

SPECIAL REPORT

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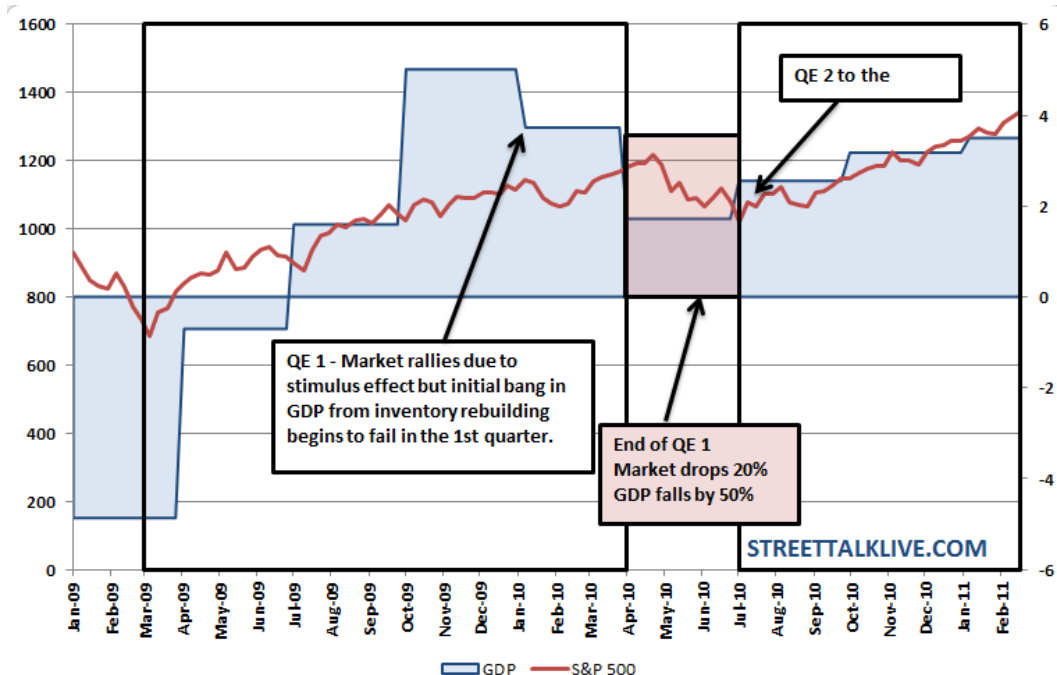
How Is The Fed Pushing Up Asset Prices by Lance Roberts



I have received a lot of emails questioning how the Fed is targeting asset prices in order to try and restore consumer confidence in order to hopefully restart the economic engine. This year the market remains extremely elevated due to the tremendous amount of liquidity being injected into the market by the Federal Reserve over the last few months. However, the question is DOES the Fed actually increase asset prices by their intervention. The answer is fairly obvious when you look at the chart below. Upon the end of Quantitative Easing (QE) 1 both the market and the economy began a fairly rapid descent – the market declined by almost 20% and the economy slid by almost 50% from a 3.5% growth rate in GDP to a 1.7% growth rate. The Federal Reserve, upon recognizing that the economy and the markets could not operate without the injections of liquidity, began injecting liquidity again at the end of August. The rest, as they say, is history.

As the chart to the right shows the market accomplished in just two years what it took 5 years to complete after the previous market crash in 2000. There are a lot of issues with this in terms of the “health” of the advance as there is very little supporting the rise in assets prices in relation to the fundamental strength in the economy.

The important part to remain focused on is that it is NOT the here and now that we are concerned with when managing risk in portfolios but the future results of those risks when things go wrong. As an investor you must ALWAYS remember that it is not the rise in the markets that is dangerous – it is the depth of the inevitable correction that is the killer. Unfortunately the timing, or cause, of such a correction is always a mystery – the only thing that isn’t; is the certainty of it.



How Does QE Work And Who Are The Players?

Most of the emails we receive each week are from individuals trying to grasp how **Quantitative Easing (QE)** from the Federal Reserve works and how their monetization efforts push up stock prices. I am not going to dig into all of the microscopic details but rather use a broader brush to illustrate the process and the players.

Quantitative easing (QE) is an unconventional monetary policy used by Federal Reserve to stimulate the economy. The central bank creates money which it uses to buy government bonds and other financial assets, in order to increase the money supply and the excess reserves of the banking system; this also raises the price of the financial assets bought which effectively lowers their yield at least in theory. However, in reality interest rates have risen during BOTH QE programs as holders of the bonds dumped them in order to move into equity based assets thereby driving the market higher.

Expansionary monetary policy normally involves a lowering of short-term interest rates by the central bank.

However, **when such interest rates are either at, or close to, zero, normal monetary policy can no longer function**, therefore quantitative easing is being used by the Federal Reserve in order to try and keep interest rates lower further out on the yield curve in hopes of stimulating the real economy.

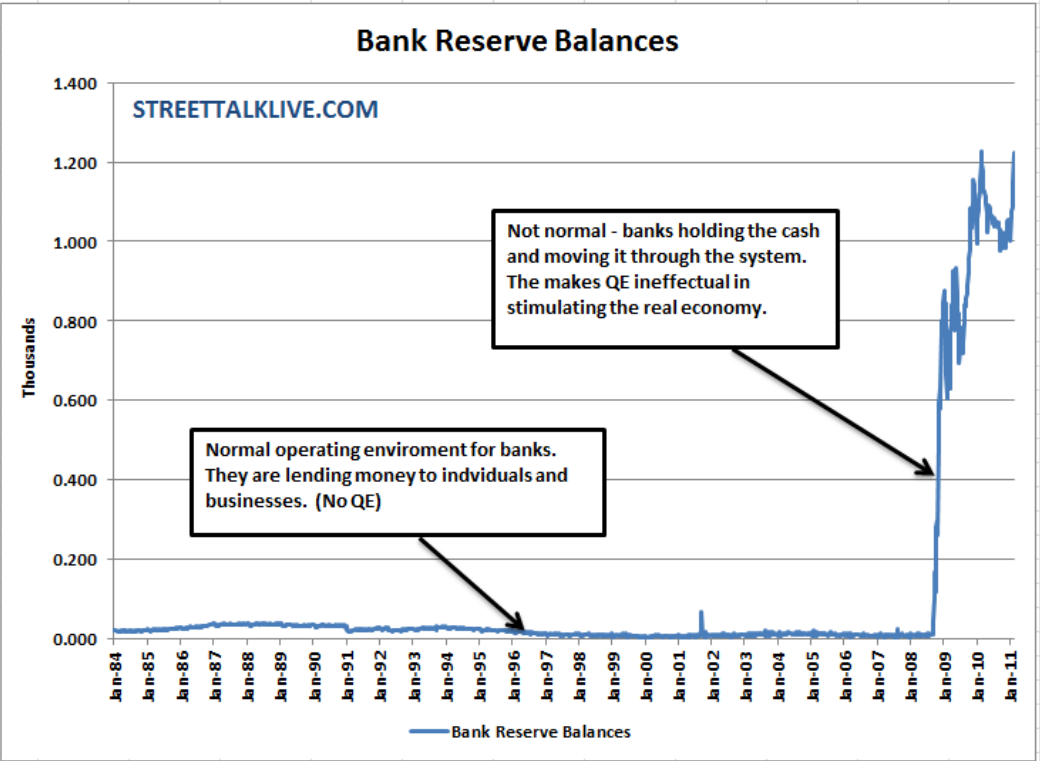
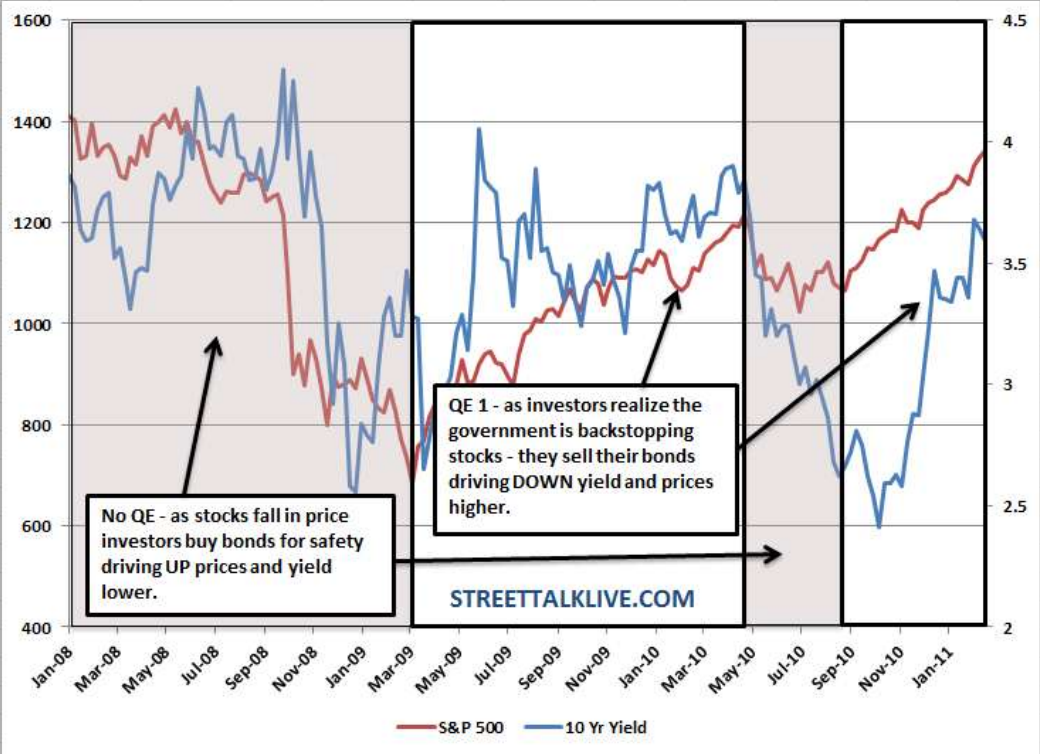
The risks is that the banks opt simply to sit on the additional cash in order to increase their capital reserves in a climate of increasing defaults in their present loan portfolio which thereby renders the QE program ineffective in stimulating the real economy.

This is, of course, EXACTLY what the banks are doing as shown in the next two charts. Since the introduction of the QE programs the banks, which are still plagued with the hangover of bad loans, toxic assets, and poor balance sheets have discovered the new nirvana – FREE MONEY.

Since the Fed is still employing a zero interest rate policy (ZIRP) the banks are able to borrow from the Fed at no interest and then buy US Treasuries from the government with a 3.6% yield currently. That is a very profitable spread for banks to make. Then they can leverage these treasuries several times to make other investments with such as buying equities.

In other words, why would they take the chance of loaning the money to individuals or businesses that potentially WON'T repay the loan versus buying at a guaranteed profit margin?

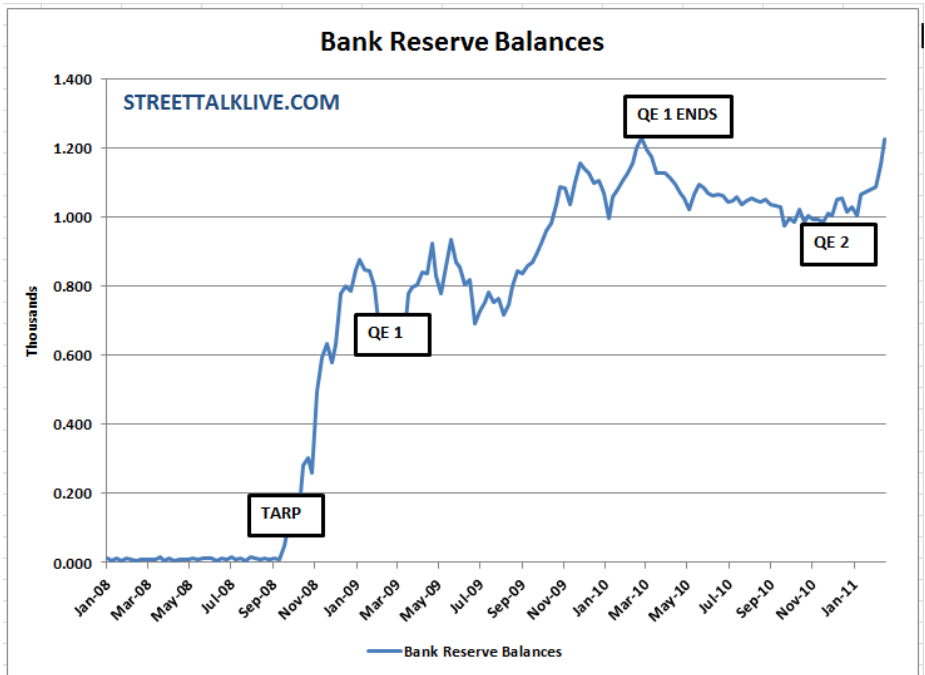
The next chart really shows where the rise in bank reserves started although there is really not much of a surprise in store for you.



There is also, tied into the QE program, a less well known program called Permanent Open Market Operations (POMO) where the Fed also buys certain US Treasuries out of the open market place to inject liquidity into the system. These two programs combined are slated to inject \$1.5 Trillion into the financial markets between September of 2010 and June of 2011.

Last week we posted the most current schedule of POMO's currently taking place which is why you continually see markets open down in the morning and finish higher in the afternoon. Here is the schedule for the upcoming two weeks.

Just so you don't have to take the time to break out a calculator that total is between \$57 Billion and \$73 Billion JUST from the POMO program between this coming week and March 10th.



But the real questions still remain. Who are the players and how does this system work?

I have put together a fairly simple diagram on the next page which I hope explains the relative Ponzi scheme...uh...I mean "government program" in a bit more clarity. Again, just for the record this is a fairly simplified diagram and excludes a lot of the minutia that goes on behind the scenes with a program of this size and scope.

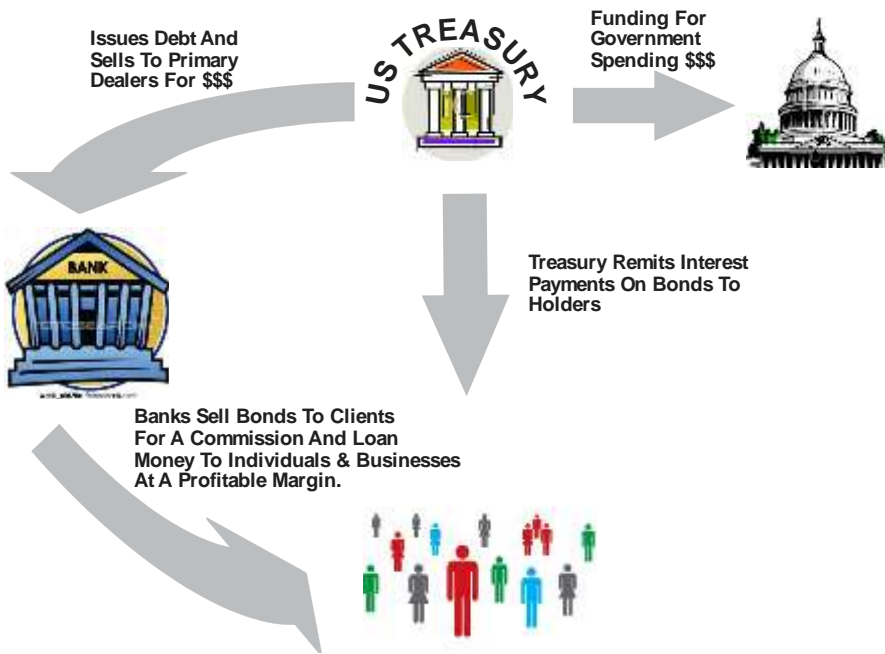
Of course, the next question we will answer is just how much of the private sector has been transferred to the public sector (the tax payer).

As you will see in the first diagram in a normal economic environment (prior to 2007) the Treasury would issue bonds for the raising of funds to meet government spending needs such as Social Security, Medicare and Defense.

These bonds were sold to a group of 20 primary dealers as shown on the next page.

OPERATION DATE ¹	SETTLEMENT DATE	OPERATION TYPE ²	MATURITY RANGE	EXPECTED PURCHASE SIZE
February 18, 2011	February 22, 2011	Outright Treasury Coupon Purchase	08/31/2013 – 02/15/2015	\$5 – \$7 billion
February 22, 2011	February 23, 2011	Outright Treasury Coupon Purchase	08/31/2016 – 02/15/2018	\$6 – \$8 billion
February 23, 2011	February 24, 2011	Outright Treasury Coupon Purchase	08/15/2028 – 02/15/2041	\$1.5 – \$2.5 billion
February 24, 2011	February 25, 2011	Outright Treasury Coupon Purchase	08/31/2012 – 08/15/2013	\$4 – \$6 billion
February 25, 2011	February 28, 2011	Outright Treasury Coupon Purchase	05/15/2018 – 02/15/2021	\$6 – \$8 billion
February 28, 2011	March 1, 2011	Outright Treasury Coupon Purchase	08/31/2013 – 02/15/2015	\$5 – \$7 billion
March 1, 2011	March 2, 2011	Outright Treasury Coupon Purchase	08/15/2028 – 02/15/2041	\$1.5 – \$2.5 billion
March 2, 2011	March 3, 2011	Outright Treasury Coupon Purchase	03/31/2015 – 08/31/2016	\$5 – \$7 billion
March 3, 2011	March 4, 2011	Outright Treasury Coupon Purchase	05/15/2018 – 02/15/2021	\$6 – \$8 billion
March 4, 2011	March 7, 2011	Outright TIPS Purchase	04/15/2013 – 02/15/2041	\$1 – \$2 billion
March 7, 2011	March 8, 2011	Outright Treasury Coupon Purchase	09/15/2013 – 02/28/2015	\$5 – \$7 billion
March 8, 2011	March 9, 2011	Outright Treasury Coupon Purchase	09/30/2016 – 02/28/2018	\$6 – \$8 billion
March 9, 2011	March 10, 2011	Outright Treasury Coupon Purchase	03/31/2015 – 08/31/2016	\$5 – \$7 billion

The Way Money SHOULD Flow Through The System



BNP Paribas Securities Corp.
Barclays Capital Inc.
Cantor Fitzgerald & Co.
Citigroup Global Markets Inc.
Credit Suisse Securities (USA) LLC
Daiwa Capital Markets America Inc.
Deutsche Bank Securities Inc.
Goldman, Sachs & Co.
HSBC Securities (USA) Inc.
Jefferies & Company, Inc.
J.P. Morgan Securities LLC
Merrill Lynch, Pierce, Fenner & Smith Incorporated
MF Global Inc.
Mizuho Securities USA Inc.
Morgan Stanley & Co. Incorporated
Nomura Securities International, Inc.
RBC Capital Markets, LLC
RBS Securities Inc.
SG Americas Securities, LLC
UBS Securities LLC.

These 20 primary dealers would then “normally” sell those bonds to clients (at a commission) or use them internally to fund lending practices and to secure certificates of deposit. The banks netted the difference between what they bought the bonds for from the Treasury and the commission that they received when they sold the bonds to clients.

The Treasury would then remit interest payments to the end holders of the bonds whether it be individuals, foreign entities or governments. The dollars the Treasury received from the sale of the bonds is then used by the government to meet spending needs. This is why we are currently wrestling with a “debt ceiling” issue so that the Treasury can issue MORE debt to meet current and future spending needs.

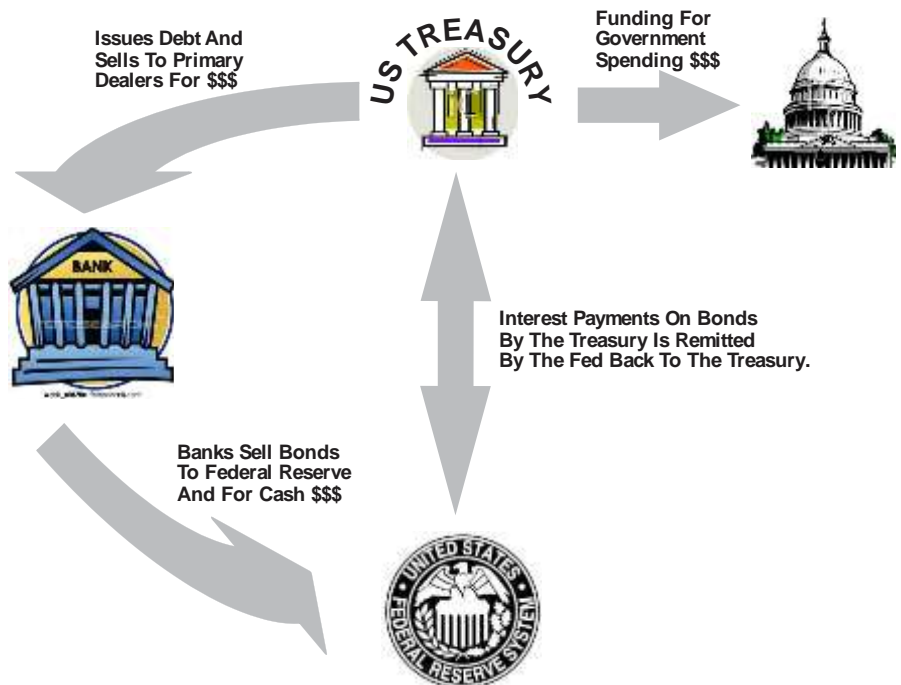
However, in today’s world the Federal Reserve has no inserted itself into the equation and effectively removed the end buyer from the system.

In this new dynamic the Treasury issues the bonds just as before and the Primary Dealers purchase the bonds at auction giving the Treasury the needed capital to meet governmental spending needs. This time, however, the primary dealers hold the treasuries rather than selling them off. They can then leverage the instruments internally through their investment operations and invest the proceeds into equities.

The primary dealers are now carrying leverage on their books which is okay because they are fully aware, since the Federal Reserve publishes a list as we have shown above, that they will be able to sell the bonds that they have acquired to a guaranteed buyer in the near future.

When the Federal Reserve buys the bonds from the Primary Dealers this is called “monetization” – as the debt is now being converted to cash. The holder of the debt is transferred from the Primary Dealers to the Federal Reserve.

The Federal Reserve Ponzi Scheme



When the Treasury pays the interest due on the bonds it is paid to the Federal Reserve which then remits the interest back to the Treasury.

The end result is now a secured system where the banks continue to rack up enormous amounts of reserves on the balance sheet effectively negating solvency issues (at least for the moment) and the excess liquidity is pushed into the equity markets for liquidity and profitability.

The banks make money, the asset markets are driven higher by speculative fervor, the Federal Reserve is able to keep liquidity flowing through the system and the end result is an economic environment that appears to be improving. That is until you look under the covers and realize that employment, housing and consumer spending has not improved sufficiently enough to create organic economic growth.

How Much Is On The Fed Balance Sheet

One of the net effects of this massive Ponzi scheme was the transfer of the financial crisis from the private balance sheets of banks and corporations to the public balance sheet of the taxpaying public – this would be you.

As of November the Federal Reserve the current balance sheet of the Fed has increased to almost \$2.5 Trillion Dollars per the New York Times chart.

The Federal Reserve is now the single largest holder of US Treasury debt in the world ahead of both China and Japan. Of course, the real question that needs to be asked is what the long term implications of this honor are.

As Kyle Bass recently stated *“We continue to be very concerned about systemic risk in the global economy. Thus far, the systemic risk that was prevalent in the global credit markets in 2007 and 2008 has not subsided; rather, it has simply been transferred from the private sector to the public sector.”*

We are currently in the midst of a cyclical upswing driven by the most aggressively pro-cyclical fiscal and monetary policies the world has ever seen. Investors around the world are engaging in an acute and severe cognitive dissonance. They acknowledge that excessive leverage created an asset bubble of generational proportions, but they do everything possible to prevent rational deleveraging. Interestingly, equities continue to march higher in the face of European sovereign spreads remaining near their widest levels since the crisis began. It is eerily similar to July 2007, when equities continued higher as credit markets began to collapse.”

These are wise words worth listening too.

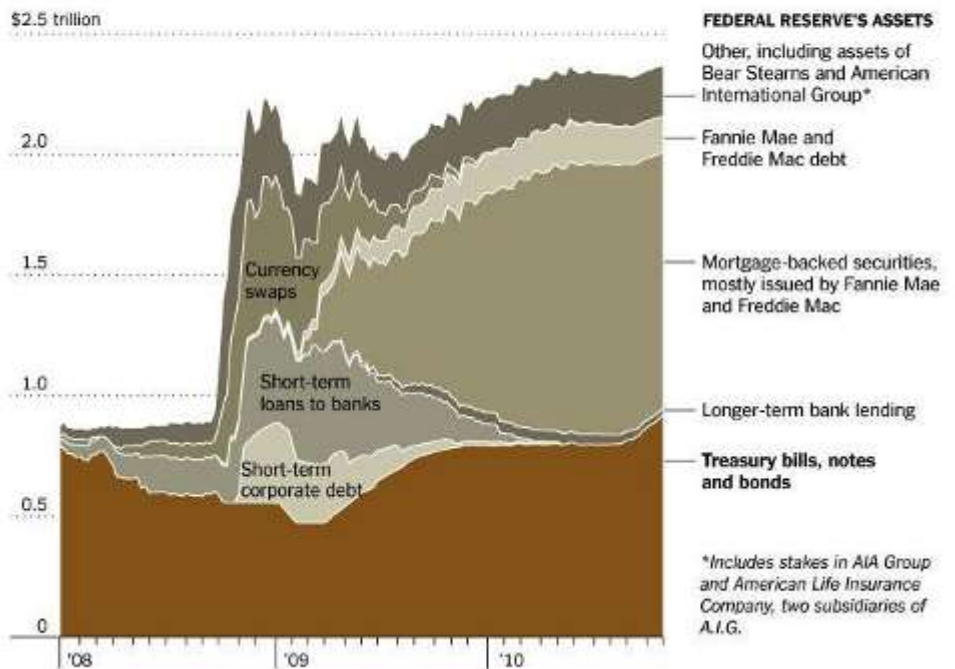
The End Game

This game can continue for quite a while longer, however, the risk in playing this game is getting very high. At some point, and no one will see the actual event coming, a crack will appear in the market and everyone will begin the stampede in the opposite direction.

The New York Times

The Swollen Balance Sheet

Though the financial crisis has abated, the Federal Reserve's balance sheet remains far larger than it was before the crisis began. Now, the Fed is preparing to buy more assets to put downward pressure on interest rates and help the sputtering economy.



What makes us different?

It's really pretty simple. We believe that managing risk is the key to long term success. Conserve the principal and the rest will take care of itself.

Risk = Loss

Seems like a simple concept – yet most people take way too much risk in their portfolio which is fine as long as the market goes up. The problem comes when it doesn't.

Managed Risk = Returns

By applying some simple risk management to a portfolio of assets the potential for large draw downs of capital is reduced thereby allowing the portfolio to accumulate returns over time.

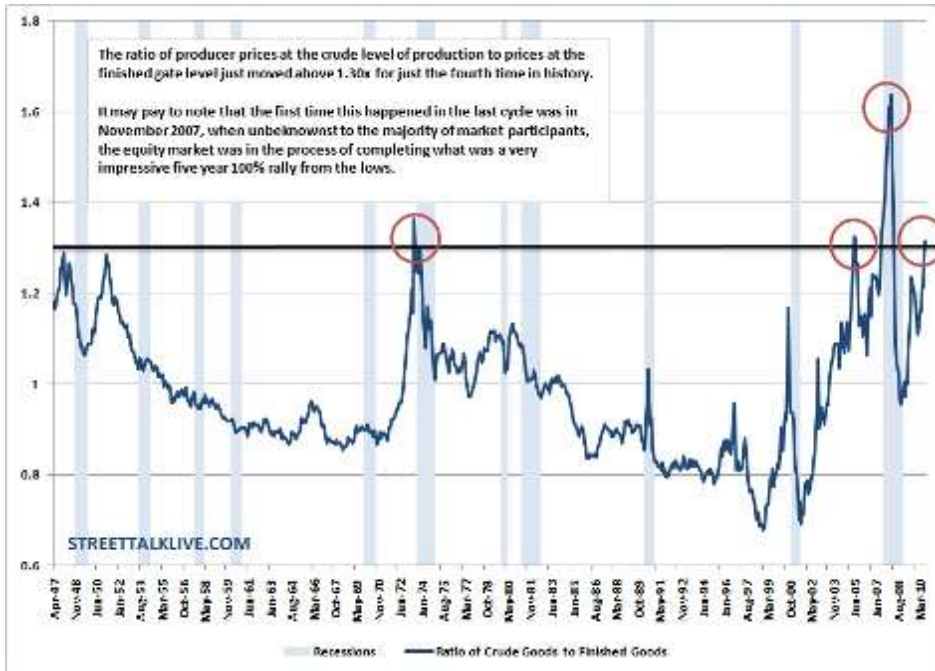
Total Return Investing

We believe that portfolio should be designed for more than just capital appreciation. There are times when markets do not rise. During those periods we want income from dividends and interest to be supporting the portfolio.

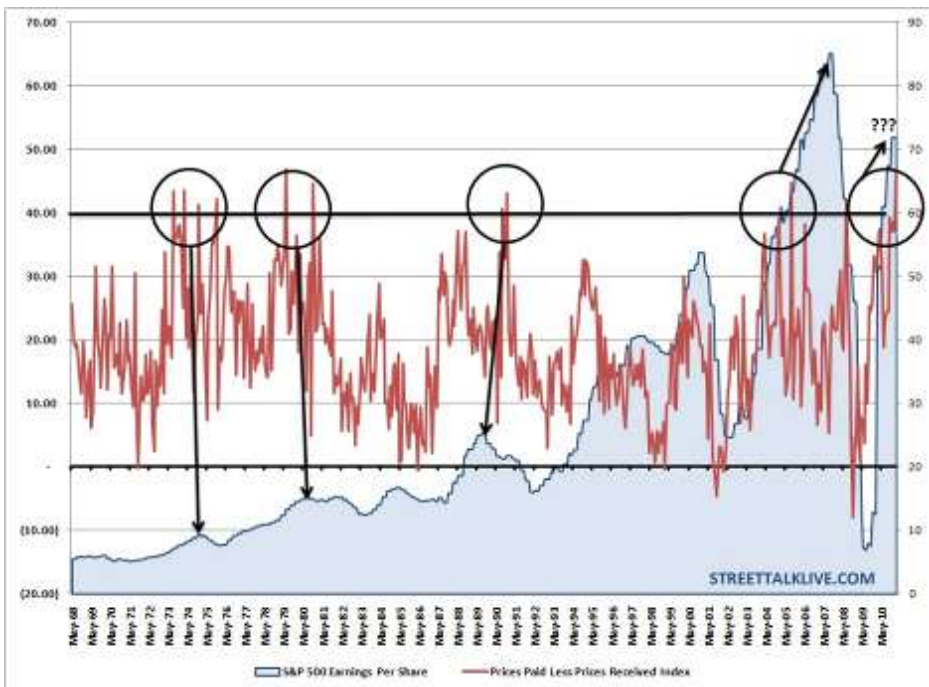
If you are ready for something different the you are ready for common sense approach to investing.

Get Started Today

One of the things that we are watching EXTREMELY closely is profit margins. We detailed on our [Facebook page](#) last week there are several indicators that are pointing to some troubling things ahead. The first is the fact that the difference between crude materials and finished goods in the Producer Price Index is now at a level which we have only seen three other times in the past – the following results of which were not great.



The second is the ratio of prices paid to prices received which is now at a level we have only seen four other times in the past. This led to a peak in earnings due to margin compression.



This game will end. It WILL end badly. It is only a matter of time...how much time, we have no clue.

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