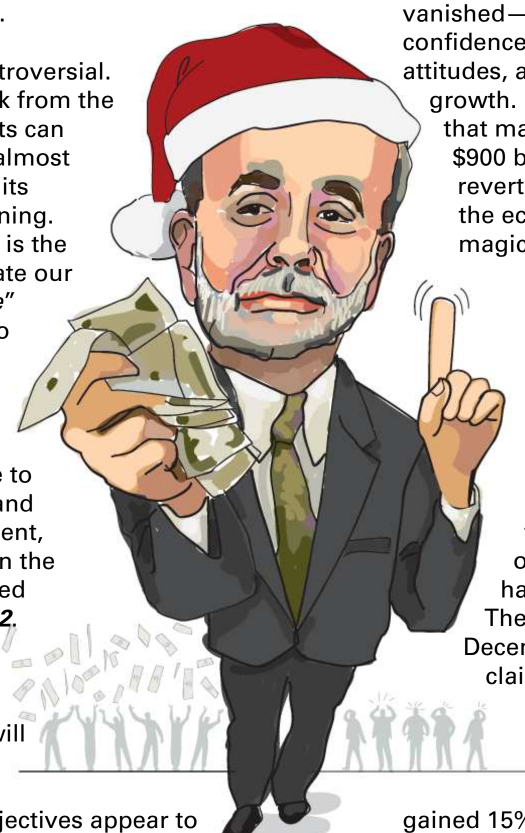
Investment Watch

4th Quarter, 2010

Naughty or Nice?

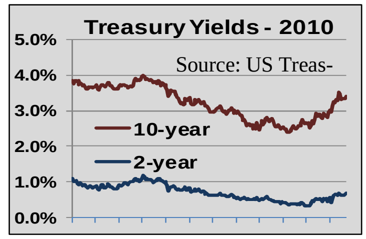
As anticipated, Ben Bernanke, Chairman of the Federal Reserve, did employ unconventional measures by opening up his wallet and releasing the second round of Quantitative Easing, dubbed ***"QE2"*** to stimulate economic growth … Merry Christmas! Critics declare that QE2 will do more harm than good, or in holiday vernacular ***Naughty not Nice***? Looking back to November 2008, no one accused the Fed of naughtiness or debated the necessity of the first round of quantitative easing when our banking system was near collapse. Back then the Fed bought $500 billion worth of toxic mortgage-backed securities to shore up the banks balance sheets thereby preventing the bankruptcy of our major financial institutions and committed $200 billion in the government takeover of Fannie Mae and Freddie Mac to forestall a mortgage meltdown.

Quantitative easing is very controversial. Now that we have stepped back from the precipice of disaster, the pundits can voice their disagreement with almost everything about it —its value, its effectiveness and even its meaning. Detractors pronounce that QE2 is the Fed's last ditch effort to stimulate our economy since the "*nearly free*" money available from near-zero interest rates has failed. This easy money supply has held interest and mortgage rates in check at historically low levels, giving the housing market time to heal. But our sluggish growth and unacceptably high unemployment, call for further action. What can the Fed do if they've already lowered interest rates to near-zero? ***QE2***.



The logic for this second round of quantitative easing is different. Under QE2 the Fed will print up to $600 billion in new money to buy longer term Treasury bonds. The Fed's objectives appear to be to hold interest rates down, prevent deflation, suppress mortgage rates and further weaken the already falling dollar—all of which the Fed believes will "*promote a stronger pace of economic growth.*"

The critics say they know what ails the US economy. They point to the stubbornly high unemployment and contend that the economic growth is relying solely on government stimulus, that QE2 will rekindle future inflation, and that the deficit producing tax cuts will constrain future growth. All valid points in these unusually uncertain times. This debate embodies the frustrating ambiguity about the health of the economy and its future direction.



The Fed is also frustrated. Interest rates should have declined when QE2 was initiated in November. But as illustrated on the chart by the 10-year Treasury Bond, interest rates were already dropping for most of the year and bonds, which move in the opposite direction as rates, increased in value. But when QE2 was announced, interest rates inexplicably rose which brought out the Grinch to put a dent into this year's bond returns. Even though they were mostly negative for the quarter, over the whole year bonds fared well.

What a difference a few months make! This summer's economic soft spot and fears of a double-dip recession have vanished—magically replaced by renewed consumer confidence, a stock market rally, and improved hiring attitudes, all of which point to self-sustainable economic growth. Maybe QE2 was "*the magic in that old silk hat*" that made the economy come to life, maybe it was the $900 billion tax cut, or maybe it was the consumers reverting to their spendthrift ways, but whatever it was, the economists' growth projections for the 4th quarter magically jumped by a full percentage point to 3.5%.

Economists agree QE2 is a desperate monetary policy that can spur inflation, but QE2 may have offered crucial physiological value for the consumer, US businesses and the markets. Consumer spending comprises over two-thirds of our Gross Domestic Product and the consumer came to life this holiday season opening up their wallets spending 5.5% more than last year, the best since 2005. US businesses are hoarding over $1 trillion in cash, according to Reuters, but have not expanded due to economic uncertainty. The Labor Department reported that for the week of December 30th less than 400,000 initial unemployment claims were filed for the first time in two years. The hope is that this heralds businesses opening up their wallets and beginning to add employees.

Finally based on the S&P 500, the stock market gained 15% in 2010 with almost half of that gain in December. These gains were helped by The Fed's easy money policies priming the economic engines and by investor optimism and consumer spending fueling the Santa Claus rally. The sustainability of these gains, as well as, the US economy should become more apparent as the stimulus is removed. But in the meantime the old adage, "*don't fight the Fed*" seems fitting.

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4940 Washington Blvd.
St. Louis, MO 63108