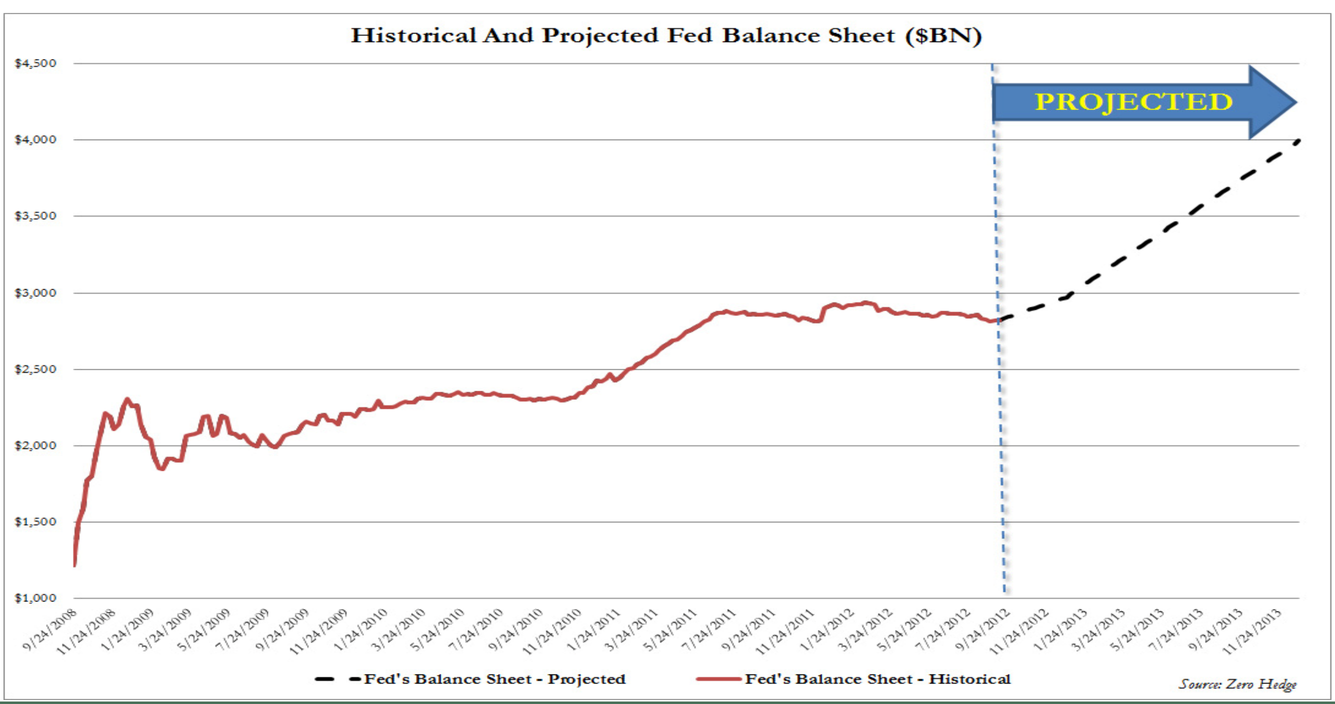
Quantitative Easing 4 AKA Qfinity Plus

The Federal Reserve (the Fed) announced an additional round of quantitative easing (QE4) on December 12th; this is on top of the third round of quantitative easing (QE3) that was announced recently on September 13, 2012. The Federal Reserve (Fed) first began quantitative easing (QE) in late 2008, while we were in the midst of a very serious financial crisis and interest rates had already been slashed to near zero. The Fed was trying anything to stop the panic and to prevent the "too big to fail" financial institutions from imploding. In November 2010, QE2 was launched amid concerns that the slowing economy might lead to deflation. This was followed by "Operation Twist" in the fall of 2011, in which short-term Treasury securities were sold and longer-term securities were purchased. Then the Fed decided to announce QE3 and quickly followed with an announcement of the overlapping QE4. We are calling this latest combination of balance sheet programs Qfinity (Quantitative Easing Infinity) Plus, because of their open-ended and overlapping nature. The combined program is summarized below:

- Federal Reserve increases QE3 (Qfinity) with an additional $45 billion in monthly purchases of U.S. Treasury securities.
- Federal Reserve will continue to buy mortgage-backed securities at a rate of $40 billion a month as announced in September with QE3 (Qfinity).
- Federal Reserve will continue to buy a combined $85 billion per month until economic thresholds are met.
- Federal Reserve commits to maintain quantitative easing until economic thresholds are met and will not commence tightening until either threshold for unemployment or inflation are met.
- Quantitative easing to continue until the Unemployment Rate gets down to 6.5%.
- Quantitative easing to continue until inflation expectations reach 2.5%.

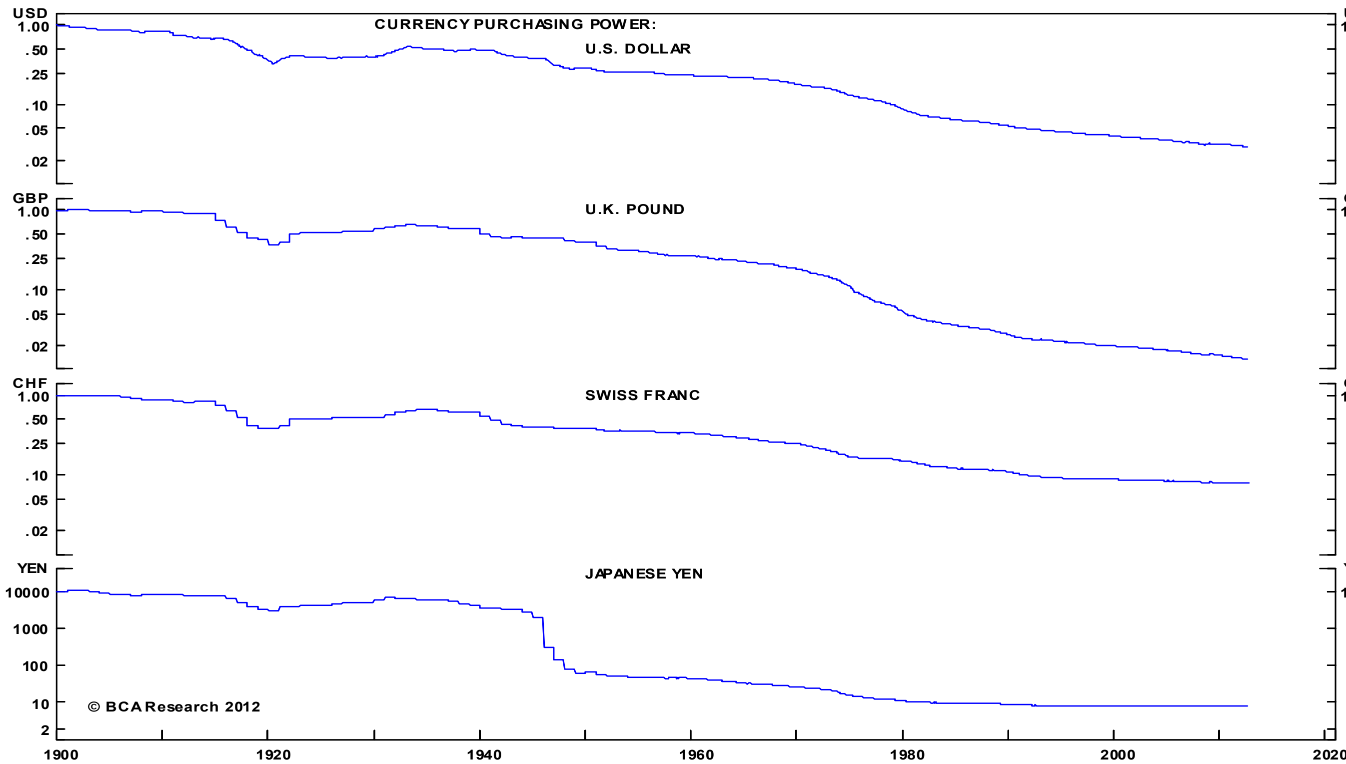
The impact on the Federal Reserve's balance sheet is shown below. In 2008, it was at $800 billion, but by the end of 2013 it could be approaching $4 trillion. Richard Fisher, the President and CEO of the Federal Reserve Bank of Dallas, has compared the unprecedented moves by the Fed to the Eagle's song, Hotel California, where "*Theoretically we can check out any time we want from this program, but practically, since we're going to have an engorged balance sheet, we may never be able to leave this position*."



Fisher's point being that unwinding the Fed's unprecedented balance sheet expansion will be difficult if not impossible. While the initial round of QE certainly staved off a possible economic depression, the success of subsequent rounds of quantitative easing is still being debated and is suspect, compared to the Fed's dual mandate of stable pricing and full employment. The consensus view is that QE2 did little to improve actual employment or production, but did have a positive impact on prices, both asset prices and the price of real goods and services. In this light, Qfinity Plus's ability to impact unemployment and support a sustained recovery is questionable and its implementation might seem reckless to some.

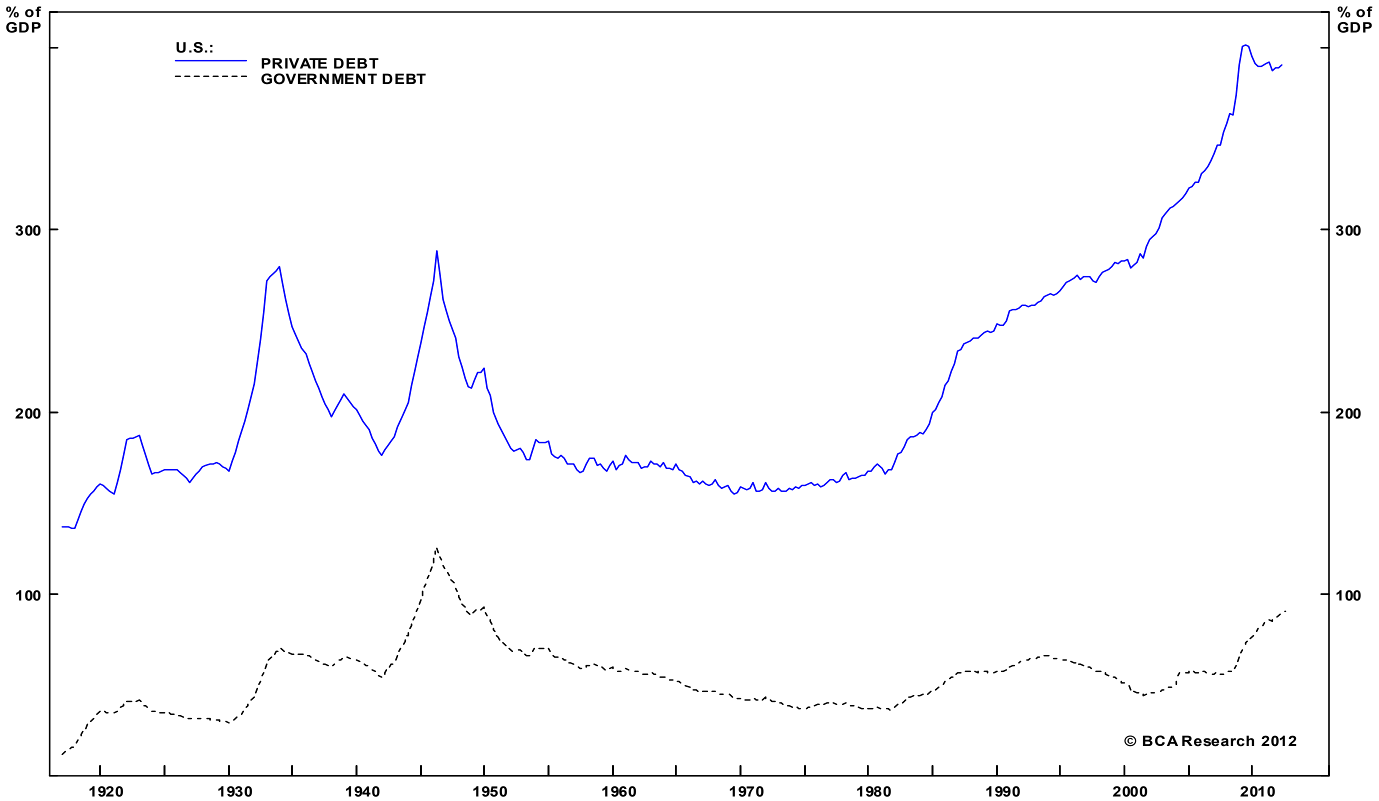
The Fed is now the largest owner of the long end of the treasury market and dominates its price and yield. It will prove very difficult for the Fed to reduce its balance sheet, since most other investors will be very reluctant to buy in the face of the Fed, the largest owner, selling. When the biggest owner of an asset class decides to sell other investors either step aside or try to front run this selling. The result could be significant price declines and capital losses for the Fed. Thus, selling does not appear to be an option and since the Fed now owns more long-term Treasuries, a reduction in its holdings through maturity will not start until 2017 at the earliest.

While Quantitative Easing and its latest iteration Qfinity Plus breaks new ground in the potential debasement of the dollar and other paper currencies, this reduction in purchasing power has been ongoing and persistent for over a century in the advanced economies. See graphs below. The new process of Qfinity Plus could very likely shift us to another gear.



The Fed's Qfinity Plus is representative of a global phenomenon as central banks across the globe embark on unprecedented balance sheet expansion. It appears that the Fed and other central banks have concluded that the best course of action for debt reduction is to stimulate economic growth and rising inflation while at the same time inflation devalues the real cost of debt as neither of the other alternative debt reduction mechanisms of spending restraints and debt pay downs nor defaults and deflation are politically feasible or popular.

In 2008, we anticipated a debt deleveraging in the U.S.; however, this has not occurred as private sector debt reduction has been more than fully offset by the huge growth in government debt in the U.S. as shown below. Deleveraging involves some painful and very unpopular choices. Austerity, where you spend less and pay down debts over time, is a difficult path as an economy runs the risk that GDP will decline faster than debt reduction. Deleveraging through default of both legal and political promises is another choice. In 2008-2009, if the U.S. housing markets had been allowed to clear, many more financial institutions would have been closed or nationalized as their liabilities (debts) exceeded their asset values. An additional element of default would be changes or reductions in the large entitlement programs to make them more fiscally responsible. These political promises will be difficult to fiscally fix or change.



The fiscal cliff debates and the difficulty of finding a politically acceptable solution highlight the debt deflation and deficit problem. With these deleveraging options eliminated for political reasons, inflation as the means of devaluing the nominal debt in real terms becomes the most likely option. Qfinity Plus seen in this light becomes rational.

While slow growth, excess capacity and high unemployment have kept inflation in check as measured by the CPI (Consumer Price Index), commodities and asset prices have seen inflation. Over the long-term, inflationary policies like Qfinity Plus could cause the value of the dollar, a paper currency, to decline versus other assets like commodities, real estate, stocks and strong currencies. Long-term fixed income instruments, as promises of future dollars, could also see their real purchasing value decline. Moreover, long duration fixed income investments would suffer substantial losses if interest rates were to return to a more normal historic relationship versus inflation and GDP growth; interest rate risk is extremely high for long duration fixed income instruments. Within fixed income only portfolios and the fixed income segment of balanced portfolios, we are reducing duration in order to lower this interest rate risk.

It is impossible to know exactly when investors will begin to anticipate a return to a more normal level of interest rates, but the nature of markets is that they often change direction more quickly and dramatically than the underlying fundamentals might suggest. Therefore, we have started to prepare for this inevitable adjustment to higher interest rates even though we don't know when it will occur. The fixed income allocation in balanced portfolios is being managed down to the lower end of the agreed upon range while we are recommending or increasing exposure to stocks that have attractive growth prospects, preferably good dividend yields and are selling at discounts to our estimates of fair value. While stocks exhibit higher short-term volatility, we believe they will produce better longer-term total returns than either bonds or cash. Qfinity Plus negatively impacts the historical risk return relationship for bonds as outlined above, but it does have a favorable impact on equity returns by limiting deleveraging, which is a drag on GDP, and by encouraging inflation, which increases nominal GDP and thus revenue and profits.

Our big concern is echoed by the Fed's Fisher in his Hotel California metaphor. The Fed may announce an exit strategy from Qfinity Plus but the markets may not allow this exit. Under a scenario where inflation expectations move to 2.5%, interest rates would tend to move higher. Given the 2.5% inflation threshold, the Fed would want to shrink its balance sheet by selling or not rolling over its maturities. This could be happening at the same time that other investors are trying to reduce holdings of long duration debt as expectations of higher interest rates become widely accepted. When the dominant buyer or holder becomes a seller, bond prices could go down significantly. The Fed may find it impossible to proceed with its exit without incurring massive losses. "*You can check out any time you like, but you can never leave*," The Eagles.