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QE2 and its Consequences (Part I)

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The Federal Open Market Committee (FOMC) announced on November 3, 2010 that it would purchase longer-term Treasury securities at a pace of $75 billion dollars per month through the Federal Reserve's Permanent Open Market Operations (POMO) facility by the end of the second quarter 2011 and potentially beyond. The Quantitative Easing Two ("QE2") program, championed by Ben Shalom Bernanke, Ph.D., Chairman of the US Federal Reserve, is expected to total at least $600 billion and the program may total more than $600 billion, if Dr. Bernanke and the FOMC deem it to be necessary. Currently, QE2 is expected to continue until the end of 2011, i.e. up to $1.2 trillion, although there is ongoing policy debate within the Federal Reserve amidst growing fears that the policy may backfire.

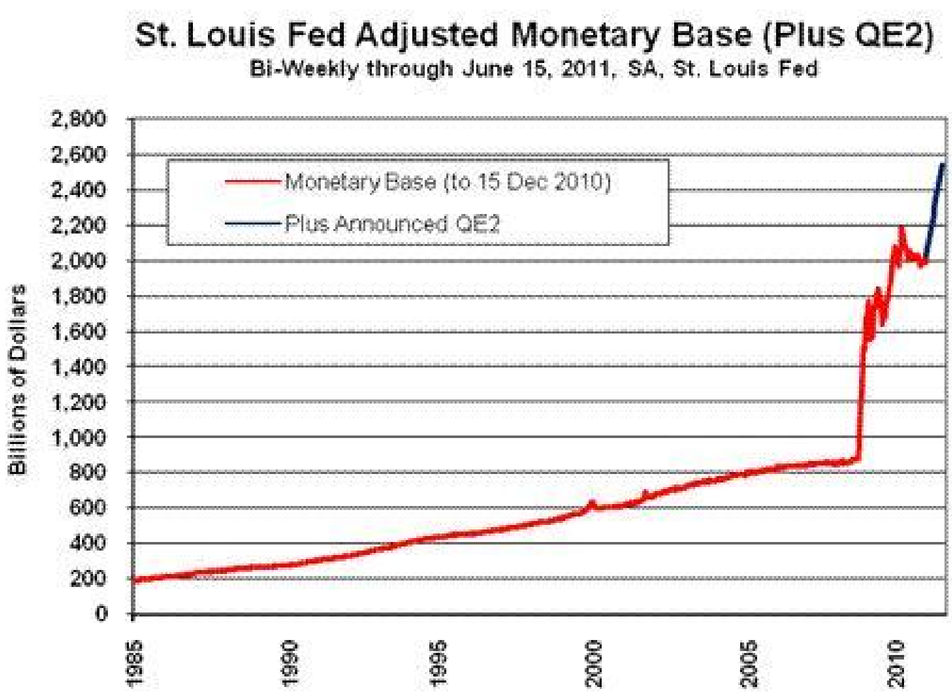

Chart courtesy of Shadow Government Statistics

Monetary inflation is one result of QE2 because when the Federal Reserve buys US Treasuries it injects newly created money into the financial system, which, in turn, reduces the value of the US dollar (due to the increase in the quantity of dollars). A lower US dollar could stimulate US exports but could have unintended consequences, such as creating excess liquidity that could lead to asset price bubbles in the US. Low interest rates are already fueling a US dollar carry trade that seems likely to create asset price bubbles abroad. In 2010, borrowing in the US and investing abroad yielded significant returns, thus, there is a profitable carry trade in the world's reserve currency, which has been called the mother of all carry trades by New York University economist Nouriel Roubini because of the US dollar's increasingly tenuous status as the world reserve currency.

Global Outcry Against QE2

The announcement of QE2 touched off an international firestorm of controversy. QE2 has been widely criticized by financial and political leaders representing US creditors, exporters and emerging economies. Nobel laureate Joseph Stiglitz has become an outspoken critic of QE2, warning that it poses a risk to emerging economies where asset price bubbles are already apparent. European Central Bank (ECB) President Jean-Claude Trichet expressed the same concern. The growing consensus on the part of emerging economies, such as Brazil, India, China, Argentina, Taiwan, Thailand, South Korea, Peru and Indonesia, is that capital controls are necessary to prevent excessive capital inflows, which can be highly inflationary. The International Monetary Fund (IMF), which bailed out a number of smaller countries in 2008, has supported capital controls since February 2010. The dilemma for exporters is that they must seek to control inflation, e.g., by raising interest rates, but must also debase their currencies to maintain their exports. The only other option is to institute capital controls. One of many critics, Brazil's Finance Minister, Guido Mantega, warned that the US-led currency war "…is turning into a trade war."

The growing consensus is that inflation in Asia will damage Asian economies before Western countries, which are debasing their currencies, fully recover from the recession that began in 2007. The trade relationship of the US and China is in the eye of the storm and fears of a trade war are growing. Debasing the US dollar reduces the value of China's US Treasury holdings while China relies on exports to the US, totaling between $200 and $300 billion annually. For exporters, QE2 is a doubly destructive policy since capital inflows are inflationary while exports are reduced due to currency appreciation. The potential effects of a downturn in manufacturing resulting from falling exports, coincident with the bursting of an asset price bubble, is a formula for disaster. As more countries begin to conduct international trade without using US dollars, the world could be split into two camps. For example, talks are taking place between the US and Japan regarding the establishment of trans-Pacific free trade.

Interestingly, QE2 has the potential to "cash out" favored holders of US Treasuries in exchange for US dollars at their current value, i.e., before the US dollar declines further. China, Russia and Brazil are already reducing their US Treasury holdings and could be favored sellers of US Treasuries to the Federal Reserve (through its intermediaries). However, given the size of the US federal deficit, the simplest explanation is that the Federal Reserve is simply funding the US government.

Keeping the Wolfpack at Bay

While it may stimulate US exports and help to create conditions for renewed economic growth in the US (rather than relying mainly on the stimulation of consumer spending), QE2 represents a debasement of the US dollar and suggests that demand for US debt may be weakening. The current facts regarding the US economy do not justify the AAA rating of US sovereign debt. In February 2010, Moody's publicly warned that it might have to cut the rating on US government debt. The warning was reiterated in December, while American politicians debated tax policy, and surfaced again in January. Until the US economy shows stronger growth, and until the US federal government gets its budget deficit under control, confidence in US sovereign debt and in the US dollar will continue to deteriorate.

US Treasury yields began to rise after the announcement of QE2 and, in December, US Treasuries experienced an unprecedented sell-off causing speculation that the US may become the next target of the so-called wolfpack, comprising short sellers of sovereign debt that are also OTC derivatives (credit default and interest rate swaps) traders. Artificial demand for US Treasuries created by QE2 could potentially head off the shorting of US Treasury bonds to generate credit default and interest rate swap related profits. Short sellers seeking to drive up yields run the risk that the Federal Reserve will step in and buy aggressively to drive yields back down, thus QE2 may preempt the wolfpack. The United States is not immune to such predatory practices might because the notional value of OTC derivatives is currently more than $605 trillion (approximately 10 times world GDP).

Chart courtesy of StockCharts.com

Artificial demand for US Treasuries could hold down bond yields thus supporting an inflationary monetary policy but the Federal Reserve's own Primary Dealers forecast higher bond yields for 2011. The Federal Reserve's control over US Treasury bond yields appears to be limited, ironically, as a consequence of currency debasement. Even if US Treasury bond yields rise, however, QE2 might still provide a means of keeping the wolfpack at bay.

Let them Eat Dollars

While QE2 has been generally positive for equities in the short term, the FOMC announcement in November 2010 triggered a sharp rise in commodity prices with gold closing over $1400 and silver closing over $30 at the end of 2010 and with the Commodity Channel Index (CCI) and global food prices at new highs. Rapidly rising global food prices pose an escalating risk of food shortages or worse, particularly in poorer countries, leading analysts to conclude that the world is one poor harvest away from chaos. President of the World Bank, Robert Zoellick, warned that rising food prices are "a threat to global growth and social stability." Food riots, for example, have already begun to break out in Africa. In the US, consumers and businesses paid an additional $25 billion for gasoline between September 2010 and January 2011 and gasoline prices have continued higher.

Chart courtesy of StockCharts.com

Since the corrosive effects of expanding the money supply in excess of the rate of increase in sustainable economic activity, i.e., inflation, could not so quickly have resulted from QE2, QE2 seems to have damaged global confidence in the US dollar and in US Treasury debt. The January pullback in gold and silver showed that the sharp rise in prices after the announcement of QE2, in November 2010, was in part reactionary. Nonetheless, the strengthening of the US dollar can be largely attributed to the ongoing debt crisis in Europe and the ongoing bull market in commodities and precious metals points to a continuing influx of capital and to a reduced preference for the US dollar and US Treasuries. Had it not been for the revelation of Ireland's economic troubles along with those of other European countries, the US dollar would certainly have fallen further compared to the Euro towards the end of 2010. What is more important is that the Euro, the US dollar and the Japanese yen have the same fundamental problem in common, which is a combination of high debt levels and economic fundamentals that, in the best case, do not inspire confidence.

Chart courtesy of StockCharts.com

All other things being equal, if the QE2 program were terminated, the US dollar would certainly rally and demand for US debt would certainly strengthen, lowering demand for commodities and precious metals. The termination of QE2 or an announcement of its impending termination is a potential short term risk for investors. Conversely, as QE2 continues indefinitely, the current commodities bull market, which has been amplified by the weakening US dollar, will continue And precious metals prices, which are currently consolidating, will move higher.

The emerging pattern since the announcement of QE2 is bullish for commodities and precious metals. Episodic flights to safety have tended to cause the US dollar to rally, despite poor economic conditions in the US, i.e., in response to economic instability in countries such as Dubai, Greece, Ireland or Spain. The pattern of US dollar-centric flights to safety has begun to break down, suggesting that investors may increasingly favor commodities and precious metals over US dollars and US Treasuries as hedges against inflation and sovereign debt risk.

Diminishing US Credibility

The credibility of the US government and the Federal Reserve is gradually deteriorating. In the worst case, a total collapse of confidence could trigger a race to divest of US Treasuries and to shed US dollars, i.e., a hyperinflationary currency event. The declining US dollar and the diminishing desirability of US debt and of the Federal Reserve's credibility bode well for commodities and precious metals while warning away any sane investor from US Treasuries.

In the face of indefinite QE2, it remains unclear (1) when the disintegration of the US dollar's status as the world reserve currency might accelerate and a new reserve currency will be established, (2) if and when holders of US Treasuries seeking a way out might reach critical mass potentially triggering a proverbial rush to the exits (i.e., a collapse of US Treasuries despite the Federal Reserve's artificial demand), or (3) if and when a race, whether global or domestic, to shed US dollars in favor of equities, hard assets, alternative currencies, precious metals or other real goods might begin. The first and second processes (removal of the US dollar's world reserve status and the divestment of US Treasuries) are already under way and the Federal Reserve's current policies are on track to eventually trigger the third.

Fundamentally, the Federal Reserve cannot prevent rising prices while the US dollar moves lower due to QE2 and due to the US' deteriorating creditworthiness and credibility, nor can it control the flow of liquidity resulting from its actions or, therefore, resulting asset price bubbles, whether in the US or abroad. In light of the Federal Reserve's current policies, it seems likely that, in the next 12 months, global economic volatility related to inflation, currency debasement and, potentially, developing currency and trade wars will increase while the financial stability of the US and of the Eurozone countries continues to decline and while commodity and precious metals prices continue to move higher.

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