> "The Federal Reserve is fully committed to both sides of its mandate—to price stability as well as to maximum employment--and it has both the tools and the will to act at the appropriate time to avoid any emerging threat to price stability."
>
> ***Ben Bernanke, Chairman of the Federal Reserve Bank***

"QE3" – The Policy and the Consequences

Since the 1930s, the American government has played a major role in "**managing the economy**" through various policy tools from **fiscal policies** of taxation and spending to **monetary policies** of increasing or decreasing interest rates. For much of the latter part of the 20th century to the present, the monetary policy of the Federal Reserve (Fed) has been recognized as the primary tool by which the economy is "managed". In fact, the Fed's congressional mandate is not only to serve as the bank of last resort, but more importantly, to fulfill three policy objectives: strengthen economic growth, ensure price stability, and strive toward full employment.

Quantitative Easing – The Fed's "New" Policy

Since the economic downturn in 2008, the Fed has instituted a new practice of ***Quantitative Easing*** (QE) – a monetary policy tool aimed at stimulating economic growth by purchasing financial assets from commercial banks, namely mortgage-backed securities, with the goal of injecting newly created money into the economy. The theory behind the QE tool is that when the Fed buys such assets from commercial banks, the new money increases **excess required reserves** by removing the asset from the bank's balance sheet and thereby replacing the asset with **new cash**. With more cash on reserve, the bank enhances its liquidity and can increase its supply of loans to consumers who therefore increase the probability of priming economic growth through purchasing, investing and hiring. Since 2008, the Fed's QE policy has done the following:

- **QE1 (2008-2010):** Fed purchased $1.25 trillion in mortgage-back securities (MBS) from both commercial banks, $175 billion in agency debt (a security, usually a bond, issued by a U.S. government-sponsored agency such as Fannie Mae student loans or Freddie Mac home loans) and $300 billion in U.S. Treasuries.
    - **Expectation** – to lower mortgage rates and increase availability of credit to homebuyers
    - **Results** – mortgage rates have dropped to historically low rates

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- **QE2 (2010-2011):** Fed continued to reinvest payments on securities purchased during the QE1 program. Additionally, it began to purchase $600 billion of long-term U.S. Treasury securities.
    - **Expectation** – to promote a stronger pace of economic recovery from even lower mortgage interest rates
    - **Results** – mortgage rates actually spiked more than 20 basis points higher than when QE2 started

- **Operation Twist (September 2011):** Fed purchased $400 billion of short and long-term Treasuries.
    - **Expectation** – lower long-term interest rates without printing new money
    - **Results** – strengthened U.S. dollar and brought risk aversion into the equity markets
        - Program was revisited in June 2012 and extended through the end of 2012 with an additional $267 billion in Treasuries

- **QE3 (September 13, 2012 – indefinitely):** Fed plans to purchase $40 billion in agency mortgage-backed securities per month until the employment market sees a sustained improvement – or, stated differently, when unemployment is significantly lower.
    - **Expected Results** – bring down ‘high’ mortgage rates as one of the primary barriers to the economic recovery (according to the Fed) while also pushing investors into more risky assets due to the lowering yields from the MBS

Quantitative Easing – The Consequences

Whether you agree or disagree with the Federal Reserve’s recent “**monetary policy accommodations**” such as the QE programs, the best advice for the investor is to understand what the Fed is and what it does. So, we endure by minimizing unnecessary risk and plan around what we know about the impact of any government policy aimed at influencing economic outcomes. The fundamental responsibility of any central bank is to serve as the bank of last resort to the commercial banking industry while also setting the policy domain from reserve requirements to interest rates. In the case of the United States Federal Reserve, the institution must also adhere to congressional law to influence economic growth, minimize unemployment and maintain price stability.

The Fed recognizes that the U.S. and other industrial nations are driven by adding economic growth through production and consumption. Consequently, firms that produce goods and services require loans to grow and consumers need financing to acquire. Simply look at a family’s or small to large business’ balance sheet, and there is usually an asset being financed by a bank. Therefore, to suggest that the Fed can impact economic growth, maintain price stability and pursue full employment with a twist of interest rates and, most recently, asset purchases, is exceptionally clever, while also immensely risky. Nevertheless, it is the system we have and forsaking a congressional change of heart, unlikely to change its function and influence anytime soon.

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What's Next?

When the Fed announced QE3 on September 13, 2012 with its $40 billion monthly purchases of MBS with no target end-date, we must read the clear message that the Fed believes the economy is a long way from fully recovering. Yes **equities** are strong – well managed companies are always rewarded for creating tangible value. Even gold has moved higher from its latest decent. Interest rates remain low benefiting the homeowner, yet at the cost of savers who must accept lower yields and find higher-risk vehicles. Inflation is also projected to remain low for the foreseeable future even with the new QE3 money being infused into the banks. But the elephant in the room remains the **Fed's balance sheet** where all of these asset purchases find their home:

- Every month in 2013 the Fed will increase its balance sheet by $85 billion, consisting of $40 billion in MBS and $45 billion in 10-30 year Treasuries thus monetizing roughly half of the U.S. budget deficit in 2013
    - **Visualized differently**
        - the Fed's balance sheet will increase from just over $2.8 trillion currently, to $4 trillion at the end of 2013
        - currently, the number of assets as a percentage of U.S. GDP the Fed holds on its balance sheet is 18%
        - by the end of 2013, the Fed's total assets from all operations will account for 24% of U.S. GDP

Eventually, or perhaps never, these assets will have to be unwound from the Fed's balance sheet and returned to the market. To suggest that we would 'lose' 24% of U.S. GDP is unthinkable. So, the 2008 "new normal" endures and we navigate not with hope, but with clarity because it is clarity that yields wisdom and through wisdom our judgments are strong. No matter how complex or political the economy remains, at Banta ***we*** "manage" the economy through tested fundamentals by seeking results for our clients from **great** companies, producing **great** value with **great** strategies.

With continued confidence,

Banta Asset Management