SUMMARY

With the phasing out of QE II by the Federal Reserve, received wisdom from the economic cognoscenti suggests that medium to long term interest rates, specifically yields on U.S. Treasury debt, will substantially increase as the lagged effects of $1.5 trillion in new reserves explode the nation's money supply resulting in rampant inflation. This tract explores the antipodal view that a combination of no new quantitative easing programs by the Fed, a cinctured banking system, an improving dollar, and an attendant sell-off in risk assets (i.e. equities and commodities) will result in dramatically lower yields on this asset class.

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THE END OF QE II – WHAT TO EXPECT – A DIFFERENT VIEW

On June 30,2011, the financial community will bid farewell to QE II, a $600 billion dollar program instituted by the Federal Reserve intended to revive the animal spirits of our flagging economy through an expansion of the money supply over an eight month period commencing last November, 2010. The incentive for the implementation of this monetary demarche was the realization by the Fed that the banking system could not at this time be relied on to catalyze economic restorative lending due to the aftermath of the 2008-2009 crippling housing meltdown and its devastating effect on bank capital ratios. To be sure, the banking system's adoption of a "once burned, twice shy" mantra to lending, new restrictive regulations imposed by Basil III and borrower's newfound religion in de-leveraging made for a lending-borrowing stalemate. Lacking roborant lending and borrowing, money multiplier expansion, the life's blood innervating recovery in the real economy through investment, spending, production and employment, was rendered feckless.

The Fed's objective, then, was to galvanize economic activity. But without requisite borrowing and lending, what would be the operative mechanism? Enter POMO, or Permanent Open Market Operation. Under this regime, the Fed would inject fresh reserves into the system by purchasing from the primary dealers Treasury notes and bonds to be held on their balance sheet "permanently." Now in the usual context of Fed policy implementation, a small injection of reserves, say $5 billion, goes a long way. To wit, the successive rounds of customary and usual bank lending to economic factors (i.e. retail, industrial and commercial borrowers) would allow the Fed to sit back and watch the money multiplier work its magic, multiplying the $5 billion by a factor of ten to a $50 billion increase in the money supply. But therein lay the rub. Ben Bernanke correctly reasoned that given the shell-shocked banks' disincentive and diffidence to lend and economic factors' desire to borrow, the multiplier dynamic would be crippled, if not bootless. He also understood the psychological aspects of the problem. Economic factors were desolated in the aftermath of the bursting of the housing bubble, causing massive

devaluation of their asset bases and subsequent forced de-leveraging. A "feel good" palliative was desperately needed. And what better way to instill that feeling than to re-inflate those debased assets, primarily embodied in stock market equities? If folks felt richer by the appreciation of their portfolios, surely borrowing would follow. But wait, if banks weren't willing to lend and wealth holders not willing to borrow, then wouldn't all those new reserves simply be held fallow by the banks in their respective Federal Reserve District Banks as excess reserves, unable to bid up equities and other assets? Absolutely not. In point of fact, NO bank lending is required to achieve this end. Here's how it works: Lets say the Fed in injects $10 billion into the system buying Treasury notes from primary dealer nonpareil Goldman Sachs. Goldman deposits that $10 billion into its account at JPMorgan-Chase bank and the money supply thereby increases by $10 billion. Assume Chase is not interested in lending any part of this $10 billion at all, and so it sits inertly at the New York District Federal Reserve Bank as excess reserves (remember, Goldman Sachs still has credit for those dollars at Chase.) Will Goldman simply hold this credit as a demand deposit inertly? Absolutely not. Wanting to deploy this wad of dough into an earning asset, it buys $10 billion worth of stocks from a hedge fund in San Francisco. The buy bids up those stocks and the seller deposits proceeds from the sale into its bank account at Bank of America. The excess reserve of $10 billion at the New York Fed District bank is now transferred to the San Francisco Fed District Bank. The hedge fund having sold stock, now opts to purchase gold and other commodities, bidding up the prices of those risk assets. And so it goes, successive rounds of sales and purchases of equities, commodities, etc., inflating their prices notwithstanding massive excess reserves in the banking system remaining constant throughout the process.

Adding to the trenchancy of this first order effect of outright and outsized purchases of Treasury debt, Chairman Bernanke also had hoped that the there would be add-on second order effects through the agency of lower yields across the entire term structure of the yield curve, inducing wealth holders to switch from riskless (presumably) Treasury instruments into more risk intensive asset classes, thus furthering the cause of "feel good", wealth enhancing inflation. However, subsequent empirical evidence often proved this not to be the case as fears of inflation generated by a money supply expanding by another $600 billion, in addition to the $900 billion injected from QE I, sent yields on Treasuries spiraling in the opposite direction. However, what Bernanke knew that most monetary pundits, panjandrums, nawabs and grandees did not, was that as long as banks remained indisposed to lending, inflation across the broad spectrum of the real economy would remain tame while the narrowly sectorialized risk asset classes would inflate. The only real problem facing the Fed was the specter of banks attempting to rid themselves of these excess reserves in the overnight market, thereby destabilizing the Fed funds rate by driving it lower than the Fed's stated rate peg. Such an eventuality would have defeated the entire QE II strategy by forcing the Fed to absorb the very funds it had just injected. Bernanke neatly solved this problem by paying the Fed funds rate (i.e. 25 bps) on excess reserves.

The foregoing narrative exposited the two pronged effects on risk assets promulgated on the domestic side of the equation. Our external sector (i.e. foreign trading partners) exerted yet another important force through auspicious currency translation. Perceived

brobdingnagian increases in our money supply (we'll get to reality versus perception in a bit) hammered the dollar in the forex markets. With the preponderance of commodities and, of course, our equity market being priced in dollars, suddenly a given amount of foreign currency would purchase an increased amount of any and all commodities and U.S. equities, adding an addition fillip to the appreciation of risk assets. In other words, to cast it in economic parlance, our foreign trading partner's demand curves shifted to the right and they went on a buying binge. What is more, the prices of all goods and services offered in the U.S. for export became relatively cheaper vis a vis the foreign currencies, thus buttressing our GDP. Of course, by the same token, imports became dearer, thus possibly offsetting the benefit of increased exports on our merchandise trade account.

A very interesting observation to note is the perception of many economic commentators and the public at large that the Fed has overindulged the "printing presses" and flooded the market with dollars in its latest QE II foray. This could not be farther from the truth. In point of fact, while the Fed has added about $648 billion in fresh reserves from November, 2010 to June 15, 2011 *(Federal Reserve Board of Governors – H3)*, the money supply as measured by M2 has only grown by $310 billion in roughly the same time period *(Federal Reserve Board of Governors – H6)*. Contraction of the money supply to the tune of $338 billion by dint of the run-off of retail, commercial and industrial loans by the banking system has been responsible for that diminution. The normally close correlation between the monetary base (i.e. total reserves plus currency in circulation) and the money supply has been temporarily suspended during this period due to the absence of any significant bank lending and the consequent money multiplier expansion. Had QE II not been implemented at all, M2 would have actually declined by that $338 billion. And when the numbers are finally in this next November, it will be seen that M2 probably expanded at a rate of somewhere between 3-5%, a very nominal expansion at best. The world's hue and cry about the unfettered printing presses at the Fed is hyperbolic at best and totally fallacious at worst, which brings us to the concluding commentary – what to expect.

With the termination of QE II on June 30, 2011, the perception of a runaway money supply will be quickly disabused, especially so if lending contraction by the banking system continues with no QE offset and M2 languishes, or even declines. This realization will give a bid to the dollar simply on the basis of the cessation of expansion of the money supply. Ongoing instability in the EU with respect to the PIIGS indebtedness plight will persist despite the temporary monetary fixes applied by the EU, the ECB and IMF, which in the end will have proven ineffectual and profligate, given the ineluctable result of punitive austerity programs…default. That sword of Damocles, in turn, will keep the Euro back on its heels with respect to the greenback and give additional lift to the dollar. The combination of the absence of QE funds bidding up risk assets plus a firmer dollar turning the forex terms of trade for those risk assets relatively more expensive for our foreign trading partners will result in a falloff in demand for commodities and equities and a consequent decline in their prices, perhaps a precipitous one given the bubbles that the opposite dynamic has created. With the unwind, a flight to quality will ensue, wherein the prettiest of the uniformly ugly alternatives will predominate and prevail….U.S. Treasuries. As long as the dollar is the reserve currency

of the world, the vehicle of choice during troubled times will be unequivocally the least risky dollar denominated assets….U.S. Treasuries. Those who would espouse rampant inflation and higher interest rates for the near future will have adopted faulty and flawed reasoning and they ultimately will be proven wrong, notwithstanding short term technical corrections (i.e. firming rates) in U.S Treasuries.