Imbalances that build in any channel are discovered by price action, beginning a corrective action. At the intersection of the loops, if households begin to spend more than save (at the margins) then funds for intermediation decrease, driving up the cost of funding until it attracts more saving. More credit costs and higher lending standards lead to a reduction in credit-based business activity, reducing jobs and asset income, forcing households to aggregately reduce spending.

The same mechanism controls channels within savings – via business through intermediation – the choice of “par” assets or “price” assets. If stocks are drawing enough funds to deprive business of direct debt funding, debt costs will rise enough to make “par” investing attractive in comparison with “price” investing in stocks. The residual decline in business activity due to lack of adequate funds coincidentally reduces stock attractiveness as profit potential is curtailed by a slowdown in the general business climate (reduced employment and capital spending).

If business credit is more attractive than consumer credit, consumer credit prices will adjust according to the scarcity of funding while the slowdown in household spending

pushes businesses to reduce demand for expansion, eventually rebalancing the equation.

None of this is enough for politicians that need to appear in command. Self-correction involves unemployment and (gasp!) investment loss. These were once part of life, but have been removed by fiat in the crusade for equality. And so central banks instituted themselves among men to remove depression. Conventional wisdom spun the necessity through tales of destruction caused by unregulated greed.

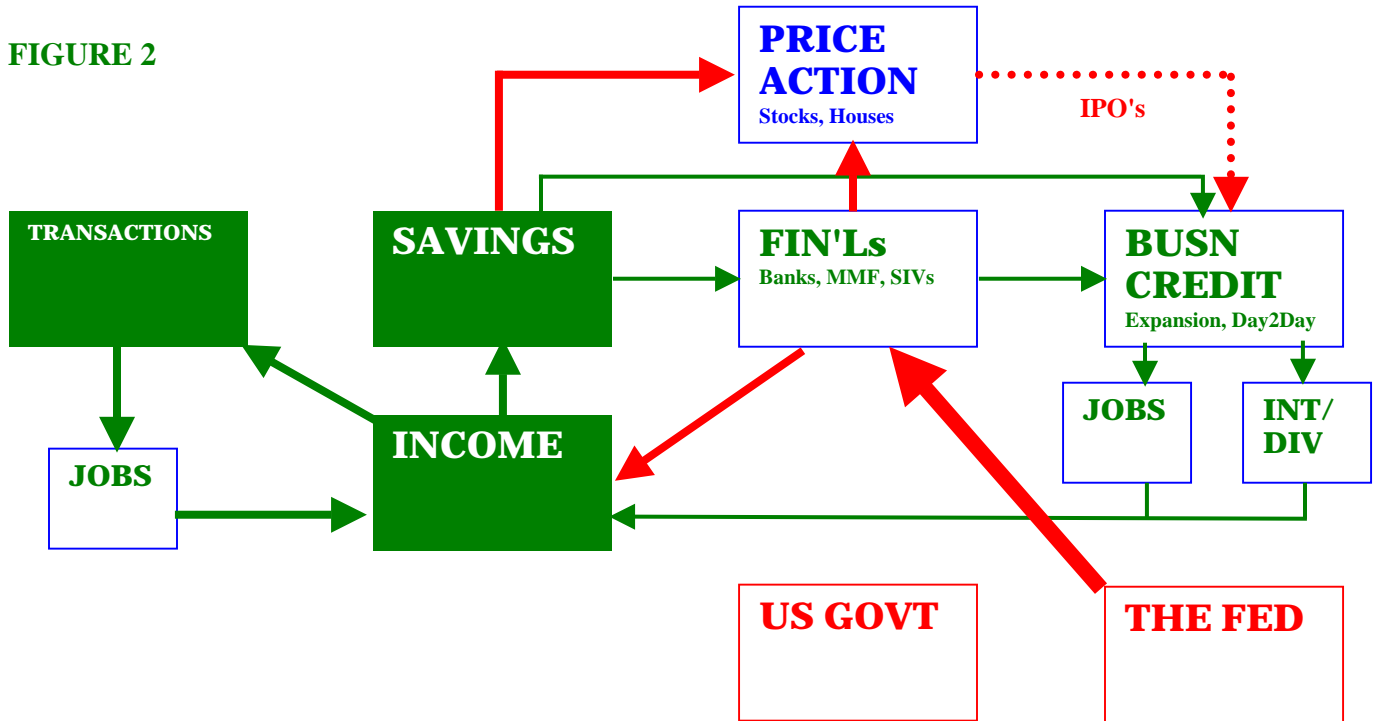
We have been told for decades that the Great Depression was forced upon the unsuspecting due to evil speculation. What is left out is that the evil speculation in the late 1920's was a direct result of one central bank (the Fed) creating money to balance trade and exchanges due to the policies of another central bank (Bank of England). Central to the “Austrian School of Economics” is the idea that business cycles are the product of central banks manipulating credit and interest rates. They do not allow prices to efficiently allocate scarce resources, resulting in the boom/bust cycle.

Under the framework presented above, reckless speculation would have resulted in imbalances that, through price discovery and signaling, would have self-corrected before the bubble got out of hand. If manipulations do get out of hand, the mechanism for self-correction takes care of the forced imbalances.

This is the essence of the Depression of 1920. That depression, created by another government manipulation of credit, was one of the most severe. But it was incredibly short. Imbalances were allowed to fully develop into proper price action that created the conditions for a sustainable recovery. After only eighteen months, employment and income had surpassed their pre-depression highs.

Central bank interference in interest rates has been the primary cause of boom/busts. The Fed has been given credit for “steering” the economy into “unprecedented” prosperity post-1982. It has even claimed that it did this with inflation remaining low. Inflation was low only if you forget about asset inflation (bubbles). The process of controlling interest rates and the economy is done by creating money in the form of short-term reserves.

This can be seen if we modify Figure 1 to demonstrate the dot-com bubble:



Here money flowed to “price” assets, bypassing intermediation (we discussed this process extensively in our August 2009 Report). Some of the stock flows made it to businesses as a result of IPO’s, but the majority of marginal flows were contained within stocks (transference from one investor to another, who then bought more stock). At this point interest rates should have risen due to the imbalance and the flows should have adjusted. But our central bank operates on a theory that rates must be controlled, so the Fed stepped in to enforce interest rates (through the Fed funds). And in order to manage interest rates, money needs to be injected into intermediaries, overriding the imbalance and any price movements that would signal one.

At this moment of intervention, the value of intermediation is diminished from its primary role of efficient aggregator to simply a dispersal mechanism (with no value added). Loosening the scarcity of money, intermediaries simply look to deploy cash in places that would otherwise have been denied – and this problem gets more acute as more money is created and all demand is met, including corporate demand for debt to foster more price action through privatizations and stock buybacks.

Instead of self-correction we have self-reinforcing. The more prices rise in “price action” assets relative to the artificially low interest rates of “par” assets, the more money is induced toward the imbalance. At even this stage, self-correction is possible when households (and businesses to a



degree) begin to shift preferences against spending and toward saving in the ever-rising “price” assets. That shift would reduce economic activity until stocks lose luster, and the equilibrium is restored. But even that was undone by the Fed.

Because so much money was created for use by intermediaries the decline in spending never occurred. It was replaced by a dramatic rise in consumer credit. The mismatch in maturities and liquidity between stock investing and spending would have cut short the stock bubble except that cheap consumer credit was an easy substitute. With balance sheets moving ever higher due to the price action, there was little thought given to adding debt (and, as we showed in August, consumers added debt at a greater rate when interest rates were rising, contrary to accepted monetary theory).

The feedback loop was entrenched further as intermediaries themselves were able to access the stock markets for funding (equity funding is leveraged many times in the process of credit production). Business funding continued to be plentiful at low interest rates despite a profit slowdown in 1997 as prices reflected less and less reality, and more and more Fed action. It lasted until the Fed removed the liquidity in a belated attempt to get a handle on the speculation it had a big hand in creating. We all know the ending.

The same process was repeated in the housing bubble. Except the housing event prominently featured two central banks recklessly expanding money. The Fed was enforcing record low interest rates to keep the imbalances from correcting while the Bank of Japan was busy experimenting with the first iteration of quantitative easing. The massive increase in Yen found its way to Wall Street through the carry trade, and the relentless surge in the repo market. The repo market became *the* funding source for leveraged trading in credit derivatives,

which drove the demand for mortgages into any and all corners of mispriced risk.

Remember that the repo market is where the Fed conducts and enforces its monetary policy. If there had been no intervention in interest rates, the demand to create mortgage assets would have dried up once available repo funding was exhausted. The massive demand for funding to engage in leveraged credit derivatives forced the Fed to create even more money to keep interest rates from rising – also remember that rates were kept low from 2001 – 2004. The housing bubble itself was nothing more than the logical consequence of trying to meet any and all demand for funds. The self-correction mechanism would have shut down the bubble not long after demand for money outstripped supply. And any price adjustment caused by this process would have been met by marginal funding taken away from household and business spending, resulting in a competition for funds that would have arrested overall economic activity to the point that the imbalance reversed (due to unfavorable price movements in real estate caused by an economic slowdown).

The really unfortunate part of the central bank interference is that the correction mechanism was in process as a recession in 2001. A second rebalancing attempt came in the latter part of 2002 as the economy slowed again. Each time the corrections were met with still lower interest rates and more money creation. Had interest rates been allowed to achieve a natural equilibrium the housing bubble would have been entirely avoided and a sustainable recovery may have followed.

Yet, despite its “dual” mandate for full employment and price stability, the Fed only cares about full employment. In destroying price stability (seen by the non-fundamental increase in price action assets) the Fed made the 2008-10 bust inevitable. If it had actually cared about both parts of its mandate, it may have accepted a recession in





In the repo market, fear was a manifestation of imprudence – lenders had accepted collateral that was not what they thought it was. Haircuts were not properly calibrated to the realities and conditions of collateral. The adjustment toward acceptance of a riskier climate forced liquidation in every market. And in doing so, it exposed central planning for what it really is, an extremely poor substitute for the framework of Figure 1.

Here's why.

As we examined above, the Federal Reserve System created money to enforce an artificially low interest rate regime. They couldn't print money fast enough to ensure demand was met, and therefore interest rates were low enough for their targets. But here we were in the summer of 2008, panic all around, and the Fed funds rate shoots higher, well past the discount rate "ceiling". This meant that the Fed was no longer printing enough money to enforce its policy rate targets. Why could it create money during lengthy periods of larger and larger imbalances but not during a short period of panic?

The panic that started in the markets also gripped authorities. They did not know what to do any more than the repo desks at Lehman or Merrill. The lack of explicit support by the Fed demonstrated to every banker and broker that the Fed could not be counted on when it was really needed (the very task it was *created* for in 1913). The message received by the financial system is that the Fed is preoccupied with its own existence rather than fulfilling its role as lender of last resort. So every time the Fed replaced a natural funding relationship with one of its new creations, it did not foster the kind of certainty that is needed to restore a naturally functioning system.

Further demonstrating that economics is much more art than science, the central reason the Fed betrayed its key role was that its economists and management were really

### MORE COUNTERPRODUCTIVE POLICY

In reducing interest rates to near zero, the Fed has given the banking system a free ride to rebuild capital through profitable carry trading. However, nothing is free. Ultimately savers are paying the cost. As we examined in August, asset income was one of the largest marginal funding sources for consumer spending. By penalizing savers the Fed is indirectly reducing economic activity, particularly since the transfer of lost income to the banking system is staying within the banking system.

The etymology of the word "economy" comes from the Greek word for "household management". Perhaps some of the original meaning has been lost in the imposition of economics as a science?

concerned with the wrong issue. The real irony here is that the Fed is only really good at one thing – flooding markets with liquidity. So what happened that caused it to freeze up when it was needed most?

In a September 23, 2008, speech before the US Senate Committee on Banking, Housing and Urban Affairs, Chairman Bernanke described events to that point<sup>3</sup>:

"While perhaps manageable in itself, Lehman's default was combined with the unexpectedly rapid collapse of AIG, which together contributed to the development last week of extraordinarily turbulent conditions in global financial markets. These conditions caused equity prices to fall sharply, the cost of short-term credit--where available--to spike upward, and liquidity to dry up in many markets. Losses at a large money market mutual fund sparked extensive withdrawals from a number of such funds. A marked increase in the demand for safe assets--a flight to quality--sent the yield on Treasury bills down to a few hundredths of a percent. By further reducing asset values and potentially restricting the flow of credit to households and businesses, these developments pose a direct threat to economic growth."



Following that, Mr. Bernanke outlined the Fed's response:

“The Federal Reserve took a number of actions to increase liquidity and stabilize markets. Notably, to address dollar funding pressures worldwide, we announced a significant expansion of reciprocal currency arrangements with foreign central banks, including an approximate doubling of the existing swap lines with the European Central Bank and the Swiss National Bank and the authorization of new swap facilities with the Bank of Japan, the Bank of England, and the Bank of Canada. We will continue to work closely with colleagues at other central banks to address ongoing liquidity pressures. The Federal Reserve also announced initiatives to assist money market mutual funds facing heavy redemptions and to increase liquidity in short-term credit markets.”

It is rather odd that he only addresses the primary problem (interbank lending in short-term credit) in the last sentence with a very short, non-specific statement. It is also odd that the effort to increase liquidity in the short-term credit markets was only “announced”. By September 24, the effort should have been going at full speed, yet the crisis deepened further.

Some of this is explained by the next part of his speech:

“Despite the efforts of the Federal Reserve, the Treasury, and other agencies, global financial markets remain under extraordinary stress. Action by the Congress is urgently required to stabilize the situation and avert what otherwise could be very serious consequences for our financial markets and for our economy. In this regard, the Federal Reserve supports the Treasury's proposal to buy illiquid assets from financial institutions. **Purchasing impaired assets will create liquidity and promote price discovery in the markets for these**

**assets, while reducing investor uncertainty about the current value and prospects of financial institutions.** More generally, removing these assets from institutions' balance sheets will help to restore confidence in our financial markets and enable banks and other institutions to raise capital and to expand credit to support economic growth.” [emphasis added]

The Fed was willing to take a supplemental role to the US Treasury's efforts to purchase “toxic” assets. The liquidity the market desperately needed was to be supplied by the US Treasury through Congressionally approved TARP. This, of course, raises the question about just why the Fed took a back seat. The answer comes from the second sentence of his speech:

“As you know, the U.S. economy continues to confront substantial challenges, including a weakening labor market and **elevated inflation.**” [emphasis added]

At that moment in time, the Fed was more worried about inflation than the disintegration of the financial system. Rather than create enough reserves to satisfy the ongoing demand for funds in the repo markets, the Fed, knowing that the amount of new cash needed was huge, was too afraid of the ramifications for inflation expectations if it responded radically. In fact, the Fed had removed liquidity in mid-September, conducting \$50 billion in reverse repurchases<sup>4</sup> (transactions that take cash out of the banking system). From a New York Fed report to the FOMC:

“In mid-September, financial market strains escalated and the Federal Reserve responded by increasing the size of the TAF operations, increasing the number and size of reciprocal swap lines with foreign central banks, and developing new funding facilities for markets that had become particularly illiquid. The ensuing massive liquidity injections prompted the



Desk to cease its overnight, 7-day, and 14-day RPs as excess reserve levels rapidly climbed and overnight fed funds traded well below the target until the FOMC’s policy change on December 16.”

The Fed was sterilizing its liquidity actions, taking liquidity away from where it was most needed. The Fed, worried about inflation and incorrectly diagnosing the area of illiquidity, astoundingly *completely shut down* its short-term *and* long-term repo programs.

Part of this madness is also attributed to the existence of the discount window. The Fed mistakenly believed that if liquidity got too tight banks would run to the discount window as a last resort. But, as we discussed in some detail in our March report, the Fed’s view of the discount window did not mesh with banks’ internal views. More precisely, the Fed misdiagnosed banks’ perceptions of how

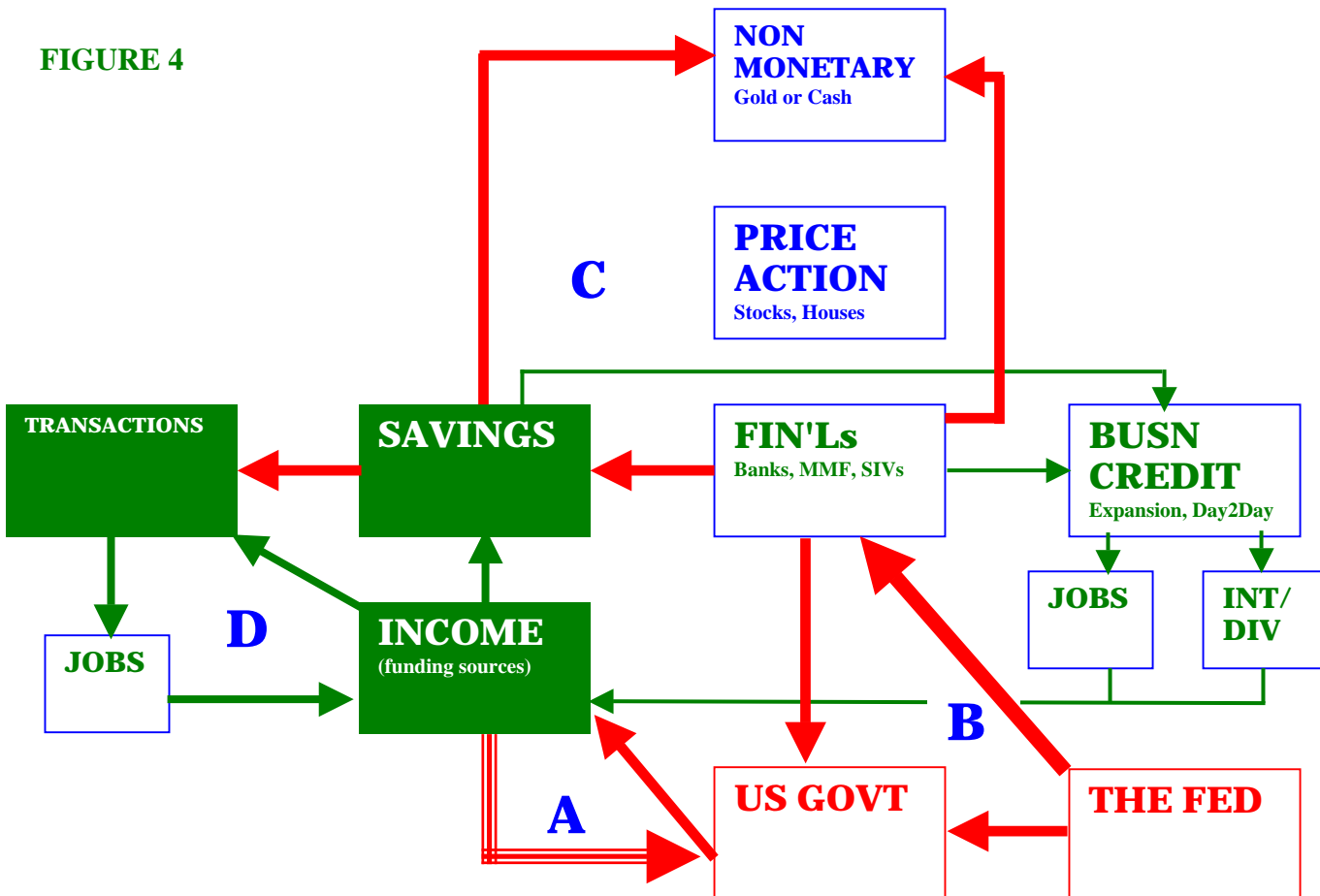
investors would feel about accessing the funding mechanism.

With so much mistrust and investors at the edge of panic, liquidity-challenged banks did not want to reveal even the slightest weakness. If they did they would follow Washington Mutual and Wachovia into the price-killing mechanism of forced-takeovers. Accessing the discount window would not be a last resort savior; it would be the final nail in the coffin.

So the Fed went into the Panic with the wrong mindset, the wrong reading on liquidity, and the wrong plan to solve the liquidity problem. But if that was not enough, authorities decided to change liquidity solutions midstream, impose political controls, and follow them up with ideological impositions.

In November 2008, TARP was changed from a plan to buy up “toxic” assets to a

FIGURE 4





forced preferred stock offering. The change was necessitated because the government could not agree on a price for the assets (banks wanted prices that reflected the longer-term value of cash flows as opposed to the short-term fear-driven valuations, while the government did not want to appear to be giving money away at favorable prices). The change in TARP failed miserably as credit prices and availability sunk further. Finally in December 2008, the Fed stepped in with zero interest rates and massive liquidity, long after the damage had been done.

The episode has been a reminder to lenders that the government and the Fed cannot be counted on for liquidity in a crisis. And as a result, financial firms that have benefited from the printing presses are keeping the new cash for themselves. It really is an exact parallel to the mistakes the Fed made in 1930 & 1931 that we examined in our April 2010 report. The Fed thought, in both cases, it had loosened monetary policy enough to foster a recovery when all it had accomplished was a real increase in uncertainty that reduced money and spending *velocities*. And in both time periods, individual actors (banks, corporations, and individuals) responded to the funding uncertainties by undertaking individual measures that strengthened individual liquidity at the expense of systemic and economic functioning.

The quantitative easing (QE) by the Fed has not led to a robust recovery. What it has done, along with the ideological fiscal “stimulus”, has created rising uncertainty. Figure 4 on Page 10 shows this well, as each organic funding loop has been completely bypassed or reversed. **A** shows the disruption to income certainty through taxation expectations, and the over-reliance on temporary government transfers. **B** shows the carry trade and the perverse incentives for the banking system. Banks borrow at near zero from the Fed and reinvest in government securities (and equities) rather than expand credit for actual

economic functions (we provided more detail on this in our March 2010 report). At **C** the normal funding processes for savers has been completely obliterated at the margins. Households, through lack of organic funding, begin to pull money out of the monetary loop, using accumulated savings to fund transactions while shifting from intermediaries to non-monetary assets (gold or cash under the mattress). This all adds more strain to the monetary loop, causing more intervention that will only create more uncertainty in **D**, showing up as declining spending velocity.

That is the point at which we find the economy now. Strains in both funding loops are becoming more and more evident, which puts more pressure on authorities (more accurately, they put pressure on themselves) to keep intervening. And the more intervention the farther we get from the ideal funding loop from Figure 1 and a sustainable path to successful resolution.

At this point, after \$2 trillion in Fed intervention, nearly \$1 trillion in fiscal “stimulus” and another promised \$1 trillion from the ECB for Europe we still have a contraction forming. Rather than learning from all the accumulated monetary and fiscal mistakes ACM expects an even bigger intervention: QE 2.0, an order of magnitude larger than the original. Critics of all this intervention point to Japan as the poster child for not doing QE in the first place, yet supporters counter that Japan did not intervene enough – they should have gone bigger! Is there any reason to believe that the Fed (cheered by “economists” like Paul Krugman and Larry Summers) will not follow that advice, especially given its insulating hubris?

The political winds have changed in the fiscal arena, making the likelihood of another massive intervention there much smaller. That just means the Fed will conclude that it will have to do the heavy lifting all by itself. Is it far-fetched to believe that QE 2.0 could be \$5 trillion?



This is especially true if the Fed begins to see economic reality for what it may be: a second leg down into depression.

Realizing what may lie ahead, the Fed has little to lose. It did not stockpile all those PhD's and economic talent for nothing. Since the last four decades of monetary

history has led it to believe it is master of the economy it will likely try to *force* a recovery on its own. In doing so it will likely prove what the rest of us non-PhD-types have been saying for years: that the Fed is really powerless. Because it refuses to recognize the absolute power of uncertainty, its interventions will be counterproductive.

## Part 2 Here Comes The Next Wave

Current stock valuations are pricing in a robust recovery, and, as many bullish analysts are forced to point to, are becoming more and more reliant on 2011 earnings projections. Those projections are based on best-case (and lowest probability) growth that the Fed recently projected<sup>5</sup> (3.7% & 3.2% GDP growth in 2010 and 2011, respectively). Recent economic indications (payrolls, unemployment, retail sales, manufacturing indices, etc) all point to a significant slowdown in growth, at best. We believe that this is the initial phase of the double dip forming, but even if it only means a slower growth trajectory those 2011 estimates begin to look dubious. Yet the stock markets have held their values after a May correction, and in the process are beginning to resemble Summer 2008. At that inflection there was a divergence in opinion for and against economic optimism while the liquidity foundation crumbled.

The same is recurring all over again. Economic indicators weaken everywhere while European monetary efficiency is being destroyed by uncertainty. While our “expert” authorities proclaim containment within Europe, the damage spreads globally into every liquid market. Bond auctions fail in Greece, Spain, Germany, Brazil and even China (more than one auction of government *bills* has been left uncovered and repo rates skyrocket). The US auctions have survived only through the malevolence of the direct

bidders from London. These are not the characteristics of a healthy global recovery.

A healthy recovery is founded on a willingness to increase risk, not seek record gold prices. If the global economy is recovering, why did Europe need to bail out its entire banking and debt system, and why are we discussing the possibility of QE 2.0?

At some point reality will be forced onto investors in much the way it was in September 2008. We could spend our entire report on providing evidence that another contraction is likely, and has likely already begun. But, in the age of massive intervention, what is more important is a discussion about just how QE 2.0 might affect the markets and economies.

The analogy I would use for the first iteration of QE is a tsunami of money. It blew ashore of the economy and lifted everything temporarily (the appearance of prosperity) and then receded leaving nothing but destruction in its wake. So the relevant questions to ask are whether or not the damage is greater today than it was before the tsunami, and whether a second wave would even create the appearance of prosperity before receding.

The first question is somewhat easy to answer in just a conceptual fashion. The Panic of 2008 was a manifestation of interbank mistrust leading to liquidations



from deleveraging. At the center of the mistrust were mortgage securities in the repo market. In 2010, liquidity trouble stems from sovereign debt concerns in the repo market (if anyone does not believe the repo market is the epicenter, then they have to explain why the ECB has gone to great lengths to ensure worthless PIIGS government bonds are still repo eligible).

The fingerprints of mortgage securities stretched into the trillions throughout the US, UK and Europe, but was limited as new issuance fell to zero. At that point the challenge became simply replacing lost funding. The tentacles of sovereign exposures are also into the trillions (likely a multiple of the mortgage securities) but are still growing. Not only is there trillions in existing sovereign debt, there is a decided need for trillions more just to maintain the entire unstable scheme. These governments need to rollover existing debt and try to entice new money into increasingly risky issues (Spain auctioned thirty year notes at 4.758% in May, but 5.908% in mid-June<sup>6</sup>, the same phenomena that Greece experienced when it actually held auctions, and has now spread to Portugal) while velocity falls and credit shrinks globally. The pockets of illiquidity are growing larger and threaten wider exposure.

Exposure to “toxic” MBS was concentrated among the largest financial institutions, but exposure to “toxic” sovereigns is not limited by size. Perhaps it is little wonder that Spain’s savings institutions are undergoing “cold fusion”, seeking mergers with two or three peers to try to gain some economy of scale in funding. The PIIGS are widespread, and, as news to “economists” and “experts” in the US, are well represented in the portfolios of US banks (who did they think has been buying at all these auctions this year? Japanese housewives?). LIBOR has increased with a wider, almost nonsensical dispersion – the actual rate charged for individual borrowers has never been so different within the survey. Increases in Euribor also suggest non-uniformity,

particularly when combined with ECB lending and liquidity program data.

Because the tsunami of leverage in QE 1.0 propped up risky asset valuations, the receding liquidity from uncertainty is even more problematic than before as asset correlations have risen. The European liquidity problems are now transmitted via the Euro/Yen carry trade. There has been a near perfect correlation between the Euro/Yen and the S&P 500, particularly since April. So flight of capital from Europe (derisking) impacts risk assets everywhere.

So the answer to the first question above is, in our opinion, an unqualified yes. The financial system is in worse shape than before QE 1.0, and much of that has to do with the affects of QE itself. The wave of liquidity has put the financial system in a still more precarious position, despite trillions upon trillions of new dollars and euros, while accomplishing nothing in the real economy (for our purposes here we are classifying the European “bailout” as an extension of QE).

For the second question, would another wave of liquidity follow the first in creating the appearance of prosperity? The answer here is complicated by the channels of the first wave. QE 1.0 was implemented as replacement leverage in the repo market for financial institutions. They then used that leverage to buy any asset not related to mortgages, but primarily have stuck with sovereigns (the US in particular). The failure of QE 1.0 is in large part the perverse incentives it created against lending in the real economy and the reluctance of banks to part with a huge cushion of liquidity (particularly when keeping in mind the Fed’s desire to remove leverage through the war on money market funds, while increasing capital requirements through FAS 166 & 167). So it is not likely that QE 2.0 will be just a larger 1.0. Rather, it is likely the Fed will examine channels to try to steer liquidity flow.



There are only three real options: 1. Repo funding and bank reserves (upsizing QE 1.0). 2. Direct purchases of public and private debt (the European option). 3. Helicopter bags of money.

Option 1 has not worked in the fundamental sense, so could increasing the size be the cure? Not likely. Increasing the repo money available, even if it were put to use in equities and risky assets, does not change the fundamental value of those assets. It created the appearance of prosperity because it began when the expectations of investors were so low in March 2009, and the massive selling pressures in stocks from delta hedging credit marks was removed by modifying mark-to-market. A market that was pricing economic Armageddon was pleasantly surprised that the end of the world was not scheduled for April 2009. There was some fundamental value in the market overshooting on the downside that QE leveraged into a 45-degree increase in stock values.

Today, the stock markets are representing less and less fundamental value, forcing the most resolute bulls to call for perfection in the form of those harder to reach 2011 earnings estimates. It gets harder to justify current valuations in the face of fractured price discovery due to the market's new structure. The "flash crash" of May 6 was an ample demonstration of market transformation out of a mechanism for fundamental capital allocation. There have been other indications as well: the 35% drop in Diebold on June 2 that was almost completely reversed in less than 18 minutes<sup>7</sup>, the 100% gain in Washington Post on June 16 for no reason<sup>8</sup> (and the first test of the ballyhooed new circuit breakers), the 40% drop each in Fannie and Freddie on news of their delisting<sup>9</sup> (as HFT traders packed up shop and left for greener pastures), the 17% decline in Citigroup in a matter of minutes on June 29<sup>10</sup> (the second test of the new circuit breakers), the erratic and exaggerated price movements in AMBAC and AIG, etc. None of these

moves reflect anything that could be called real price discovery. The problem for the broader market is that some of these ridiculous movements are now present in the price of every stock and index.

Adding liquidity to a market does not guarantee the direction of movement. In many ways QE 1.0 pushed the market higher simply because that was the path of least resistance off an historic, panic-driven bottom. Now that fundamental valuations are in doubt as more and more economic indicators roll to red, the upward direction of the market is no longer assured. The artificial inventory recovery of earlier in the year provided some thin circumstantial evidence of a V-shaped recovery, but continued evidence is getting scarce. Without a clear sense of direction (remember that carry traders require low volatility) stocks may not be the ultimate destination of QE 2.0 money.

In fact, the Japanese may have provided us with the most likely candidate for newly created dollars. Somewhere else. Little of the Yen printed as part of the mid-decade QE stayed in Japan. The Yen carry trade spread throughout the globe as a cheap source of leverage funding. This was mostly a result of zero-bound Yen interest rates and low growth expectations for a Japanese economy mired in periodic deflation.

The United States is now exhibiting much of the same problems. Zero bound rates have forced many investors (particularly the institutions full of those newly created reserves) to take their cheaply borrowed, Fed-created money to other places like Greece and Spain, and any number of BRIC assets. The search for yield has been one of the largest allocation factors during this episode of QE. So QE 2.0 may simply amplify the search for yield while mispricing risk even more. Those Greek sovereigns yielding north of 6% looked good in January, but not so much now.



The counter argument is the dollar as a global reserve and the US as a safe haven. Despite its problems, money ran to dollars when it got rough in 2008 and 2009. But that does not mean the dollar is immune to a Euro-type flight. There are already indications that countries around the world are diversifying reserves away from dollars (not only China, but also Saudi Arabia, India and Russia<sup>11</sup>). Official protestations to the contrary, the US can lose its preeminent status as favored investment destination. The probability increases if the US experiences another contraction at the same time the Fed debases the currency in such a large and obvious manner. The only question at that point is the relative shape of every other major economy in the world.

This explains the recent popularity of gold. When financial assets fall out of favor, hard assets are much more in demand – there is not much else left untainted. If the US has to resort to another round of money printing after failing the first time, it will call into question the very notion of the US as a safe haven. The 1930's are again a relevant comparison. There were no financial assets where investors could safely park money, and no countries were spared the economic carnage (though some fared better than others). The resultant deflation was a result of monetary uncertainty leading to a mass withdrawal of money out of the financial system. The price of gold, in this respect, will be an inverse barometer of monetary success.

There has to be some point at which marginal money creation has little to no affect on fundamental demand. We have seen this in three prime examples already: Japan, QE 1.0 and the European “bailout”. Wherever governments intervene, private investors flee. In QE 1.0, the Fed bought mortgage securities. Now there are no private mortgages offered. In Europe, the ECB purchases PIIGS debt directly, becoming the primary source of funding.

There is no organic process to reestablish equilibrium. The combination of pricing and commitment to efficiency is where recoveries begin and prosper. By purchasing debt directly the central banks are simply affording investors a golden opportunity (to use a pun) to exit from the market without ever establishing the new equilibrium. The issuer is never forced into those hard decisions that lead to efficiency, which is necessary for sustainability and profitability. And it establishes the infamous moral hazard upon investors who no longer have to worry about losses. Rather, investors' only concern becomes what investment offers the *most* risk while maintaining bailout likeliness.

A QE 2.0 that resorts to the outright purchase of debt will fail because of these interruptions to the natural processes. We can envision this new program expanding from just MBS and UST to include the direct purchase of muni debt, and even financial and corporate debt (which already happened – TARP, GM, Chrysler). In doing so, it will push private investors completely out of those markets. Muni offerings become nothing more than extensions of US Treasury auctions.

If municipal issuers begin to face shrinking liquidity as bond investors wake up to the true default risks (I sincerely hope that they are not expecting AMBAC or MBIA to make good on insurance claims), then the market is enforcing discipline on both investors and issuers. These new price signals tell other investors about the true risks of the asset class, and allow capital to allocate properly to those that commit to efficiency. By stepping in and directly buying bonds, the Fed will keep that price signal from occurring. As it comes into the market and bails out issuers, private investors no longer know what prices mean. Issuers can talk about austerity, but receiving full funding or full commitments in advance greatly reduces the urgency of action to the point that it becomes a doubt. Knowing that some issuers get bailed out



will give other issuers comfort in putting off efficiency measures, believing themselves to be next on the handout list. This creates more uncertainty within the entire asset class, causing investors to exit the class instead of just the issuer in question. The monetizing action really is nothing more than a contagion to the entire class, making the problem bigger while not actually accomplishing anything that can reasonably be called a resolution or solution.

So as investors leave asset classes due to the uncertainty that issuers will ever need to actually implement measures that make their issues investable, the Fed is hoping that they redeploy their money in other places, thus having the effect of propping up asset prices outside of the intervention target (rising prices in all markets). But, as we have seen in every intervention, this interrupts price discovery far and wide, leading to volatility far and wide. That volatility leads to increasing uncertainty and a greater drive to withdraw money from financial assets altogether. The process of intervention itself is the direct cause of its own failure.

In either potential case of QE 2.0 (repo market expansion and direct purchase of debt) the repercussions amongst foreign debtholders would likely mute any short-term positive response. I have little doubt that China, Japan and the Middle Eastern US Treasury investors would decry a massive dilution of their largest asset. If they immediately begin to sell their US Treasury holdings (or other dollar-denominated assets) the currency pressures would wreak havoc on international trade.

We have seen a microcosm of this process in the Euro/Swiss Franc. The Franc has gained steadily as the crisis has engulfed continental Europe. The upward pressure is from Euro investors fleeing Europe and large Swiss banks selling out of Euro/PIIGS exposure. This has caused the Swiss National Bank to purchase Euros directly to try to keep the Euro from sinking into export-killing territory. But it is also trying

to keep the value of Euro-denominated assets within those banks from devaluing. The massive loss in value will eventually impact the solvency of the Swiss banks, with total exposures at multiples of Swiss GDP.

The same is true for sovereign reserves. Calling into question the value of other countries' reserves will have the effect of weakening each countries' currency. If the total value in local currency terms of a country's reserves falls dramatically, it destabilizes that local currency. The country may be forced to print more currency to offset the new imbalance (to keep from destroying its exports), or to meet excess demand in the face of reserve sales (if China sells UST bonds it will need to convert the dollars back to Yuan, or some other currency). In either case, currency markets stop functioning as they are and trade becomes difficult. The end result is a 21<sup>st</sup> century version of Smoot-Hawley.

A Federal Reserve that directly purchases trillions in debt will essentially be destroying the dollar as reserve currency. It will create the conditions whereby investors will actively seek other safe havens (gold) because they will have little incentive to invest here – low interest rates with massive dilution risk. At best it will only recreate the carry trade conditions Japan experienced, where capital is created and then dispersed, doing little good internally.

The only other alternative is to helicopter the money directly to individuals. That might seem to be the best option, but it would be directly inflationary. Dispersing \$5 trillion directly to 300 million people would put about \$17,000 directly in the hands of individuals (\$34,000 to a married couple, and \$68,000 to a family of four). There is little chance that doing so would not be massively inflationary, even if it were a one-time event. That inflation would quickly overwhelm any economic benefit of spreading the money around.



Despite all the brainpower in Washington, I do not think it likely that they will find the correct amount per person to make it doable (remember the \$300 per person in 2008 was not enough to have any lasting impact). So while it may be theoretically possible that there is some amount between \$300 and \$17,000 that will increase output without inflation, can we really have faith that the government will find it? And then deliver that magical number uniformly without resorting to the pressures of rent-seeking constituencies? There are too many problems for the helicopter option.

Creating money does not solve any of the lingering capacity and employment issues (itself an overcapacity of labor). The only way to restore functioning is to allow uncertainty to recede as a result of proper pricing and a widespread commitment to efficiency. Allowing those to establish a new equilibrium is the only way to move forward in an efficient, stable recovery. It should not seem like a novel idea, but governments should let investors that made

mistakes actually experience loss. Thinning the herd usually leads to healthy expansion. The desire to protect the banking system is entirely understandable in the context of the 1930's. But at some point these "experts" should begin to realize that their efforts to prevent a 1930's-style panic (which occurred anyway in 2008) is simply creating a 2010-style panic.

The question for investors is whether another 2009-type rally in stocks is possible. In our opinion the answer is a decided no. The rally in 2009 occurred under fundamentally different circumstances. The massive bailouts and interventions since then have rightfully jaded investors about their effectiveness. There is a good possibility that the announcement of QE 2.0 begins *a nasty decline in stocks*. For all the bluster and misleading, at some level investors know that if we need another massive intervention all is not well, and the V-shaped recovery has been dead and buried. If investors really need a sign of just how bad everything is, this would be it.

### Part 3 Venturing Into the Theoretical

So much of our work over the past ten months has been focused on the negative, on how events and circumstances have been trending toward gloom. At some point, just as it was for us in January and March 2009, we will again be writing about the chances for recovery – and maybe even a likelihood of success. In fact, as long-range investors and analysts, this is precisely what we need to be thinking about even now, on the eve of some nasty times. As the latter part of 2009 was the engine of portfolio profitability, so too will there be another opportunity at some distant date.

Defining what will make a recovery sustainable is no easy task in the patchwork network of Fed

entanglements, distorted markets and inaccurate pricing. Short of repealing any and all liquidity and fiscal spending (which is no longer possible) we need to anticipate how we can retreat back to a normalized financial and economic operation.

The effort is complicated by the fits and starts of any economic process. What we thought could be a recovery in the spring of 2009 has been turned into nothing more than a false dawn, an **overburdened recovery** and fool's rally. Given the desperate nature of the ruling political classes there are likely to be much more intervention to come, and probably more false dawns and fool's rallies. Our job as analysts and portfolio managers is clear: distinguish the



artificial from the real. By doing so we can ride the false ones and protect against their inevitable failure.

To really distinguish the real recovery from the false starts, we need to detour a bit into economic and monetary theory. So much of our current predicament is bad theory put into practice (I have made a living writing about it). Somehow monetary theory has morphed into a determined effort to control the cost of credit. Not the supply, but the cost. The underlying basis for this effort is that low costs will stimulate economic activity while high costs will retard it. And so the whole economy can be controlled simply through cost.

Much of this hubris can be traced to the early 1980's. Conventional wisdom has assigned a revered place for Paul Volcker and his "defeat" of inflation (for a very detailed explanation of why we vehemently disagree, please read our August 2009 report). The subsequent decline in consumer inflation that supposedly promoted economic growth and bull markets only entrenched that sense of control. Once control was added as a special power, the Fed's real mission got lost – changed from lender of last resort to manipulator of credit cost to master of the economy.

It was really reinforced in the early 1990's under Alan Greenspan. In his view, he successfully navigated the collapse of the savings and loan system (up to that time the largest financial collapse since the Great Depression) with only a mild recession in 1990. All of this was accomplished simply by changing the cost of credit. In reality, the supply of credit (we call it credit production) through monetary stimulus was completely unchecked and eventually led to two of the largest asset bubbles in human history. Yet the collapse of those bubbles has not changed the Fed one bit. It has retained both its hubris and its adherence to the cost of credit philosophy.

Now that we are in the throws of the liquidity trap (can anyone rationally argue otherwise? Mortgage rates are at historical lows yet mortgages and home sales fall by record

amounts.) it should be apparent that cost of credit is not the determining factor in economic activity. What we are dealing with is an overhang of capacity (both physical and labor) that was built on a massively imbalanced supply of money. Where current monetary thought put into practice falls apart is in taking into account the emotional reaction to the natural process of dislocation. This is particularly true when the dislocation is large. Recessions are scary, and large recessions are that much more unsettling.

You can print all the money in the world, but if consumers are uncertain of their funding sources they will not spend it. The same, unfortunately for the Fed, holds true for business and banking. Businesses will not spend without a reasonable expectation of profitability, and banks will not lend without the same.

The real road to recovery begins in price discovery. True price discovery in itself is not a cure-all, but it is a confidence booster. For firms (or in our current predicament, countries) that experience declining pricing and growing illiquidity, there is the survival motive to undertake hard measures to return to profitability (sustainability). By being forced into these measures, the marketplace itself is reassured of that commitment to efficiency. For firms that cannot meet efficiency goals, they are destroyed and their resources are reallocated by price action to stronger hands, or at the very least to persons with good ideas. Unfortunately, losses do occur, but the entire process is reassuring to investors on the whole, just as the weak hands serve as a stark reminder to all of the penalty for failure. The only way to avoid extinction is to recommit to efficiency at all levels of operation – faking it will not be enough.

For investors, a massive, economy-wide commitment to efficiency is very reassuring. So too are the price signals that highlight those firms that are not committed or whose commitment comes too late. This means dislocation and contraction, but every recovery is formed and sustained by this reallocation. Interfering in this basic mechanism leads to perpetual dysfunction. The only path to



economic success is a policy or policies that try to restore the normal mechanisms we described in Figure 1. And in many cases full restoration is not needed, only a solid commitment to getting there over time.

It does not matter if the Fed is actually smarter than all the rest of us put together. If its master plan includes heavy measures that are counterintuitive, it will create unease. And that unease is compounded exponentially as these measures move beyond counterintuitive into counter-historical. The public knows that printing money does not end well because it has *never* ended well. Despite the unending hubris of the Fed, the public also knows that the Fed's track record is not to be envied. It is rightfully common knowledge among the least educated that asset bubbles are created by too much money chasing too few financial assets. And that "too much money" is the purview of only one institution. The public may be forgiven for buying into the Fed's genius in the 1980's and 1990's, but not after the collapse of two of the biggest bubbles in history.

The Fed is *demanding* unwavering trust and a complete suspension of critical analysis. Yet its track record demands that someone take its power away. Our system is not a top-down system. In treating it as such, monetary authorities belie their public mandate to their supposed inferiors, betraying their supposed genius as the ignorance it really is. The Fed is trying to turn the financial system into something that is easier for it to manage. In doing so it is making it harder for individuals and investors to recognize it and participate in it. By trying to make it easier for itself, it is making it harder for those whom the system is supposed to serve. The Fed does not exist to serve itself, and should remember that once in awhile. It was not created to control everything, so it should cease the attempt. *In the effort to be master of the economy, the Fed looks at the dollar as nothing more than a means to an end.*

The value of our currency, the dollar, is not usually given much thought. In times of severe economic strain, its value is paramount simply because the value of everything else around is in

Restoring barbarity to the dollar and removing the power to print money from the Fed may seem like a crackpot theory from the fringe of economic thought. But it is not as far-fetched an idea as it may seem on the surface.

The need for universal currency is derived from a need for portability. The Federal Reserve Notes that now serve as currency have already been replaced to a large degree. Portability of deposit dollars is now accomplished by VISA, Mastercard and Amex. Using your debit card is nothing more than moving deposit ledgers from one bank to another – with no need to access debt guaranteed by any level of government.

The deposit currency from private banks is based on the same faith as the Federal Reserve – the ability to pay claims. At one time it may have been unthinkable to compare the value of the government's ability to tax with a private bank's ability to stay liquid and solvent, but these are very interesting times.

The FDIC would continue to guarantee depositors that should not bear risk, while responsibility for solvency and liquidity are enforced by disabling moral hazard. Corporate structures of banks may need to be realigned or altered to ensure that all stakeholders are fully represented – perhaps including initiatives that enforce primary motives toward depositors as opposed to equity shareholders. Maybe banks need to be stodgy old companies that value safety rather than sizzling stock opportunities. Appropriate risk decisions are largely taken out of the hands of management by full transparency, and enforced by the movements of depositors.

I am not suggesting such a transition would be easy, only that out-of-the-box thinking should not be dismissed out of hand. There would have to be a lot of pre-planning and educational efforts. It would take a lot of coordinated work, but the benefits should far outweigh any short-term disruptions.

The government's ability to expand and impact so much of the economy is a direct result of the unique ability to issue currency. And it shows no signs of relinquishing that power. Rather, it uses every failure as a rationalization to expand it into unsettling spheres. Sustainable prosperity at this juncture may only be accomplished by decentralizing currency authority while recommitting and limiting the Fed to its original role as lender of last resort. As long as it resorts to creating more and more money, the discipline the economy needs will remain elusive – and we will be stuck in a perpetual state of malaise.

If we believe that our current predicament has been created by abuse of power, as we have demonstrated these past few years, then removing that ability is the logical conclusion.



doubt as price discovery does its dirty work. Consumers and businesses want to know how they will survive during and after economic dislocation.

The value of sound currency becomes apparent as consumers and businesses realize their exposure to being on both sides of transactions. High inflation reduces the value of savings as purchasing power erodes over time. Deflation punishes borrowers since they will have to give up greater purchasing power to repay their debts in the future. Businesses and individuals are both savers and borrowers at the same time. They are affected by changes in currency values in both directions. Uncertainty reigns when the value of the dollar is not stable.

By incorporating dollar creation into its efforts to “rescue” the financial system and the economy, the Fed has created and deepened one of the most powerful forces of uncertainty. This is particularly true now that the dollar itself has no intrinsic value. The further our currency falls into uncertainty, the harder it will be to rescue. At some point, once faith in fiat is breached, the only way to restore it will be to renew some form of intrinsic value – either through convertibility or codified scarcity.

Most people do not realize that the currency we use today has not been used in the past. Before 1971, each dollar had a theoretical ability to be converted into gold (only by central banks). Before 1913, currency was not even issued by a government institution. Private banking entities issued bank notes that were directly convertible into gold. There was no need for a central bank to issue universal notes since purchasing power was not derived from the currency itself. As long as the issuing entity had reasonable access to gold (and could reasonably stay solvent) its paper held purchasing power.

Money supply was controlled in the pre-Fed period by the quantity of gold (with some notable exceptions during the Greenback period and the Silver agitation period). A miner could walk into any bank and deposit gold in exchange for some combination of deposit credit (for ease of savings) and bank notes (for ease of

spending). That bank, now having gold on reserve, could expand the amount of loans it underwrote, expanding credit.

The gold standard itself did not lead to the boom/bust cycle, but its peculiarities did. Here I have to agree with the Austrian School in that improper control of money and interest rates are responsible for the business cycle. Since the intrinsic value of the currency was derived from a metal found naturally in the ground, the amount of currency could expand or contract based on nothing more than the efficiency of mining operations.

The money supply was also directly impacted by gold as the only accepted form of foreign exchange. When the US agricultural harvests were robust in comparison to Europe (in particular) it would mean a large amount of gold would be added to reserves in the US as trading partners used the metal to pay for the trade imbalance. That would also loosen the money supply based on nothing more than favorable weather.

So while gold provided intrinsic value for currency it was not a panacea. The challenge is to find some way to provide intrinsic value to what should be nothing more than a medium of exchange. Short of outright bartering there is no perfect answer, but fiat currency is definitely not it.

Intrinsic value for currency is valuable in a monetary regime precisely because it adds certainty. Investing has reduced risk if the ability of future currency payments to purchase goods and services is very similar to the present ability. If currency itself were a solid, predictable store of value because it has value of its own the investment process would be much simpler. It would reduce the channels for potential uncertainty. Currency debasement is impossible if a central bank has no ability to create money.

The act of saving is now relatively more important (as opposed to valuable) than the act of spending because the Fed has introduced doubt into the currency. It is entirely logical to



believe that since the Fed monetized debt once, it can do it again on nothing more than its own perverted outlook. Spending velocity falls because the viability of current savings has been called into doubt from the historical record of money printing failures. Those failures were spectacular enough to force humans into the wholly rational decision to worry about the value of future spending power, and to ration current income accordingly.

The Fed wants us to just blindly follow its policies. But since the vast majority of investors are not classroom students of the stupendously smart economists, the failure of the brilliant class to predict and act on the last two bubbles overwhelms any proclivity to give the geniuses the benefit of the doubt. The further the Fed violates the principles that humans have been using to establish well-defined economic lives, the more people will retreat into economically damaging trade-offs (in the current time period, the trade-offs become beneficial to the economy over time). And the only way to get them out of this shelter mentality will be to take the currency out of the hands of the monetary authorities.

By restoring some form of barbarity to the currency, the people's faith in it will return. The tired act of the Fed loudly and condescendingly proclaiming its superior understanding of currency is now counterproductive. Monetary authorities need to do the opposite – denounce debasement and embrace scarcity. By acknowledging past mistakes and committing to learning from them, the Fed will gain new credibility for itself and our currency. And once committed to the policies of a sound currency, the Fed must stick to it even if it means making the same hard decisions that fiscal authorities are

forced to in times of illiquidity. The sole reason the Fed was given “independence” from the political process was so it could make those hard decisions. Standing in the wreckage of the Fed chasing the easy way out time and again, there are few outside the classroom that would argue for a bubble redux.

When the US left the gold standard in 1971 the Fed was given the same responsibility that gold had: enforcing a physical limit to the currency. Instead of accepting that responsibility it has done everything else. It got away with it because of circumstances – asset inflation was welcomed, at first. Now the folly is in full view and few welcome the destruction that follows bubbles. Going down the same road of massive credit production and monetary debasement is seen as suicide by a growing number. The resistance to the genius plan of even more of the same is grounded in empirical reality while the schemes of the authorities have no basis in experimentation, yet we are supposed to yield solely on credentials?

The damage has been done both to the economy and the Fed's credibility. The more worthless academic papers it publishes the more the informed investors are convinced it should not be allowed to possess the switch to the printing press. These are the very same investors that are now moving massive amounts of money to safe havens, signaling to the rest that all is not well. The more monetary initiatives are undertaken, the more the public wants to see results over talk. The more the results are the opposite of success the more the public will resist. While the public may not be preoccupied with the Fed in any visible political sense, it is definitely voting with its wallet and investment portfolio.



## Conclusions

It is extremely unlikely that the markets are expecting a severe slump in both the economy and financial system. The possibility has been raised in the past month but is still, for this market, an open question. Because of this, in my opinion, an announcement of an intention to implement another round of quantitative easing would be very damaging to those expectations. In short, it would have the effect of simultaneously confirming the bearish case and discrediting all previous monetary and fiscal “rescues”. A market that is priced for perfection will not stand a healthy dose of reality.

As the economy begins to sink again, what chance is there that the Fed stays on the sidelines? Its massive volumes of academic posturing support the theory that it will most assuredly act. And act in a big way. It no doubt believes that if QE 1.0 failed it was not because the theory was wrong, it was because the Fed just needs *more power*.

A large program of QE 2.0 will exhaust itself of the bank reserve option. Interest rates are at zero already so there is no need to throw printed money into Fed funds. The likely target will be direct debt purchases of more US Treasuries, municipal debt and even stocks.

If the stock markets suffer a significant decline I would expect the Fed to commit funds directly purchasing equities (a TARP program on

steroids). The political backlash would be intense, but the Fed would use exigent circumstances language to justify the program expansion. And ironically, it would be using fear as a means to *prop up* prices!

For all the reasons cited in this report, *such a program would not only fail it would be counterproductive*. Throwing money at the structural issues within our economy is not the answer. The economy must be allowed to return to its natural state, removing uncertainty. Prices must be allowed to signal resource reallocation. Overcapacity must be allowed to idle and transform. These processes are how recoveries are formed and sustained.

Authorities must commit to the basic principles of scarcity and efficiency. Fiscal bodies are getting that message worldwide – whether or not they follow through is a separate topic. There has to be a concurrent commitment of monetary institutions to enforce barbarity. The more intervention we get the less faith the interventions engender. Currency barbarity is the only way to demonstrate that true economic power no longer resides in those that made this mess in the first place. By taking away the fool’s option of money printing, the discipline that is enforced on companies, individuals, governments and economies will be reassuring in a way that no genius academic plan could ever be.



## Endnotes

<sup>1</sup> “Economics is Hard. Don’t Let Bloggers Tell You Otherwise”, Dr. Kartik Athreya. Research Department, Federal Reserve Bank of Richmond. June 17, 2010.

<http://www.scribd.com/doc/33655771/Economics-is-Hard>

<sup>2</sup> “Fed’s Bullard Says Could Do More Quantitative Easing If US ‘Got Into Bad Downturn’”, Tyler Durden. Zero Hedge, May 25, 2010.

<http://www.zerohedge.com/article/feds-bullard-says-could-do-more-quantitative-easing-if-us-got-bad-downturn>

<sup>3</sup> Speech before the Committee on Banking, Housing, and Urban Affairs, US Senate September 23, 2008 by Federal Reserve System Chairman Ben Bernanke.

<http://www.federalreserve.gov/newsevents/testimony/bernanke20080923a1.htm>

<sup>4</sup> “Domestic Open Market Operations During 2008”. A report prepared for the Federal Open Market Committee by the Markets Group of the Federal Reserve Bank of New York, January 2009. Pages 8-10.

<http://www.newyorkfed.org/markets/omo/omo2008.pdf>

<sup>5</sup> “Economists Raise U.S. Growth Forecast”, Joseph Bonney. The Journal of Commerce, May 24, 2010.

<http://www.joc.com/logistics-economy/economists-raise-us-growth-forecast>

<sup>6</sup> “Spain’s Successful Bond Auction Prompts Sigh of Relief”, William L. Watts. MarketWatch, June 17, 2010.

<http://www.marketwatch.com/story/spain-bond-auction-prompts-sigh-of-relief-2010-06-17>

<sup>7</sup> “Sen Kaufman Ties Diebold Stock Swing To Flash Crash, Seeks Inquiry”, Jacob Bunge. The Wall Street Journal Online, June 16, 2010.

<http://online.wsj.com/article/BT-CO-20100616-710635.html>

<sup>8</sup> “U.S. Stocks Retreat as Treasuries, Dollar Gain on Housing Data”, Nick Baker. Bloomberg BusinessWeek, June 16, 2010.

<http://www.businessweek.com/news/2010-06-16/u-s-stocks-retreat-as-treasuries-dollar-gain-on-housing-data.html>

<sup>9</sup> “Fannie, Freddie Stock To Be Delisted From NYSE”, Lorraine Woellert. Bloomberg, June 16, 2010.

<http://www.bloomberg.com/news/2010-06-16/fannie-freddie-stock-to-be-delisted-from-nyse.html>

<sup>10</sup> “Reporting Error Triggers Citi Circuit Breaker”, Donna Kardos Yesalavich. The Wall Street Journal Online, June 30, 2010.

<http://online.wsj.com/article/SB10001424052748704103904575336834002120488.html>

<sup>11</sup> “Central Banks Diversifying Into Gold – Bolstering Meager Gold Holdings”. International Business Times, June 21, 2010

<http://www.ibtimes.com/articles/29706/20100621/gold-silver-platinum-palladium-rhodium-precious-metals.htm>

Atlantic Capital Management of Florida, Inc., is an SEC registered investment advisor. Atlantic Capital's Form ADV, Parts I & II, are available upon request or online at [www.adviserinfo.sec.gov](http://www.adviserinfo.sec.gov). Atlantic Capital's Disclosure Statement is also available upon request. All research and analysis is done by ACM staff. All Special Research Reports are for educational purposes ONLY. These reports do not take into account specific investment criteria of individual clients. All opinions expressed are current opinions as of the date indicated on the reports and may be changed without notice. Information obtained from various sources is believed to be reliable but ACM makes no guarantee of the accuracy or completeness of such information. No investment recommendations are given or implied. Past performance is no guarantee of future results.

© 2010 Atlantic Capital Management.



## **ACM INSTITUTIONAL SERVICES**

580 VILLAGE BLVD, SUITE 315

WEST PALM BEACH, FL 33409

1 (888) 810-1588

[www.acminstitutional.com](http://www.acminstitutional.com)