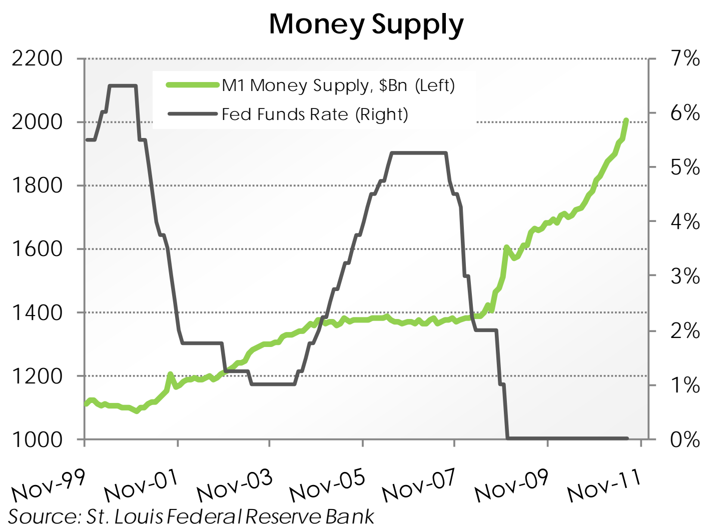
When there is a week in which the Federal Reserve Chairman's annual speech from Jackson Hole is the third biggest news story, you know it was an eventful week. Chairman Bernanke's speech was a flash in the pan not only due to the east coast earthquake and Hurricane Irene, but also because it delivered no new information. In our opinion, no news is good news. Despite clamoring by many investors for more stimulus in the form of additional purchases of Treasury bonds, the Fed did not deliver. This outcome was not only expected, but the correct decision. We cannot be sure of Chairman Bernanke's exact reasons for not announcing another round of bond buying as he did last year, but we have many reasons why we think it would have been a big policy mistake. The old cliché does not hold in this instance…third time's ***not*** the charm.

Time and Again

Repeating the same behavior and expecting different results is often cited as the definition of insanity. The first two rounds of quantitative easing (QE) did not do much to put the recovery on a permanent trajectory, so why would a third round be the magic bullet? One of the Fed's goals for QE was to increase liquidity by lowering interest rates beyond the point possible via normal monetary policy, i.e. below zero. A lack of liquidity has not been the problem, however. In fact, money supply has been growing, as shown in the graph at right, since the Fed started lowering its policy rate in late 2007 with little lasting impact on consumer demand.



Source: St. Louis Federal Reserve Bank

The Fed is holding onto the idea that lower interest rates will stimulate demand for credit and mortgages. This relationship held in the last several decades, but now that we have entered an *era of deleveraging*, traditional monetary measures do not work like before. Lack of liquidity and too-high interest rates are not keeping growth low; consumers (and governments) are choosing to keep more cash on their "balance sheets" and forego taking on more debt. Instead of kicking off a virtuous pro-growth cycle, easier and easier policy is exacerbating the slowdown by causing inflation.

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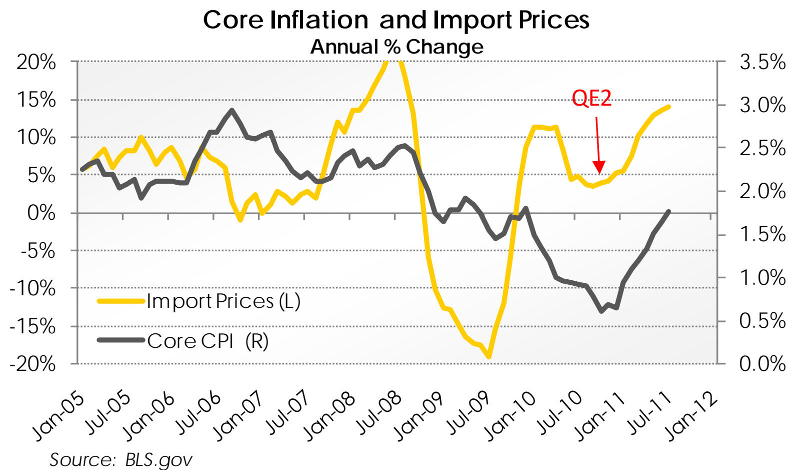
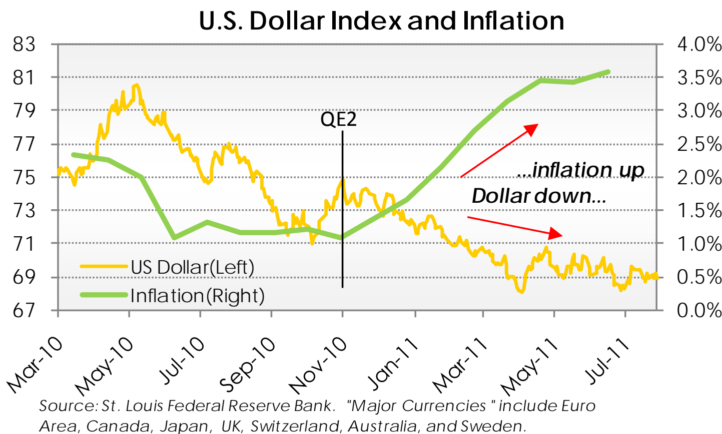
Out of the Frying Pan and into the Fire

One thing that the second round of QE *did* accomplish was to ignite inflation. Lower rates depressed the U.S. dollar, thereby fueling a boom in commodities, which are mostly priced in dollars. The weaker currency did arguably boost the export sector of the U.S. economy for a short time, but that boost came at a steep price. Exports make up only about 12% of U.S. GDP, while the consumer segment accounts for more than 70 percent. In order to stimulate exports, the weaker dollar effectively "taxed" two-thirds of the economy with a higher cost of living. Despite the Federal Reserve's focus on "core" prices, which exclude the direct costs of food and energy, higher commodity prices still meaningfully impact consumers through the prices of imports, as seen in the graph at right.



Source: BLS.gov



Source: St. Louis Federal Reserve Bank. "Major Currencies" include Euro Area, Canada, Japan, UK, Switzerland, Australia, and Sweden.

Initiating a new round of quantitative easing at this point in the inflationary cycle would not be wise. When QE2 was announced in August 2010, headline consumer inflation (CPI) was running at an annual rate of just over 1% and core inflation was even lower at 0.9%. Today, CPI is 3.6% and rising, and the core rate has doubled to 1.8%. Import prices are soaring at a 14% annual rate. QE3 would likely mean continued dollar depreciation, and a renewed drag on disposable income in the form of higher commodity prices for two-thirds of the U.S. economy.

An Uphill Battle

Many investors have compared the path equities have taken in 2011 to that of 2010, and now expect an equity rally to again take hold throughout the rest of the year. We disagree, and not only because the Fed has not provided another round of QE. The global macro backdrop is very different today than it was a year ago.

In mid-2010, most world economies had been easing policy to spark growth, and inflation was at a low level. Today, inflation is rising, and most countries outside the U.S. are well into a tightening cycle to fight those inflationary pressures. A slow down

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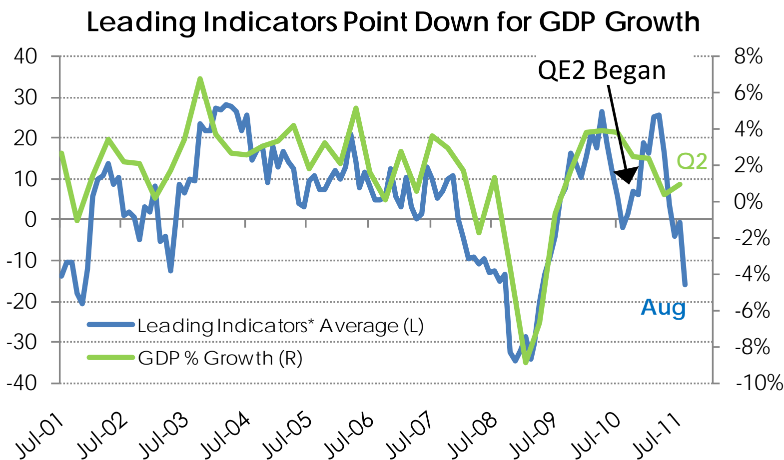
caused by higher prices - and the fight to stave off those higher prices - has caused growth to slow enough that many are concerned about another recessionary period. GDP in the second quarter grew at only a 1% annualized rate, while the estimate for the first quarter was revised down to 0.4%. Late to the game per usual, economists have begun slicing GDP estimates for 2011, which have fallen from over 3% earlier this year to around 1.75% currently.



Source: Wolfe Trahan, bea.gov, regional Federal Reserve banks
**Average of Empire Manuf. Index, Kansas City Manuf. Index, Philly Fed Index, and Richmond Fed Index*

Data series that tend to foretell the direction of growth do not paint a rosy picture for the second half of the year. The leading indicators from regional Federal Reserve banks that have been released for August all point in the direction of slowing growth. A composite of the New York, Kansas City, Philadelphia, and Richmond leading economic activity indices, shown at left, fell decisively into negative territory in August. Since stocks are also a leading indicator of the economy, the path of equities could follow suit. Last year, when the Fed began QE2 these indicators were rising, heralding an improvement in growth and markets even before the stimulus. It is impossible to know what would have happened without the second round of quantitative easing, but the macro data showed an uptrend was already in place. Today, we are on the opposite side of that coin.

Many people would argue that the deteriorating economic backdrop is the very reason the Fed *should* intervene with more stimulus. We disagree. The monetary and fiscal policy steps taken at the onset of the financial crisis helped lessen the impact of the recession, but now the game has changed. The fed funds rate already has hovered near zero for a multi-year period, and the Fed has promised to keep rates at this low level through mid-2013. At this point, monetary policy may have done everything it can do in a period of consumer deleveraging.

Hands Are Tied

During his speech at the Jackson Hole conference, Chairman Bernanke separated the economy's challenges into two parts: a near-term recovery, and the realization of its long-term growth potential. The challenge for the Federal Reserve is that it is responsible for the former, but has little influence over the latter. For that, the country is dependent upon fiscal policy determined in Washington. Chairman Bernanke reiterated in the speech his long-held view that monetary policy alone is not the answer for sustainable economic growth, saying, *"…most of the economic policies*

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that support robust economic growth in the long run are outside the province of the central bank." The Chairman listed some of the structural problems faced by the U.S., including an aging population, weaknesses in the K-12 education system, and the high cost of health care in the U.S. without commensurate health results, and stressed the importance of maintaining fiscal sustainability without endangering an economic recovery. This balance is the most challenging problem for the country as a whole. The political environment in this country is becoming less, not more, compromising, and extreme views on the role of the federal government have left many Americans believing that any form of government spending is distasteful. Without a doubt the U.S. must put its fiscal house in order and stop kicking the can down the road to the next generation, but slash and burn tactics for political posturing will absolutely endanger the economy in the near term.

Basically, the Fed Chairman is acknowledging that the bank's ability to be more than a cyclical fix is limited. He is asking members of Congress to put the country's economic future ahead of their own political interests, and make real structural changes. He even managed to insert a very polite dig regarding the debt ceiling fiasco that embroiled Washington, D.C. over the summer, *"…the country would be well served by a better process for making fiscal decisions. The negotiations that took place over the summer disrupted financial markets and probably the economy as well."* If a more prudent and thoughtful atmosphere in Washington is a key factor in determining the long-term health of our economy, that is a cause for concern.

Sticking Your Head in the Sand

After a tumultuous start to August, the U.S. equity market has crept upward over the past week or so despite a continued deterioration in economic data reports. All eyes were on the speech in Jackson Hole with investors betting for and against additional stimulus, roiling equities in the week prior. Since that day, the bulls have grabbed a hold of anything positive gleaned from the speech, even something as small as extending the September policy setting meeting to two days. Comments such as, *"….the growth fundamentals of the United States do not appear to have been permanently altered by the shocks of the past four years,"* amount to not much more than "It will get better, I promise." Unfortunately, our policymakers' track record when it comes to positive assessments of the economy is dismal. Listed below are some quotes from Ben Bernanke that have surely come back to haunt his dreams:

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Ill-Timed Quotes from Fed Chairman Bernanke

Quote	Date
"We've never had a decline in housing prices on a nationwide basis"	July 2005[1]
"At this juncture, however, the impact on the broader economy and financial markets of the problems in the subprime market seem likely to be contained."	March 2007[2]
"The Federal Reserve is not currently forecasting a recession."	January 2008[3]
"Among the largest banks, the capital ratios remain good and I don't anticipate any serious problems of that sort among the large, internationally active banks that make up a very substantial part of our banking system."	February 2008[4]

Policy makers are not alone in wearing rose-colored glasses. A string of business surveys has presented a deteriorating view of growth, yet investors are choosing to accentuate the positive for the second half of 2011. For example, the Dallas Fed's Texas manufacturing outlook survey for August was decidedly downbeat. Respondents made comments such as:

> *"We have seen a noticeable drop-off in new orders and requests for quotation this summer"*
>
> *"We are getting more discouraged about our general economic outlook,"*
>
> *"All of the improvement expected in six months is based on adding additional customers. We are not expecting any improvement from our current customer base."*

At this point, we believe it is a matter of time before investors' outlooks and expectations realign with the fundamentals. The inflation-driven slowdown occurring now has already been in the pipeline for months, and likely would continue regardless of new monetary policy measures. Dissention is rising within the Federal Open Market Committee as well, leaving little chance of additional monetary stimulus regardless of whether it is warranted. Several of the regional Fed Presidents, such as Dallas' Richard Fisher, have vocally opposed additional measures for some time now, and his supporters are growing in number.

It is always difficult to have a negative outlook on the markets, but the direction of recent economic data makes that outlook warranted in the near term. We have taken steps to reduce the risk exposure in many of our portfolios in recent months, and believe that this stance remains prudent for clients who have a conservative risk profile or a short time horizon.

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[1] "Drop Foreseen in Median Price of Homes in U.S.," David Leonhardt & Vikas Bajaj, New York Times, August 26, 2007
[2] Testimony before the Joint Economic Committee, United States Congress, March 28, 2007
[3] "Fed 'not currently' predicting US recession: Bernanke," AFP, January 10, 2008
[4] Q&A after testimony before Senate Banking Committee, February 14, 2008

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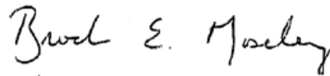
A volatile market inspires a rollercoaster of emotions, but at times like these it is most important for investors to remain faithful to their longer-term risk profile, and not the daily direction of the market. It is unclear whether we are facing a mild slowdown or a real "double-dip" recession, but in the coming months we will see how the economic backdrop impacts financial markets. In light of the revisions to GDP growth for the first half of 2011, the case may be that the recession never truly ended, but took a temporary vacation. As we always say, however, the markets are not the economy, and many factors can impact investors' penchant for risk-taking behavior. If Washington can present some sort of fiscal solution for sustainably reducing the country's budget deficit, or if investors deem the rock-bottom yields on Treasurys too low for comfort, we may see support continued for the equity market. Right now, the macro backdrop is very important, and investors should monitor any changes that could reverse the cyclical downtrend in place. The good news is that markets *are* cyclical, and equity weakness could be a buying opportunity for investors who have a longer-term perspective.

August 31, 2011



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