# Investment Watch

*3rd Quarter, 2013*

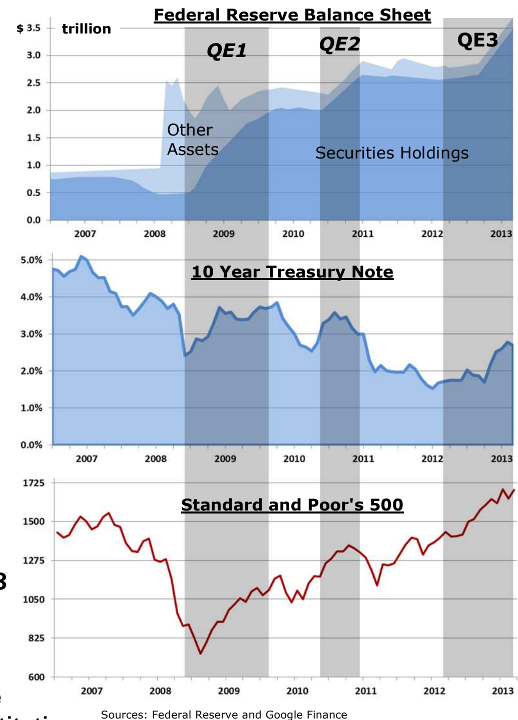
## Keep Going and Going!

On September 18th, the Federal Reserve surprised the world by announcing that they would continue their latest round of **Q**uantitative **E**asing, **QE3**, pumping $85 billion per month into our economy. A little over a year ago, Federal Reserve Chairman, Ben Bernanke, launched the most recent version of their bond-buying stimulus plan designed to reduce longer-term and mortgage interest rates, fuel a housing recovery, promote consumer spending, and encourage corporate investment and employment.

In the past the Fed's typical tactic of lowering the fed funds rate to reduce short-term interest rates provided enough stimulus to rejuvenate economic growth. These normal monetary practices were stretched to the extreme in early 2008 when the Fed lowered rates to effectively zero, but failed to stabilize our economy. With near-zero interest rates, many thought the Fed had run out of juice. Then Bernanke's Fed, pulling a rabbit out of the hat, unleashed unprecedented financial stimulus introducing the world to the unconventional and controversial monetary policy of Quantitative Easing (**QE**) which is used by central banks to pump liquidity into the economy when standard strategies prove insufficient.

Quantitative Easing increases the money supply by the Fed's purchase of bonds and other financial assets on the open market from banks and private institutions. As can be seen from the chart, the Federal Reserve's Balance Sheet began to swell with the first round dubbed **QE1**. The Fed usually buys short term bonds to lower short-term rates. In these highly unusual times, with near-zero short term rates, the Fed implemented experimental policies not only to increase the monetary base, but also to lower the stubbornly high mortgage and long-term rates.

Last May when Bernanke signaled the possible unwinding of **QE3**'s bond buying, the stock market shuddered and longer-term interest rates quickly shot up. The 30-year mortgage rate spiked from a historic low of 3.35% in early May to 4.46% in August. This rapid rise in interest rates jolted the housing recovery and slowed the economy from its already meager pace. Then just two weeks ago Bernanke's Fed defied conventional wisdom, adding more uncertainty to these uncertain times, doing an about face by voting to keep **QE3** intact. This startling news sent the stock market soaring with investors feeling that **QE3** would keep going and going.




Sources: Federal Reserve and Google Finance

The Federal Reserve's Balance Sheet has swelled to over $3.5 trillion. Experts realize that **QE3**'s bond purchases cannot go on forever. However, they also know that the US economy has not yet transitioned sufficiently from the crutch of the Fed's stimulus. Timing is every-thing and the Fed may be running out of time on **QE3** as their balance sheet skyrockets to unsustainable heights. As can be seen above, Quantitative Easing drove down interest rates and fueled a rebound in the stock market.

To shift from pouring over $1 trillion of stimulus into the economy each year to ultimately ending **QE3**'s bond pur-chases poses formidable challenges for the Fed. Not to mention the hurdle of raising interest rates from the current near-zero policy to more normal levels. The Fed's batteries are running low, forcing them to begin winding down **QE3**, most likely by early next year. However the Fed still has the juice to maintain the stimulus of exceptionally low federal funds rate as far as the eye can see.

Normalcy seems a distant memory. The Great Recession threw the entire world into deep economic desolation. Central banks and governments around the world responded to forestall a global depression. The nascent world recovery has been slow and uneven. Here at home the recovery has been stronger. But now the Fed has added more uncertainty to our already unusually uncertain world.

Back in 2011 our political dysfunction resulted in a market slump and the US losing its AAA rating. This year, seemingly immune to these uncertainties, investors have propelled the stock market to new heights even though corporate profits have not kept up. Many pundits had predicted that the market's gotten ahead of itself, but thankfully as your statement illustrates over the last quarter as well as the past year, it kept going and going.

*September 30, 2013*

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