Lassus Wherley ...a view from the top
Building Better Futures
Issue 29: November 18, 2010

QE2 Is Not a Ship

Food for Thought

The recent downturn in the market should not come as a surprise when you look back at how quickly we have come back from 2008. We haven't fixed everything. In fact we have many challenges still remaining, including the issues with debt not only here in the US but in Ireland and other countries in Europe.

When we think about the difference between the market behavior over the past year or so and what we experienced two years ago at this time, we are amazed by how far we **have** come in terms of regaining some sense of confidence in the financial markets. No……..the world is not in a totally positive place, but we are moving in the right direction. It does not matter what the world powers do or our newly elected Congress, we will always have challenges. At this point, our biggest challenge is in figuring out how to manage debt in the US and other countries around the world. The deficit is a real issue and one that is not going away anytime soon. It is one of many moving parts.

We spend a lot of time focused on analyzing and understanding these moving parts, to figure out what is happening and we try to share as much of that understanding as we can. Here are some of our current thoughts.

There have been a lot of happenings over the last few weeks. We had the mid-term elections, the Federal Reserve announcement and the monthly jobs report for October. We have spent quite a bit of time looking into all of these news items and trying to figure out just what they will mean for investments.

Until this past week, global stock markets have been rallying for two months as investors anticipated a new round of Treasury purchases by the Federal Reserve in an attempt to stimulate economic growth. Several members of the FOMC (Federal Open Market Committee) have been talking to the press in support of this plan since late August. Stocks have moved up in expectation of this further boost of liquidity, and the Fed's recent announcement provided the confirmation of their plan.

There are many questions surrounding what the Fed is doing and how they will do it, so we begin with a discussion of these.

Question: *What will the Fed be doing?* **Answer:** The Federal Reserve has actually engaged in "Quantitative Easing" before, with QE1. In March 2009, the Federal Reserve announced that they would invest $850 billion in mortgage-backed securities and $300 billion in longer-term Treasury securities. The Fed felt this would work since, starting in December 2008, when the financial crisis was at its worst, the Federal Reserve bought securities such as commercial paper and mortgage-backed securities in an attempt to unfreeze financial markets. This tactic worked and by March 2009, the Federal Reserve decided that a more

dramatic, larger program of purchases (QE1) was needed to support the economy and in particular, give housing a boost. This program helped some and was allowed to expire in late March 2010.

While the economy has certainly improved over the past two years, the Federal Reserve voted last week to engage in another program of buying securities to support the economy. The Federal Reserve has been given a double mandate by Congress - to support maximum employment and price stability. The Fed announced this latest program, as they believe that economic growth is too slow and inflation is too low.

So…………. the Federal Reserve announced on November 3rd that they will be buying $600 billion in longer-term Treasury securities (QE2) by the end of June 2011, at the same time that they will reinvest the maturities of mortgages that they already own. They have retained full flexibility in running this program and have said that they will regularly review the pace at which they are buying securities and the size of the program in light of new economic information.

As a student of the Great Depression, Fed Chairman Bernanke believes in the importance of using monetary policy to support the economy. He would rather run the risk of inflation down the road than to have the economy falter or deflation take hold.

Question: *How will the Fed's purchases of Treasury securities help the economy?* **Answer:** The Fed cannot cut interest rates in the conventional manner since the Federal funds rate is already as low as it can go, at effectively 0%. They are convinced, however, that the economy still needs a very easy monetary policy that will keep interest rates low. They have chosen to provide easy money by buying Treasury securities. This should help the economy because the dollars the Fed uses to buy the securities will end up in the banking system. Once in the banking system, these dollars will be added to the banks' reserves. Since many banks already have more than sufficient excess reserves to back their deposits, they should, in theory, feel free to use these additional reserves to make loans.

This is crucial, in our opinion, as banks have been hesitant to make loans to small businesses or to give mortgages to consumers. Lower rates on mortgages should also help make housing more affordable and allow more homeowners to refinance. Any measure that would help break this log jam in the banking system should be helpful.

The Federal Reserve is also looking for the low rates which will result from this program to boost the economy by encouraging corporations to invest and consumers to spend. If corporations and consumers increase their spending, this should lead to higher profits and incomes, which will also support the economy.

Question: *QE2 looks good on paper, so why would anyone not be in favor of this second round of quantitative easing*? **Answer:** One concern is that the Federal Reserve will not be able to stop providing all this liquidity before it is too late. Keep in mind that the Fed actually prints new dollars to enable them to make these securities purchases. The potential downside is that it might be hard for the Fed to act quickly enough to stop the printing presses and to move from an extremely easy monetary policy to one which is less so. This could result in future inflation.

Until concerns over Ireland's debt crisis returned, the chance that inflation will result

caused the US dollar to weaken. Other nations with higher rates of growth are concerned that they will be importing inflation from the US. Both Australia and India raised rates for this reason in the wake of the Fed's announcement. China, Russia and Germany have also voiced their concerns that the Fed is acting to weaken the US dollar. A weaker dollar is helpful to US exporters making our goods cheaper in other countries but not so helpful to those importing goods into the US.

Others are concerned that lower interest rates will not get corporations and consumers to spend more readily. They believe that they are holding back for other reasons than interest rates, including uncertainty about tax policy or the direction of the economy.

Finally, some are skeptical that this program will actually entice banks to lend given that there are already over $1 trillion in excess reserves sitting on banks' balance sheets and yet they have not been lending.

Question: *What impact do you think QE2 will have on our portfolio?* **Answer:** After a brief pause to digest the announcement, riskier assets like stocks, commodities and real estate moved up strongly. Until this week these asset classes have been moving up as the Fed has made it clear that interest rates will stay low at least for several more months and, in the case of commodities and real estate, because investors are looking for protection from inflation.

We know that a well-diversified portfolio is the best way to navigate this market. Not all asset classes move up together but they "take turns," depending on the circumstances. For example, bonds, which have performed very well relative to stocks for the past 10 years due to the financial crisis, may not do quite so well in the next decade. We think this will be true as we see stocks as cheaper than bonds at these levels.

Question: *What about the bond funds we hold? I keep hearing that they are the next big issue.* **Answer:** We continue to monitor inflation, which has more of a negative impact on bonds than on stocks. Stocks can benefit since earnings and stock prices go up based on price increases and stay ahead of inflation. In spite of the very strong price action we have been seeing in commodities, especially in gold, real estate and emerging market debt, we do not think that inflation is an imminent threat as unemployment and excess industrial capacity remain very high and will be likely to keep a lid on inflation for the foreseeable future. Recent news from the Fed means that interest rates could start to increase sooner than we had been expecting, but this news is already being reflected in bond prices.

We hold short to intermediate term bond funds in our portfolios. The impact on these bond funds should not be dramatic even if interest rates rise as their duration or sensitivity to changes in interest rates is quite limited. It is important to keep in mind that, while losses are possible in bonds or bond funds when interest rates are rising, the impact of these losses is reduced by the increased yields that investors may receive from the higher rates. Finally, if we become more concerned about inflation and rising interest rates, we will adjust the weighting in our portfolios more towards short-term bond funds to provide a higher degree of safety.

We have chosen to invest most of our bond allocation in actively managed bond funds rather than in bond index ETFs. We are confident in the bond managers to whom we have entrusted your dollars and believe that they will be able to navigate through a period of rising rates whenever it comes. The one

exception here is the iShares Barclays TIPS Bond Index (TIP) which is an important way that we add inflation protection to our portfolios.

Question: *Why do we continue to add dollars to commodities and real estate?* **Answer:** Both of these asset classes provide us with inflation protection, and this is the primary reason why we feel it is important to have exposure there. The commodity asset class should benefit if the US dollar continues to weaken over concerns about the impact of QE2.

Real estate continues to be a very significant part of our hedge against inflation. It has performed well over the years, and we continue to believe that it is an asset class that is needed for diversification purposes.

Question: *Are you thinking about any other portfolio changes right now?* **Answer:** In the very uncertain market climate of late 2008, we decided to increase our commitment to hedge strategy funds. At that time, we felt it was important that we have a portion of our portfolios invested in funds that were able to position themselves nimbly for changes in the markets. We hold shares in two funds in this asset class, Hussmann Strategic Growth Fund (HSGFX) and EAS Genesis Fund (EASIX). These two funds differ from each other in terms of holdings and strategy but basically offer us a means of offsetting the volatility of the equity positions in our accounts.

We are considering reducing our allocation to the Hedge Strategy asset class as the markets and the global financial system stabilize. We will continue to have some dollars invested here but are weighing just how sizable a position is called for at this point in time.

As we reduce the size of our commitment to hedge strategy funds, we will increase the weighting in portfolios in US large-cap stocks (USL) and emerging markets stocks (EM). We like the valuations of US large-cap stocks, which have lagged other equity classes in performance over the last 10 years. We will continue to add to our holdings in emerging markets in order to capitalize on their superior growth profile versus the other developed markets.

Question: *What do you see happening in the markets between now and the end of the year?* **Answer:** We expect that volatility will increase as we head into the end of the year. Investors have some nice gains that they may want to book this year, and markets have rallied very sharply since September.

At this point, the consensus seems to be that the Bush tax cuts will be extended. This may not happen before year-end, however. Congress may need to act on this next year, in which case the extension would likely be made retroactive to January 1, 2010. In any event, many investors with big capital gains may choose to take some profits off the table before year-end.

If the US dollar continues to weaken, we would expect to see continued strength into year-end from both commodities and international stocks. Both of these asset classes are beneficiaries of a weaker US dollar and given the recent announcement of further asset purchases by the Fed, they could stay in the spotlight.

Question: *If small business is still having so many issues, where do you expect the growth in the economy to come from?* **Answer:** We believe that at some point the very easy monetary policy which the Fed is conducting will gain traction and will stimulate economic growth. We also believe that the US and the rest of the developed world will continue to benefit from the

superior rates of growth in the emerging world. While we continue to talk about how slow the recovery is, it is important to note that the global economy, including the US and the rest of the developed world, is still *growing*.

While the current 2%- 2.5% rate of US GDP growth is disappointing, it is still positive. We expect that the economy is likely to be bolstered going forward by some of the following factors: 1) a rebound in exports due to the very weak US dollar and continued strong capital spending in the emerging markets, 2) gains in personal income which should sustain consumer spending as we head into the holiday season, and 3) a boost from domestic infrastructure spending as dollars previously allocated to this use continue to be spent.

Question: *Shouldn't we increase our emerging market exposure since everyone says that is where the future growth will be?* **Answer:** We have begun to increase our allocation to emerging markets in most portfolios. This increase will be gradual and will not be completed until early next year. Emerging market equities have been outperforming developed market equities year-to-date. The reason behind this outperformance is the growing recognition of the sustainability of the emerging markets story. The secular growth story in the largest emerging markets countries, China, India and Brazil, is in its early stages. Economic growth in these countries, and several others, is likely to remain well above the developed world for some time to come. We are seeing a middle class develop in the emerging world and consequent heavy spending on infrastructure. Lastly, the finances of the emerging markets are actually in better shape than those of many developed nations. This represents perhaps the biggest secular change and the most relevant to investors.

Question: *What about the emerging market bond fund (PEBIX)?* **Answer:** We started to invest in PIMCO Emerging Markets Bond fund (PEBIX) earlier this year. We had established the International Fixed Income asset class as an asset class in many of our portfolios earlier by adding DFA Selectively Hedged Global Fund. We decided that it made sense to split the allocation to this asset class between developed and emerging markets so that we could have some exposure to the superior balance sheets of the emerging markets countries.

Emerging markets debt is attractive because these nations have no debt bubble. Yields are higher than in the developed world and funds have flown into the highly rated debt issues of the emerging markets as large developed nations such as the US, the UK and Japan have kept interest rates low.

PEBIX invests mostly in external debt of emerging markets. This debt is debt denominated in major currencies such as the US dollar, the Japanese yen or the Euro. We chose this fund rather than the PIMCO fund which invests in local emerging markets currencies because we did not want to take on the added volatility and risk of devaluation that have been common in emerging markets currencies in the past. PEBIX also has a much longer record, having been opened in 1997 while the PIMCO Emerging Market Local Bond Fund has only been open since 2006.

Recently, some of the finance ministers of emerging markets nations have shown their displeasure with the enormous capital flows into their bond markets which have resulted from the very low interest rates in the US and other developed countries. It makes it difficult for countries such as Brazil to handle the inflows, and this country has begun to take measures to slow the capital inflows.

This is one of the unintended consequences of the quantitative easing being conducted by the Fed and one of the issues which we will continue to monitor. The US dollars that have flowed into emerging markets bond funds have also caused the yield spread on these bonds versus US Treasuries to compress, which temporarily reduces their attractiveness.

Much Food for Thought

Three main challenges remain in 2010, including waiting for Congress to deal with the expiring tax cuts, health care reform, and financial regulatory reform. These challenges will continue in 2011 which is just around the corner.

Keep those questions coming in. If you are wondering about something, the odds are pretty good someone else may also be thinking about the same topic. When you ask—we get the chance to share our thoughts on the topic with others.

Please let us know if you have any questions or concerns. Have a warm, safe and happy holiday season!

Diahann

Investment Committee:

Diahann W. Lassus, CFP®, CPA/PFS, Chair
Anne L. Kehl, Investment Officer
Betty S. Thomas, Investment Analyst
Chadderdon W. O'Brien, Investment Analyst
J. Charles Pawlik, CFP®, Associate Financial Planner

Compliance Disclosure

Please remember that past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product made reference to directly or indirectly in this newsletter, will be profitable, equal any corresponding indicated historical performance level(s), or be suitable for your portfolio. Due to various factors, including changing market conditions, the content may no longer be reflective of current opinions or positions. Moreover, you should not assume that any discussion or information contained in this newsletter serves as the receipt of, or as a substitute for, personalized investment advice from Lassus Wherley or any other investment professional. To the extent that a reader has any questions regarding the applicability of any specific issue discussed above to his/her situation, he/she is encouraged to consult with the professional advisor of his/her choosing. A copy of our current ADV II is available for review upon request.