



ATLANTIC CAPITAL MANAGEMENT

## **A DESPERATE FED**

### **QE 2.0 Is A Hail Mary Toward the Wrong Endzone**

SPECIAL INVESTMENT RESEARCH REPORT  
November 16, 2010

EDITION 6 **THE NEXT PHASE SERIES**

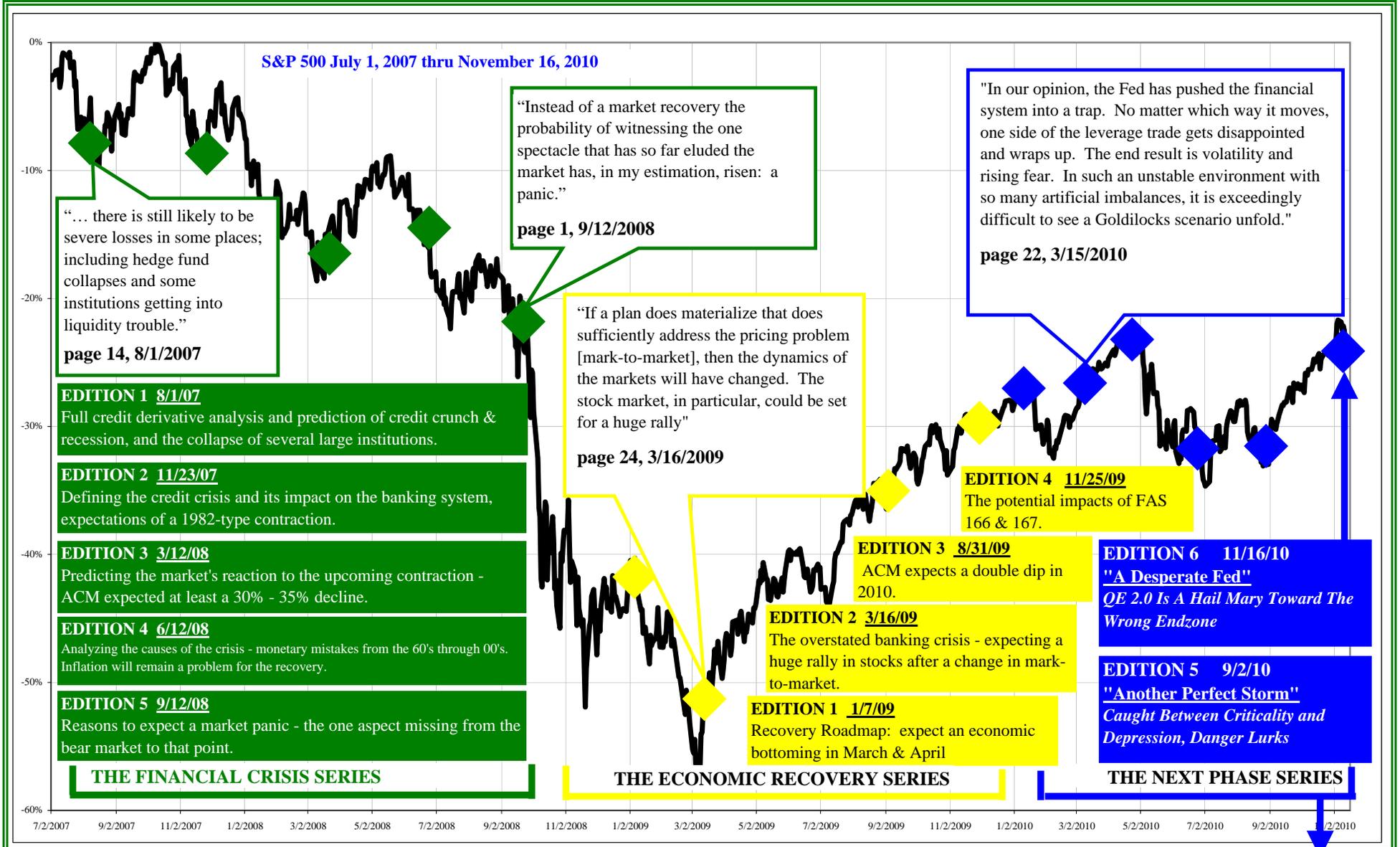
Written By  
Jeffrey P. Snider, President

Additional Research Provided By  
Steven Stejskal, Assistant Vice President, Research



# ACM INSTITUTIONAL SERVICES

research.acminstitutional.com



**EDITION 1 1/4/10**  
“A Market Pause For Reality”  
Some Indications for 2010

**EDITION 2 3/15/10**  
“Channel Distortions From The Fed”  
The Chapter on Liquidity Traps Was Left Out of The Textbook

**EDITION 3 4/26/10**  
“A Lasting Pandemic Of Bias”  
Elite Opinion Is Often Harmful In Atypical Climates

**EDITION 4 6/30/10**  
“Why Quantitative Easing Cannot Work”  
And Why We Will Get More Anyway

## REPORT SUMMARY

The market advance since late August has been in anticipation of QE 2.0, the new monetary policy that is no different than the old one. We spend one research report in June on this topic but felt it necessary to revisit it from a different angle, with more real world detail.

The primary difference between now and then has to be the reception QE 2.0 has received. Because there has been a very public backlash, this latest monetary move reeks of desperation at the Fed. That in itself speaks much more forcefully than the simple purchase of bonds ever could.

### Part 1 – Spending Is About Sources, Not Cost

---

The growth in consumer spending in this current recovery is far weaker than the previous three. There are three primary reasons for this:

1. Private income sources have been decimated, especially wage and asset income (because of “stimulative” interest rate policy. Without a massive decline in taxes paid, private income would have declined by a dramatic amount.

2. Government support of households is at an all-time high. This is not conducive to a sustainable recovery, and it may be hindering it.

3. Debt restructuring in both consumer credit and mortgages is taxing cash needs. QE 2.0 seeks to improve credit conditions.

### Part 2 – Wealth and the Chinese Imbalance

---

Spending on goods has been unusually robust despite overall weakness in total PCE. This is due to reduced personal service expenses for financial services and housing. The foreclosure process and strategic defaulters have created room in their discretionary budgets to purchase goods. This is not conducive to a sustainable recovery, particularly since housing expenses rose significantly in Q3 2010.

Though goods spending was robust, most of it went overseas. This trade imbalance means much more than short-term negatives. The wealth creation imbalance is far more damaging, and was one of the leading causes of the housing bubble and bust. Unfortunately, the same imbalances in the velocity chain and wealth creation are being rebuilt into the current recovery, making it far weaker than it could have been.

QE 2.0 will knowingly weaken the dollar (though it will never be publicly admitted) to address the imbalance.

### Part 3 – Missing Real Risk

---

Recoveries are more than just rebounds in spending levels. The true basis for recovery is willingness to take on real risk (meaning risk in the economic rather than financial sense). The only real source of strength has been inventory building. But we question whether this is risk-taking or inflation beginning to root.

QE 2.0's real focus is negative real interest rates. Negative rates make safety expensive and is thought by the Fed to push banks into risk in the hope of creating that true recovery. The problem is that monetary policy has been directly responsible for bank deleveraging (credit contraction) and the switch from traditional bank lending to securities-type lending (which favors large business and government at the expense of small business and individuals).

*“Uncertainty is nothing more than a lack of market discipline. What is needed right at this moment is for businesses and investors alike to know without any sliver of doubt that government and businesses and consumers are being forced to regulate themselves. With the threat of illiquidity and bankruptcy never far away, economic actors will behave as if their survival depends on maintaining sound and sustainable habits. And that brutal market discipline is what makes investors less uncertain about investing, makes banks less uncertain about lending to households, makes businesses less uncertain about future growth”*

## INTRODUCTION

### A DESPERATE FED

#### QE 2.0 Is A Hail Mary Toward the Wrong End Zone

On April 14, 2010, the S&P 500 Index closed above the 1,200 level for the first time since September 2008. It would trade around that level until succumbing to selling pressure on May 3. Those early spring days were alive with optimism: the V-shaped recovery was thought to be an empirical reality, companies saw rapidly growing bottom lines, and stocks were in a low-volatility forty-five degree ascent.

There were, of course, ominous warnings, especially PIIGS. As Greece fell into union-controlled anarchy the “best spring real estate season in years” quickly disappeared with Washington’s latest flirtation with incentivizing. And most tellingly, the first iteration of quantitative easing had just ended.

I wrote in mid-March 2010:

“...the Fed has pushed the financial system into a trap. No matter which way it moves, one side of the leverage trade gets disappointed and wraps up. The end result is volatility and rising fear.”<sup>1</sup>

That pretty much sums up the May-August period.

Noticing the sharp declines in stock prices and the massive volatility that spooked retail, institutional and inside investors alike, Chairman Bernanke relit the QE pilot light with the MBS reinvestment program. Everyone knew that it was a prelude to QE 2.0 since that is the Fed’s go-to policy.

Now that the S&P 500 has recrossed that 1,200 level we have to question its legitimacy. Has anyone talked about that V-shaped recovery lately? For the first time since early 2009, earnings estimates are being cut (for 2011), in step with GDP estimates. What does it say about this “sustainable” recovery if the Fed – the same outfit that immodestly declared its own success in March – now feels an overwhelming need to restart the same policy. And do so over the rising objections of a growing number of high-ranking insiders?

In his November 4, 2010, oped in the Washington Post<sup>2</sup>, Mr. Bernanke helpfully explains that QE 1.0 “helped end the economic free fall and set the stage for a resumption of economic growth in mid-2009.” From this attempt at massaging expectations we are left to believe that the first massive monetary intervention had such limited ambitions. Perhaps we are supposed to forget that the Fed stated with crystal clarity that low interest rates *would* (not should or may) “stimulate” the economy, ipso facto.



In fact, Mr. Bernanke casually hints at this further into his opinion piece, describing the original QE:

“This approach eased financial conditions in the past and, so far, looks to be effective again. Stock prices rose and long-term interest rates fell when investors began to anticipate the most recent action. Easier financial conditions will promote economic growth.”

Many commentators have taken exception with the second sentence (as well as the first) as an almost fully explicit admission of intent. Namely that the Fed is actively trying to manage the economy through the stock market. While I fully agree to the folly of such a plan (if stocks lead the economy, what happened in Summer 2008 when the economy was already tanking yet stocks held their ground?) I really take exception to the third sentence.

Economic canon at the Fed still seems to hold as a simple equation: reduce interest rates and economic activity follows. Yet, in 2009 and 2010 we have definitive, conclusive, unambiguous proof that such a maxim is *false*. What has been stimulated by low interest rates? Wallowing further into the absurd, Mr. Bernanke immediately follows the easier conditions line with:

“For example, lower mortgage rates will make housing more affordable and allow more homeowners to refinance. Lower corporate bond rates will encourage investment.”

Mortgage rates are not suddenly low. They have been obscenely low for quite awhile now and the housing market has not sprung back to vibrancy. Corporations are borrowing at record levels not because they are optimistic about the future but are instead pessimistically self-financing as banks drastically reduce their exposure to the entire sector. Those robust earnings are a product of massive *declines* in business investment.

At its most basic level this current “recovery” has stalled precisely because there is a distinct lack of willingness to undertake real risk. Unfortunately, the Fed believes that risk is simply a number in a calculus, or a model.

I wrote back in August that quantitative easing was really a two step program. Monetary expansion was only step one. The second step is on deck, negative real interest rates. For the Fed, what ails the economy is exactly how low interest rates can truly be stimulative. By making cash and short-term investments produce negative real returns the Fed’s textbook says that businesses will begin to invest and savers will turn to spenders. By making safety expensive, everyone will return to risk. But quantitative easing creates distortions that move the economy away from what is really needed.



## Part 1 Spending Is About Sources, Not Cost

Figure 1-1 below is a comprehensive look at household income, expenses and savings during the past four recessions and recoveries. We examined cumulative changes of various segments compared to a pre-recession high to gauge how much spending/borrowing power was lost, and how much of that was regained during the subsequent recovery – our total timeframe is 11 quarters (i.e., we use the fourth quarter of 2007 as our baseline and compare it to the 11 quarters that come after, encompassing both the contraction and the recovery).

Our survey breaks down into four basic sections: 1) private sources of money income, 2) government sources of money income (mostly transfers), 3) changes in consumer credit, 4) flows to or from investment asset classes. Although our data does not encompass every possible source or use of money, it provides enough detail to properly analyze the household sector of the economy.

---

### Line by line explanations:

**Line 1** – Private sector wage and salary disbursements, gross of taxation. The largest single source of household income.

**Line 2** – Supplements to wages, including private pension contributions, health insurance, and FICA taxation.

**Line 3** – Cumulative changes to personal income taxes are shown as an inverse. Declines in personal income taxes are shown as positive since less taxes means a larger spending pool.

**Line 3a** – Rental income of household property owners (noncorporate) is shown for the 2008-2010 period only. In the prior periods it is not significant.

**Line 4** – Proprietors' Income is essentially small business net income (from pass-through type businesses).

**Line 5** – Household asset income from both dividends and interest.

**Line 6** – Cumulative total of Lines 1 thru 5.

**Line 7** – Adjusting Line 6 by backing out Line 2 (wage supplements) since supplements are not accessible for spending.

**Line 8** – Adjusted private income changes.

**Line 9** – Government wages and salaries.

**Line 10** – Social security payments to individuals.

**Line 11** – Government (federal and state) unemployment insurance payments to individuals.

**Line 12** – Other transfer payments to individuals (welfare, food stamps, etc.).

**Line 13** – Cumulative total of Lines 9 thru 12.

**Line 14<sup>3</sup>** – Total household income changes (adjusted), Line 8 plus Line 13.

**Line 15<sup>4</sup>** – Change in outstanding revolving credit arrangements for consumer loans (credit cards).

**Line 16** – Change in outstanding non-revolving credit arrangements for consumer loans (auto, school, etc.).

**Line 17** – Cumulative changes to primary spending sources, Lines 14 thru 16.

**Line 18<sup>5</sup>** – Inverse change in Personal Outlays. Increases in spending are shown as a negative (use of funds), including personal consumption expenditures (PCE), non-mortgage interest, and personal transfers. Mortgage interest and principal payments are included within PCE as “imputed rental of owner-occupied non-farm housing” where the Bureau of Economic Analysis attempts to estimate mortgage-related expenses. It is included within household spending on services (more on this later).



**Line 19** – Money sources left for investment, Line 17 plus Line 18.

**Lines 20 – 26<sup>6</sup>** show money flows out of and into various asset classes, including assets subject to price movements. These flows *do not* represent changes in market values, only estimates of real cash movements.

**Line 27** – Cumulative surplus or deficit encompassing wages (private and government), consumer credit and asset flows.

**Line 28<sup>7</sup>** – Not accounted for are changes to larger household liabilities such as mortgages outstanding. Since large percentages of mortgage loans do not end up as spendable sources of cash it is difficult to estimate with any precision just how much of the changes in liabilities increase or decrease spendable money sources. We include flows to or from mortgages to provide a rough estimate.

---

We can clearly quantify (and should be of no surprise to anyone) the severity of the lost private sector income compared to previous contractions. Even through the recovery phase private sources of money income are still down compared to the baseline. In fact, if not for the massive decline in taxes private sector income sources would have declined by a huge number. It also puts into perspective the “jobless” recoveries of 2002-03 and 1991-92. The last really robust recovery in 1983 shows a 10% cumulative change in private sector wages on top of a 31% increase in asset income.

The reduction in asset income (a topic we have spent a lot of time on previously) is a major drag on spendable income. While the declines in asset income were relatively modest in the previous two contractions and recoveries the 6%+ decline in 2008-10 is an absolute killer. On an absolute basis, the decline in asset income is nearly as great as the decline in wage income (70% as large). That is a lot of purchasing power shifted from spenders to the banking system.

Also abundantly clear is the level of government intervention. In the early 1980's the ratio of private income growth to government interventions was 2.7 to 1. By the early 1990's, the ratio had flipped in favor of government, with a 1.3 ratio. In the early 2000's the ratio was 1.1 in favor of government transfers. In the current contraction and rebound, it's 79.0 to 1. Correlation is not causation, but, as we shall see, the rise in government intervention is

certainly one of the main factors in these “jobless” recoveries.

By providing over \$1 trillion in cumulative income growth the size of the government intervention is astounding. Analyzing those numbers further we see that nearly a third of government transfer growth is from the “other” category (welfare and foodstamps). This is not exactly a formula for a robust recovery since these programs are geared to be a transitory safety net during the worst times. It is hardly sustainable income and most households do view it as nothing more than temporary subsistence.

The other temporary income, unemployment insurance payments, jumped far more than the previous episodes, even surpassing the increase in total government wages (which are admittedly weakened by state and local governments).

In the overall context of government support and private weakness it is not surprising that total personal outlays have not grown more. The 1% change in the current cycle is far less than the 6-7% growth in the previous two, and the near 14% growth in the early 1980's (not adjusted for inflation, but by 1983 inflation had receded dramatically).

As much as the above explains weakness in spending, flows related to household assets and liabilities are equally important. In all three recoveries prior to this one there was a cash deficit after asset flows. In the 1990's and 2000's the deficits are easily explained by cash flows *from* mortgages (especially



the housing bubble). The cash deficit in the early 1980's was partially offset by mortgage flows but was largely due to high interest rates in less risky assets like CD's and savings deposits attracting previously untracked funds.

In 2010, the net cash deficit is far smaller but not surprising in the context of the flows *into* home mortgages. In other words, households have been conserving and raising cash to pay off debt (including consumer revolving credit), suppressing the desire to consume.

What this data shows is that households, for the most part, are being constrained in ways not seen in decades. For policymakers to not see the long-term benefits of this is beyond maddening. The markets are enforcing discipline on households whether they like it or not. It certainly makes for short-term economic weakness that can go on longer than most would ideally like, but the long-term positives far outweigh any short-term weakness. After a decade of unearned, monetary-fueled extravagance balance sheet repair is the right thing to do.

In fact the constraints on the “small” actors in the economy are a striking contrast to the “large” actors. Small businesses have yet to see any improvement off the bottom of the recession (**Line 4**) while big corporations have recovered almost all their lost profitability. Large business has shared the loss of available credit from banks but has been more than able to replace that credit with bond issuance. Small business has lost a greater share of its credit access but was forced to replace it by drawing down savings and financial assets. Most of the lost credit for small business has been bank loans, mortgages and trade payables. The reduction in credit in these categories is matched almost exactly by a reduction in financial assets.

The loose monetary policy Mr. Bernanke speaks about is not uniform. It is entirely limited to large actors. This tiered system is no doubt one of the biggest reasons that the backlash is growing more determined. QE 2.0 will not change this. Households and small businesses cannot be forced into constraints by policy that favors one over another (more on this in Part 2). True market discipline extends to everyone, big and small.



2008-2010 (11 quarters)			Billions of Current \$'s, Cumulative Changes over Beginning Period Baseline		
	1,256.5	4.30%	DPI, as calculated by BEA		
1	-523.5	-3.51%	Private Industry Wages & Salary Disbursements		
2	205.0	5.10%	Personal Supplements to Wages & Salaries		
3	738.4	17.69%	Personal Current Taxes (Inverse)		
3a	264.0	57.87%	Rental Income of Persons		
4	-96.3	-3.22%	Proprietors' Income w/IVA & CCAAdj		
5	-369.5	-6.34%	Personal Income receipts on Assets		
6	218.1				
7	-205.0		Minus Personal Supplements to Wages & Salaries		
8	13.1		Adjusted Private Income Sources		
9	171.0	5.63%	Government Wages & Salary Disbursements		
10	338.8	12.10%	Old Age Survivors, Disability and HI		
11	187.1	196.02%	Government Unemployment Insurance		
12	337.9	20.29%	Other Government Social Benefits to Persons		
13	1,034.8		Total Government Income Sources		
Sources (Uses) of Funds					
14	1,047.9		Adjusted DPI		
15	-119.6	-12.70%	Change In Revolving Credit		
16	11.7	0.74%	Change In Non-revolving Credit		
17	940.0		Total Primary Spending Source Changes		
18	-289.5	1.01%	Inverse Change in Pers Outlays (PCE, Non-mtg Int, Xfers)		
19	650.4		Money Sources Left for Investment		
20	170.8		Flows from (to) Liquid Asset Levels (Checking, Time, MMF)		
21	79.7		Flows from (to) Equities		
22	-836.9		Flows from (to) US Treasury Bonds		
23	-137.3		Flows from (to) US Muni Bonds		
24	455.5		Flows from (to) Corporate & Foreign Bonds		
25	-511.0		Flows from (to) Mutual Funds (all types)		
26	-128.7		Cash Surplus (Deficit)		
	-355.3		*Flow data thru Q2 2010, From Federal Reserve Z1 Memo: Flows from (to) Home Mortgages		

2001-2003 (11 quarters)			Billions of Current \$'s, Cumulative Changes over Beginning Period Baseline		
	1,351.8	6.50%	DPI, as calculated by BEA		
1	-70.3	-0.61%	Private Industry Wages & Salary Disbursements		
2	351.3	12.70%	Personal Supplements to Wages & Salaries		
3	607.2	17.02%	Personal Current Taxes (Inverse)		
4	89.5	3.75%	Proprietors' Income w/IVA & CCAAdj		
5	-105.0	-2.81%	Personal Income receipts on Assets		
6	872.7				
7	-351.3		Minus Personal Supplements to Wages & Salaries		
8	521.4		Adjusted Private Income Sources		
9	195.1	8.82%	Government Wages & Salary Disbursements		
10	150.0	8.33%	Old Age Survivors, Disability and HI		
11	61.8	88.86%	Government Unemployment Insurance		
12	174.1	16.72%	Other Government Social Benefits to Persons		
13	581.1		Total Government Income Sources		
Sources (Uses) of Funds					
14	1,102.5		Adjusted DPI		
15	67.3	9.60%	Change In Revolving Credit		
16	250.9	23.71%	Change In Non-revolving Credit		
17	1,420.6		Total Primary Spending Source Changes		
18	-1,199.5	5.93%	Inverse Change in Pers Outlays (PCE, Non-mtg Int, Xfers)		
19	221.1		Money Sources Left for Investment		
20	-803.6		Flows from (to) Liquid Asset Levels (Checking, Time, MMF)		
21	604.1		Flows from (to) Equities		
22	184.8		Flows from (to) US Treasury Bonds		
23	-153.0		Flows from (to) US Muni Bonds		
24	-70.7		Flows from (to) Corporate & Foreign Bonds		
25	-456.5		Flows from (to) Mutual Funds (all types)		
26	-473.9		Cash Surplus (Deficit)		
	2,001.4		*Flow data from Federal Reserve Z1 Memo: Flows from (to) Home Mortgages		

1991-1993 (11 quarters)			Billions of Current \$'s, Cumulative Changes over Beginning Period Baseline		
	882.3	7.47%	DPI, as calculated by BEA		
1	266.9	4.32%	Private Industry Wages & Salary Disbursements		
2	176.6	10.89%	Personal Supplements to Wages & Salaries		
3	14.2	0.86%	Personal Current Taxes (Inverse)		
4	80.0	7.88%	Proprietors' Income w/IVA & CCAAdj		
5	-28.5	-1.12%	Personal Income receipts on Assets		
6	509.2				
7	-176.6		Minus Personal Supplements to Wages & Salaries		
8	332.7		Adjusted Private Income Sources		
9	107.6	7.47%	Government Wages & Salary Disbursements		
10	133.6	13.75%	Old Age Survivors, Disability and HI		
11	38.5	77.68%	Government Unemployment Insurance		
12	143.6	31.17%	Other Government Social Benefits to Persons		
13	423.2		Total Government Income Sources		
Sources (Uses) of Funds					
14	755.9		Adjusted DPI		
15	55.2	23.53%	Change In Revolving Credit		
16	-41.9	-7.27%	Change In Non-revolving Credit		
17	769.2		Total Primary Spending Source Changes		
18	-764.7	6.92%	Inverse Change in Pers Outlays (PCE, Non-mtg Int, Xfers)		
19	4.5		Money Sources Left for Investment		
20	74.7		Flows from (to) Liquid Asset Levels (Checking, Time, MMF)		
21	122.9		Flows from (to) Equities		
22	-114.1		Flows from (to) US Treasury Bonds		
23	-34.0		Flows from (to) US Muni Bonds		
24	-61.2		Flows from (to) Corporate & Foreign Bonds		
25	-358.0		Flows from (to) Mutual Funds (all types)		
26	-365.1		Cash Surplus (Deficit)		
	457.7		*Flow data from Federal Reserve Z1 Memo: Flows from (to) Home Mortgages		

1981-1983 (11 quarters)			Billions of Current \$'s, Cumulative Changes over Beginning Period Baseline		
	772.0	13.30%	DPI, as calculated by BEA		
1	321.4	10.09%	Private Industry Wages & Salary Disbursements		
2	122.3	15.58%	Personal Supplements to Wages & Salaries		
3	-87.8	-10.03%	Personal Current Taxes (Inverse)		
4	-17.5	-3.40%	Proprietors' Income w/IVA & CCAAdj		
5	310.1	31.31%	Personal Income receipts on Assets		
6	648.4				
7	-122.3		Minus Personal Supplements to Wages & Salaries		
8	526.2		Adjusted Private Income Sources		
9	83.2	11.04%	Government Wages & Salary Disbursements		
10	93.0	20.27%	Old Age Survivors, Disability and HI		
11	14.2	29.57%	Government Unemployment Insurance		
12	20.0	9.46%	Other Government Social Benefits to Persons		
13	210.3		Total Government Income Sources		
Sources (Uses) of Funds					
14	736.5		Adjusted DPI		
15	18.6	33.82%	Change In Revolving Credit		
16	47.3	15.93%	Change In Non-revolving Credit		
17	802.4		Total Primary Spending Source Changes		
18	-711.2	13.69%	Inverse Change in Pers Outlays (PCE, Non-mtg Int, Xfers)		
19	91.1		Money Sources Left for Investment		
20	-515.6		Flows from (to) Liquid Asset Levels (Checking, Time, MMF)		
21	98.4		Flows from (to) Equities		
22	-58.2		Flows from (to) US Treasury Bonds		
23	-114.3		Flows from (to) US Muni Bonds		
24	0.0		Flows from (to) Corporate & Foreign Bonds		
25	-27.0		Flows from (to) Mutual Funds (all types)		
26	-525.6		Cash Surplus (Deficit)		
	190.8		*Flow data from Federal Reserve Z1 Memo: Flows from (to) Home Mortgages		



## Part 2 Wealth and the Chinese Imbalance

Constrained consumer spending is understandable in the face of such substantial headwinds for households, but a more careful examination reveals something even more troubling. Taking apart personal consumption expenditures (PCE) further we see that spending on *goods* (both durable and nondurable) during the five quarters of the current recovery is actually outpacing both of the past two. The comparison holds for both nominal and real consumer spending.

While household spending on goods is proceeding more rapidly, spending on services is lagging. Within the services sector spending on recreation, financial services and housing/utilities are the primary centers of weakness (these three segments accounted for 46% of all services spending in Q3 2010). What this suggests is that reduced outlays for non-discretionary services is adding to discretionary budgets, and therefore spending on goods.

Household expenses for rent, mortgages, utilities, etc., are mostly non-discretionary. In many cases spending on financial services is also non-discretionary. By far the largest decline in housing expenses is the “imputed rental of owner-occupied nonfarm housing” mentioned in Part 1. This means that the BEA is acknowledging that households are spending less on monthly mortgage payments (through a combination of refinancing, foreclosure and strategic defaults) now than at the trough of the recession. In the case of financial services there has been little growth in “financial service charges, fees and commissions”, as well as insurance (and an outright decline in life insurance fees). In both cases spending remains below pre-recession highs, with service fees & commissions well below.

If we adjust only imputed rental, financial fees & commissions and insurance spending

higher by the growth rate of overall PCE, it would have taken a massive \$83 billion out of household discretionary budgets, enough to cut the growth rate in goods spending by 36%.

The bad news is that, once again, obtaining budget room from non-discretionary spending is not a stable foundation for economic growth. This is particularly true since housing expenses moved sharply higher in the third quarter of 2010, partially due to utility expenses and partially from a renewed increase in rental expenses (perhaps the increase in foreclosures is finally forcing people to move on to rental units?). If this trend holds, and the inflation the Fed is trying to create might well mean it will, then household budgets face another round of tightening.

Given the constraints on income and the transitory nature of the windfall from lower discretionary expenses, it is not surprising that the increase in spending on goods was not universal. Rather, goods spending tended to be concentrated in only a few segments. Purchases of autos and gasoline & energy accounted for 44% of the total increase in goods spending.

If we cross-reference those two segments with the increases in spending on imports, unsurprisingly we find that the rapid rise in imported goods coincides with household spending on autos and energy.

Overall growth of imported goods increased by a \$500 billion annual rate in the third quarter of 2010 over the second quarter of 2009, an astounding 34% increase. The rise in imported goods far outpaced overall PCE (5.8 to 1) and even spending on goods (3.7 to 1). Of the \$500 billion increase, 42% were autos and petroleum. The bulk of the rest was industrial supplies & materials (raw materials) and consumer goods. This means



that much of the rise in household discretionary funds went overseas.

This is certainly one of the biggest reasons that employment growth has yet to materialize. To quantify the problem, if we halve the growth rate of imports in the five quarters since the bottom of the recession, the GDP growth rate rises by 40%. And that does not take into account ancillary benefits from better growth, such as actual hiring and better incomes.

It is little wonder that policymakers have focused so much time and energy on China and permanent trade imbalances. Most of their bluster misses the real problem with these imbalances, namely foreign trade as it relates to velocity and wealth creation.

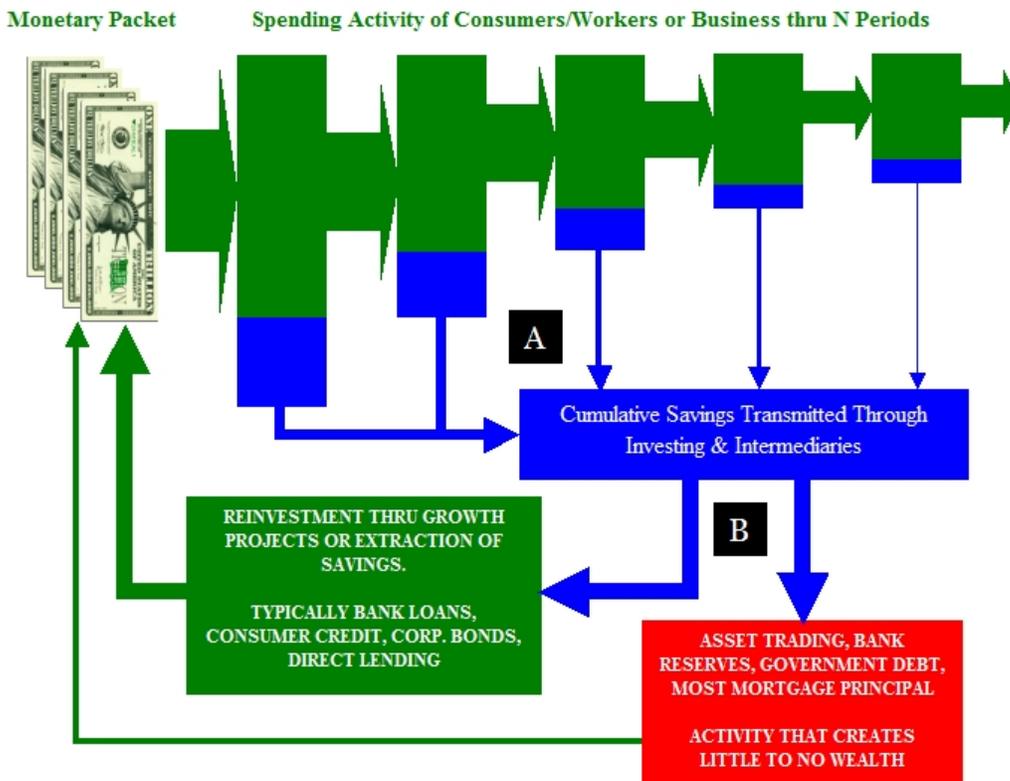
Money is not wealth and wealth is not money. Thus economic progress is not really monetary, though it can be measured in money (dollars, euros, gold, etc.). So much emphasis has been on the monetary that lost in the noise is the true measure of economic strength, i.e., the creation and maintenance of production. Production is

not strictly manufacturing since it can also encompass service sector business. Any service that increases productivity can be rightfully judged as creating wealth.

In our June 2010 Special Report, “Why Quantitative Easing Cannot Work” we laid out conceptually the economy from a funding perspective. Here we are going to use that framework to demonstrate the economy in terms of velocity and true wealth creation. There are a lot of misconceptions about money velocity and the widely held definition is partly responsible for that: velocity is thought to be how many times a dollar is circulated in the economy within a given time period.

At ACM, we think of velocity as slightly more complicated. Instead of thinking of a dollar transmitting from one hand to another, we think of packets of dollars (or whatever medium of exchange). This monetary circulation goes beyond single movements amongst economic actors since there are decision points in each monetary packet that affect overall economic activity. Conceptually it can be presented as:

FIGURE 2-1



Velocity becomes a summation of transactions with decision points at several intervals along the way. The first decision is spend vs. save (A). Consumers make aggregate decisions about how much of their income they want to save and how much to spend. For businesses, the same decision is made in terms of expenses and net income (where they have less discretion than consumers). This process repeats for each given time period



to where velocity is the sum of the exchanges of labor for goods/services facilitated by money. During periods where propensity to spend is higher than the propensity to save, velocity and economic activity are higher. On the flip side, when consumers and businesses prefer to save vs. spend, the amount of money exchanges is reduced as more money is used as a store of value for future exchanges.

In the modern world cash money is rarely used as a store of value so it is exchanged for some type of asset that can be converted back into liquid money at some point in the future. Here savers have choices of directly investing in securities or investing through intermediaries, with risk and return considerations dictating preferences. Intermediaries themselves go through the same kind of calculations as individual savers, ending up with an aggregate mix of general types of investing (B).

The aggregate flows at point (B) determine the amount of savings flow toward either broad category of assets demonstrated in the Figure 2-1. Investing in the first category (direct loans, consumer credit, corporate bonds, etc.) clearly has a larger impact on spending velocity, effectively recycling savings back into transactions. The second category (asset trading, bank reserves, mortgages) has much less impact on economic transactions. Stock trading in the secondary market does not create cash flow for companies or individuals (only the primary market for companies, and only for individuals that extract their stock holdings by not reinvesting the proceeds) while bank reserves are essentially dead money (which is why banks loathe them).

Government borrowing and taxation (which is not explicitly modeled in Figure 2-1) is placed in this low wealth creation box simply because government activity is a drag on the economy. Government employment does not create any sustainable enterprise or spending. If it did then any government could stimulate simply by

hiring as many firemen, police officers and teachers as possible. This is not to say that these are not worthy professions or that they have no effect on the economy. Teachers, for instance, are a net investment in the productivity of the future labor force, and firemen certainly create productivity by limiting damage and prolonging the lifespan of productive individuals within the labor force. These effects are limited, however, especially in the short-term.

Police officers, for instance, trade their labor to the government for money to spend on goods/services. In that tradeoff the government creates or sustains the production of *nothing*. Contrast that with factory workers that trade their labor for the production of goods. In this case, both sides of the equation facilitate the creation or maintenance of wealth. If the factory is profitable then the workers have facilitated sustainable production by participating in the production process. This is not to say that there is no value in having police officers, there clearly is. However, in the strictly economic sense no wealth is created by their labor so they are essentially a subtraction of wealth. Our economy has come to the conclusion that they are a very necessary cost and we are more than willing to give up some creation of wealth to keep them around. The only question, and it is often a difficult one, is the optimal level of subtraction or cost.

The same type of wealth subtraction takes place with transfer payments from government. These types of payments subtract wealth by keeping productive individuals from engaging in productive activities. In the form of Social Security payments to retirees, the government is providing the means to remove some of the most valuable members of the labor force. Again, this is not to say Social Security (or even retirement in general) is not a worthy goal, only that in an economic sense there is a loss of potential wealth creation. In the case of unemployment insurance payments or foodstamps, again productive members of



the workforce are being given the means to remove themselves from productive activities.

The counterargument is that these are necessary payments to keep households from being removed permanently from the workforce in times of contraction, particularly the current one. But this is only the case when there is no possibility for re-employment. The payments to keep labor unproductive are harmful since they hinder the necessary rebalancing during economic dislocation. The choice is not between paying unemployment insurance and not paying anything. The real choice is between subtracting wealth from productive uses to transmit money in the form of unemployment insurance vs. allowing the same funding to find more productive uses. Employed persons with steady income are much more likely to spend than persons receiving government stipends with a finite expiration. The question of cost to the economy then has to be whether or not there are any productive alternatives.

The balance of that equation is certainly dictated by whether or not government interference in job creation is one of the main sources of structural joblessness. If government is partially a cause of joblessness then its payments to the jobless constitute a barrier to removing those policies. Absent those payments there would be a much more concerted effort to alter the harmful policies. Payments for idleness represent a payoff to those affected most against taking action to force government change. In this case, these payoffs are counterproductive in the short-term and a subtraction from aggregate wealth creation and maintenance.

Velocity is then the summation of the propensity to spend among consumers and businesses plus the summation of the indirect activity of savings determined by the mix of assets. The only variable not directly included is the time period lags involved with indirect activity. Since

velocity is a measure of a finite time period, the temporal lags from implementation of savings transmission are a factor. There is a clear difference between savings directed to consumer credit (which is likely to be spent in the short-term) vs. business loans for a major expansion (which will take more time to complete) vs. stock issuance in the primary market (which may be used for any number of purposes and may take time to find one that impacts current transactions). What this means for any economic system is that the mix of savings transmission vehicles is extremely important in maintaining wealth fluidity.

The final piece to the economic puzzle is sustainability. No wealth creation or productive activity is infinite so within each transaction there has to be a sustainability component. There are two sides of the sustainability coin, with each presenting different challenges and signaling trouble in different ways. The first is sustainable enterprises; the second is sustainability of spendable income.

Sustainability is detected through a widespread diversity of knowledge and information (efficient market be damned). When prices signal distress from a perceived lack of ability to continue profitably, investors move to cut off that business from funding (**market discipline**). If that business is not profitable (most likely) then it will have an acute need for external funding. The loss of external funding leads to an eventual death spiral, which bleeds into customers. A business thought to be close to bankruptcy is likely to lose existing customers to competition, completing the creative destruction process.

Lack of sustainability for spenders is a function of sources of cash. Income from price action in assets is transitive, at best. It can only last as long as asset prices keep rising. Paradoxically, the higher prices go the greater the acceleration is needed to keep the price extraction process from collapsing – the ponzi aspect to asset bubbles.



With sustainability in mind we can begin to think of economic activity as a full spectrum of wealth creation: from high quality wealth (sustainable well into the long-term) to low quality (little sustainability beyond the very short-term). More often than not, businesses and investors care more about sustainability than consumers do, with obvious exceptions for bigger ticket items that need servicing, such as autos. An example of low quality wealth is HDDVD technology from Toshiba. The company put a lot of internal cash flow plus external funding into developing the technology clearly believing it would be a lasting DVD standard. A lot of consumers spent money on players and discs believing the same, creating wealth. However, it was low quality because the larger marketplace decided Sony’s Blu-ray was the ultimate winner and the entire HDDVD standard was scrapped.

There are any number of examples of low-quality wealth from the dot-com era, including many companies that were able to create wealth for more than a few quarters. But as the accumulation of low quality wealth reached a tipping point, price signals warned investors to pull back from these enterprises and eventually enough of them (and the wealth they created) were destroyed in the dot-com bust and 2001 recession. The wealth destruction increased the savings component of the velocity chain (business spending in particular), reducing overall economic activity.

The relative quality of wealth creation is one of the primary sources of weakness in the current recession, and a primary culprit of the Panic of 2008 and subsequent economic contraction. In the years after the dot-com bust we can fairly say that the spending side was creating low quality wealth. This is

largely due to the weakness in job creation, pressuring wage income and forcing (with little reluctance) households into debt spending as asset prices rose (thank you Fed).

Arguments abound as to why job creation was so difficult but many correctly point to the rise of imports. Unfortunately, the conversation gets little beyond the US exporting jobs to low cost producers overseas. This misses the crucial idea of wealth creation and its relation to velocity.

We can adapt Figure 2-1 to show velocity entirely within the supply chain by contrasting a true bilateral trade regime with a forced imbalance system.

For equilateral trade (Figure 2-2), imports are balanced by exports and the chain of wealth creation is mostly intact. US consumers that purchase imported goods/services transmit money through the supply chain to the overseas manufacturer who passes on the money to an intermediary that passes the money further to a foreign importer that pays for US goods/services. There is only some leakage as foreign profits typically stay out of the recycling

FIGURE 2-2

Monetary Packet

Spending Activity of Consumers/Workers or Business thru N Periods

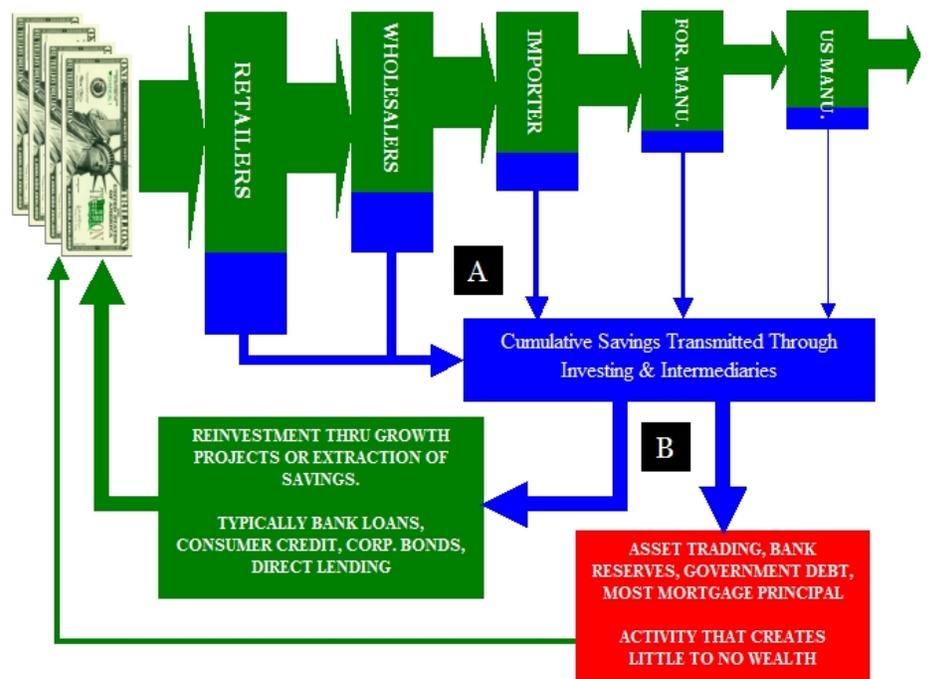
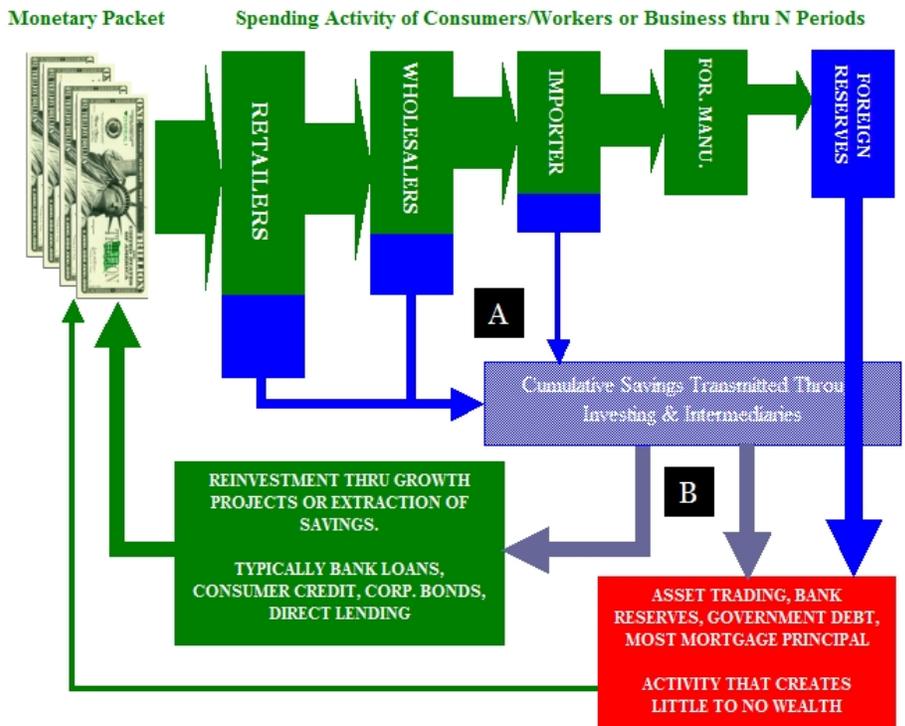


FIGURE 2-3

mechanism (from the US perspective).

This is not how trade is conducted in the 21<sup>st</sup> century. The US imports a lot and exports not as much, leading to a large and sustained trade imbalance. Much of the focus is with China, but our trade deficits persist with Japan and energy exporting nations. Floating exchange rates should allow for a correction but are not really enough to offset the huge wage disparities or willingness to exploit resources.

Under this imbalanced equation money flows back to the US far differently (Figure 2-3)



In the imbalanced trade system money comes back to the US only partially as foreign reserves. In the decade of the 2000's far more dollars found their way into the banking system through private owners. The effect on money velocity and wealth creation is the same as if consumers saved more than spent. The foreign exchange breaks the velocity chain and stunts the transmission of money in the process of creating wealth. Rather than creating sustainable wealth on both sides of the exchange, the imbalanced system creates wealth for the exporter while *at the same time* creating claims on future wealth creation from the importer. Much like government activities, this type of trade system is a net cost to the economy. If the scarcity of resources or the comparative advantage of production is high enough then subtracting domestic wealth may make sense as a necessary evil. Judging, however, from the decade of the 2000's it is far more likely that this subtraction was allowed to fester solely because of complacency and its complementary lack of leadership.

The domestic end of the forced imbalance system in the past decade saw foreigners

claim future wealth in the form of US Treasuries, agency debt and repo agreements – the perfect triumvirate of housing bubble financing. From the beginning of 2002 through the second quarter of 2008, imports of goods and services as a percentage of total purchases grew from 12.4% to nearly 18%. That is a massive amount of spending growth away from domestic sources (by comparison it was under 10% for all of 1983 and around 10.5% for all of 1984). This, of course, led to growing trade and current account deficits throughout the period, essentially stranding dollars outside the US. Since most of those dollars went to countries (read: China) with export economies there was no reciprocal purchases of US goods to maintain the wealth creation chain. **It would not have made a huge difference if the exchange rate floated toward some theoretical “parity”** (more on this later).

The stranded dollars had to come back in some form and it is well known that they were used to purchase US Treasury and agency securities (Fannie Mae & Freddie Mac debt). According to the BEA, foreign official flows to US Treasuries over the



period totaled just over \$1.1 trillion, while foreign official flows to agency debt was \$776 billion.

While those numbers had a huge impact on the housing bubble, they were more than matched by “unofficial” flows to US assets. This included \$1 trillion in direct investments and \$459 billion in additional US Treasury purchases. But the biggest flows were to “other” US securities (\$2.6 trillion) and US liabilities reported by banks and brokers (\$1.5 trillion). The former category includes agency debt but also corporate debt and even equities. The latter, as we know from the Federal Reserve’s Flow of Funds report (Z1) was mostly repurchase (repo) agreements with banks and brokers.

Furthermore, since there is still a large amount of dollars unaccounted for in the current account survey and knowing that most repos were over-the-counter private agreements, we can reasonably conclude that the extent of foreign dollar flows into the repo markets were considerably greater than even these numbers suggest (for more details on the repo market’s role and the Fed’s lack of response, see our March 2010 Special Report).

In simple terms, the US appetite for imported goods was **directly channeled into the housing bubble**. The only reason it went on for 6+ years was the unusual amount of economic activity that was initiated by the massive increase in mortgages. Had the housing bubble been contained to housing price inflation alone the lack of wealth creation would have dragged the economy down and shut down the demand for imports. However, since mortgages were responsible for much of the increase in household spending funds and home building investment grew at two standard deviations above the Fed’s historical baseline, there was some wealth creation, distorted as it was.

The distortion of economic activity outside the normal velocity chain meant that marginal wealth creation was due to indirect savings flow. Because of this, and largely determined by price action of real estate alone, the wealth that was created was very low quality (unsustainable). The US economy got shorted on both sides of the exchange – higher quality wealth was created overseas in the creation of productive capacity and low quality wealth was created in the US through the housing bubble. The Fed, supposedly responsible for credit creation, was more than happy to allow this one-sided relationship to continue as long as prices kept rising and interest rates stayed “stimulative”. What the Fed should have done is either channel the foreign flows to more productive uses or shut down that credit creation conveyor belt with offsetting changes to reserve requirements.

Since the bottom of the 2007-09 contraction the current account has started to return to that unsettling pattern. Imported goods (as noted above) have grown much faster than domestic GDP, siphoning economic activity from domestic sources. This grows the trade deficit since there is no reciprocal increase in US export activity (at least on a comparable scale) meaning dollars are once again stranded in numbers outside US borders. The primary difference is that foreign flows to agencies have completely reversed. There are significant flows to bank liabilities (repo) but the pace is slower than mid-decade, and flows to other US securities have fallen off dramatically. Taking up the slack has been, unsurprisingly, flows to the US Treasury.

This process explains much of the weakness of the current recovery. It is an almost exact replica of the mid-2000’s trade dynamic except there is *no wealth creation at all* in the US upon return of the stranded dollars. Where the flows to repo leverage and agency debt were at least fostering low quality wealth and the appearance of prosperity through asset inflation, the recent flows to the US Treasury create nothing (noted above).



## Part 3 Missing Real Risk

Can a recovery sustain itself on imports, inventory and an aggregate reduction in risk?

We know that the primary driver of GDP growth since 2009 has been inventory accumulation. Since it was a primary source of weakness, it stands to reason that some sort of mean reversion would occur. But comparing inventory levels now to pre-recession highs, what seemed like risk-taking appears to be a small step at best. Remember that the large GDP growth in the fourth quarter of 2010 was due entirely to second order changes in inventory direction. In other words, inventories were still shrinking in that quarter only at a far smaller rate. So what seemed to be a huge positive was really just a smaller negative.

All tolled, the inventory rebuild in 2010 (it has been limited to just the past three quarters) has only replaced about 39% of what was drawn down. After the much smaller inventory reduction during the 2001 recession, about 54% was restored in the four quarters of recovery. So the mean reversion case is hard to make.

What is also striking in comparison is the driving forces behind the inventory rebuild. After the 2001 recession retailers accounted for all of the rebuild (two-thirds from auto retailers). In 2010, auto retailers are again in the lead but the rest of the retail industry is conspicuously absent. Manufacturers and wholesalers are accumulating the bulk of the new inventory. This distortion in the supply chain is highly suggestive of inflationary expectations pushing inventory, whereas a retailer-driven rebuild would suggest a final demand inventory pull. Remember that consumer spending never really fell off in 2001 and 2002; it was largely a business-spending event. Even in a weak recovery robust end demand is pulling inventory up through the chain, not pushing from below.

Within the auto segment, there has to be growing concern about the size of inventory accumulation. For GM, there is certainly some affect on inventory from reopening so many of the dealerships that were closed in the 2009 “restructuring” that could potentially inflate sales. GM reported<sup>8</sup> October sales of 183,759 vehicles, an increase of 3.5% over the previous month. But dealership inventory grew by 37,000 units over the same period, *representing 20% of the sales number.*

If we analyze the financing arm of GM, Ally Financial (formerly GMAC), we find an all-out effort to boost sales. Total loans for Ally have increased by 27% in 2010, with the increase coming from both individual auto loans and fleet loans. But to finance the massive increase in loans Ally has had to sell off assets. It sold \$10 billion in “loans for sale” in the first part of 2010. As part of the adoption of FAS 166 & 167, Ally consolidated \$17 billion in securitization trusts, but classified \$10 billion as “held-for-sale”. In other words, Ally was forced to sell a majority of the loans put back on its balance sheet – no details regarding the terms of those sales. Ally also sold pieces of its existing business, including ailing ResCap.

On the funding side, Ally has expanded its deposit base through aggressive promotion of the interest rates it pays. These above-average costs led to an addition of about \$6 billion in deposit liabilities. But that only just offset a \$4.7 billion decline in short-term borrowings and a \$500 million decline in outstanding long-term debt.

**FIGURE 3-1**

	2001-IV	2002-I	2002-II	2002-III	2002-IV	2009-IV	2010-I	2010-II	2010-III
<b>Change in private inventories</b>	-80.8	-13.4	13.2	18.3	30	-44.2	50	80.4	130.2
Farm	-4.2	3.3	-10.3	-2.3	-0.7	7.1	9.3	9.6	7.5
Mining, utilities, and construction	7	-0.1	-3.4	-5.1	-3.7	-17.3	-11.9	4.9	2.9
Manufacturing	-30.7	-25.3	-3	5.9	5.6	-7	23.6	-2.1	26.9
Durable goods industries	-28.2	-15.4	-6.2	-2.7	4.6	-21.8	9.9	25	20.9
Nondurable goods industries	-2.5	-9.9	3.3	8.6	1	14.8	13.7	-27.1	6
Wholesale trade	-14.5	-7.3	4.2	4	-1.3	-10.9	15.7	36.5	58.5
Durable goods industries	-18.1	-6.7	3.3	9.4	-4.5	-27.5	9.3	12.7	28.9
Nondurable goods industries	3.5	-0.6	0.9	-5.4	3.2	16.6	6.3	23.8	29.6
Retail trade	-36.7	19.1	24.5	17	31.7	-9.5	13.7	27.2	32.2
Motor vehicle and parts dealers	-28.8	19.7	18.5	2.9	28.1	6.5	12.3	17.2	25.7
Food and beverage stores	0.2	-0.1	0	1.6	-0.8	-3.4	1.3	-1.1	0.5
General merchandise stores	-5.1	-1.8	-0.3	3.8	4	-1.1	-0.2	4.9	3.4
Other retail stores	-3	1.3	6.3	8.7	0.4	-11.5	0.3	6.2	2.6
Other industries	-1.6	-3.1	1.3	-1.2	-1.5	-6.6	-0.3	4.3	2.2



Some might see these moves as an aggressive cleanup of the balance sheet of the previously worthless GMAC. To some extent we would agree, except that a business does not usually increase its loan base by 27% during the cleanup phase. Further, Ally is *aggressively* courting depositors to replace lost debt funding (not a good sign).

If we look a little further into the numbers we see an increase in per unit vehicle financing by over 500,000 vehicles, to just under 1.3 million total unit financings. Of that half million increase only 113,000 are new GM vehicles in North America (only 23% of the increase). Used car financing increased by a like number, but the largest increase came from Ally financing new **Chrysler** units, 220,000 or 44% of the entire increase. So far in 2010 Ally Financial has financed 41% of **Chrysler's** new car sales (there were only a total of 30,000 Chrysler vehicles financed by Ally in all of 2009).

Taking these bits of information together we have to question the motivations of Ally Financial. The balance sheet shift could have been plausibly regarded as a cleanup operation, albeit a risky one. However, in light of the Chrysler info it is hard to see this as anything other than the execution of another government “stimulus” strategy, not coincidentally at the two car companies owned by said government and their union boosters. Since the reach of Ally into the auto market is quite significant, it creates significant doubt about whether the auto inventory build and sale surge are due to politics rather than economics/profitability (or GM’s IPO). And we cannot forget that none of these loans would have been possible without \$10.9 billion the US Treasury invested in GMAC preferred stock. Given the extreme volume of loan growth, it is relatively safe to assume that repayment of that investment is not in Ally’s plans.

Government stimulus efforts, both stealth and obvious, do not lead to sustainability. Forget the distraction over the mythical multiplier of government spending. A recovery is nothing more than a willingness of investors, businesses and even consumers to take on real risk. Risk in this context is not simply moving from bonds to stocks. It means a willingness, through perceived opportunity or depressed price signals, to undertake investments that increase real wealth (Part 2 above). The auto activity created by GM and Ally cannot really be classified as risk taking for economic reasons (it is risk taking only in the political sense). The intrusion of government into the marketplace through fiscal and monetary means distorts pricing as it relates to discovery of opportunities. If GM and Chrysler had failed and gone into unassisted bankruptcy, the opportunity for other carmakers to take market share would have been created (which they did anyway). An important part of that opportunity in the big picture economic sense would have been being able to sell cars without “busting out” one of the biggest financial businesses in the country. In a world of scarcity, sustainability counts far more than shortsighted artificial sales, particularly if Ally needs another handout from Uncle Sedan-maker.

On the monetary side, the Fed is distorting interest rates and asset flows to engineer what it believes is a textbook risk-taking climate. The goal of “stimulative” monetary policy (SMP) is to reduce the cost of credit to entice firms and consumers to increase borrowing. The goal of the Fed’s zero interest rate policy (ZIRP) is to ensure that those stimulative, low interest rates do not tax bank profitability. The entire economics profession has preached that these policy tools create the ideal conditions for credit growth. However, if we look at the banking system we do not see anything like that.



We analyzed balance sheet changes in 2010 for the stress test nineteen (the largest nineteen financial companies that were stress tested in 2009) plus one larger regional bank (Comerica) to make an even twenty. Looking at these banks individually gives a lot of detail and granularity with respect to the effects of SMP and ZIRP. From our analysis it is quite *easy* to conclude

that both monetary efforts have been a *complete failure*. We could already conclude this from the aggregate data collected by the Fed, but that data misses some of the finer details that really show the distortions created by the monetary textbook.

Figure 3-2 summarizes our key findings.

**FIGURE 3-2**

	Short-Term Assets Declining?		Total Loans Declining?			FUNDING SOURCES				
	Jun-10	Sep-10	Jun-10	Sep-10	%	Deps Up?	Debt Up?	Fed Funds?	Amount Fed Funds/Repo	
<b>WALL STREET BANKS</b>										
JP Morgan Chase	YES	NO	YES	YES	-8.70%	NO	NO	YES	\$314 billion	+\$52 b
Citigroup	YES	NO	YES	YES	-16.30%	NO	NO	YES	\$192 billion	+\$38 b
Bank of America	NO	NO	YES	YES	-11.10%	NO	YES	YES	\$296 billion	+\$41 b
Wells Fargo	NO	YES	YES	YES	-3.70%	NO	NO	YES	\$50 billion	+\$12 b
Goldman Sachs	NO	NO	No Loans			N/A	YES	YES	\$150 billion	+\$22 b
Morgan Stanley	NO	NO	No Loans			NO	YES	YES	\$167 billion	+\$12 b
MetLife	NO	NO	No Loans			NO	YES			
State Street	YES	NO	NO	NO	27.00%	YES	NO	YES	\$5.3 billion	+\$0.8 b
<b>MID-LEVEL NATIONALS</b>										
PNC Financial	YES	NO	YES	YES	-4.70%	NO	NO	YES	\$4.7 billion	+\$0.7 b
US Bancorp	NO	NO	YES	NO	-0.90%	YES	YES			
Bank of NY Mellon	NO	NO	NO	NO	3.20%	YES	YES	NO	\$3.3 billion	-\$0.04 b
SunTrust	YES	NO	YES	NO	1.20%	YES	NO	NO	\$1.1 billion	-\$0.4 b
BB&T	YES	NO	YES	YES	-1.40%	NO	NO	NO	\$5.8 billion	-\$2.3 b
Regions Financial	NO	YES	YES	YES	-12.20%	NO	NO	YES	\$2.5 billion	-\$0.3 b
Fifth Third	NO	YES	YES	YES	-6.70%	NO	NO	NO	\$0.4 billion	-\$0.0 b
Key Corp	NO	NO	YES	YES	-23.50%	NO	NO	YES	\$2.8 billion	+\$1.3 b
Comerica	YES	YES	NO	YES	9.60%	YES	NO	NO	\$0.2 billion	-\$0.3 b
<b>CONSUMER BANKS</b>										
Ally Financial (GMAC)	YES	YES	NO	NO	27.00%	YES	NO			
Capital One	YES	YES	YES	YES	-26.00%	YES	NO	NO	\$0.9 billion	-\$0.2 b
American Express	NO	NO	YES	YES	-11.10%	NO	YES			
<b>TOTALS</b>	<b>9/20</b>	<b>6/20</b>	<b>13/17</b>	<b>12/17</b>		<b>7/19</b>	<b>7/19</b>	<b>10/16</b>		



We segregated the twenty banks into three groups: Wall Street banks (the largest banks that engage in securities-type lending through brokerage activities, including the big banks with large brokerage subsidiaries), mid-level national banks (typical banking firms that invest in traditional loans) and consumer banks (specialty banks that primarily invest in consumer vehicles such as credit cards and auto loans).

What we can conclude from our data is: 1) ZIRP is making deleveraging rather than credit creation easier, contrary to its stated purpose, 2) the Fed is concentrating control over the financial system through the Wall Street banks addition to Fed funds, 3) that concentration is stimulating investing through securities rather than loans, leading to the non-uniform liquidity conditions, 4) FAS 166 & 167 did have huge negative consequences for total lending, even though it was limited to the Wall Street and consumer banks.

Key Corp and Regions Financial demonstrate point #1, that ZIRP is a gift to banks that want to *reduce* their overall exposure to *lending*. The low deposit rates have hit Key hard, losing \$7 billion in deposit liabilities as investors have fled CD's. The bank has also dropped nearly \$3 billion in long-term debt. With long-term rates low you would think Key would be increasing its longer-dated debt to lock in rates, so this suggests that Key (definitely not TBTF) is not an equal participant in these loose monetary conditions.

To counteract that \$10 billion shortfall in funding sources, Key reduced its exposure to commercial loans by about \$15 billion and residential mortgages by \$2 billion. The drop in loans (plus some smaller asset shifts) have seen Key increase its securities portfolio by about \$9 billion, adding potential liquidity to the bank but subtracting credit in the real economy. Add these moves to the lower level of total debt and you can fairly conclude that Key is actively and purposefully *reducing* its risk.

Regions Financial suffers from a similar dynamic. While its deposit base has held steady,

it has seen its debt level fall by about \$7 billion. In response, it has cut its loan portfolio by nearly \$12 billion while increasing its available-for-sale securities by about \$4 billion. Most of the increase in securities was agency mortgage securities. Regions, like Key, is not acting like a bank in a true recovery.

The rest of the mid-level national banks show the same type of activities that have reduced overall loan portfolios in favor of securities, particularly mortgage securities run through government agencies. This reduces the overall risk since the government is guaranteeing a larger share of bank portfolios, and also reduces the bank's calculation of risk-weighted assets due to the greater discount under Basel II. The likelihood of finding repo financing rises with agency MBS since it is still a preferred collateral, preserving the option for the bank to use funding leverage.

We see the same drop in loan portfolios for both the Wall Street and consumer banks, but here it is a function of FAS 166 & 167. JP Morgan Chase, Citigroup, and Bank of America have cut their loan portfolios by massive amounts, 16.3%, 10.8% and 15.5% respectively, when adjusting for the repatriation of securitized assets. Those huge reductions in outstanding loans had to take place to make room under each bank's capitalization framework – these banks predicted last October that the accounting changes would lead to drastic reductions in lending activities and it did. Capital One and American Express (and Discover Financial not presented here) reduced their current loan portfolios for the same accounting changes.

So where the largest banks may have had a willingness to increase credit regulators forced them to reduce exposure by requiring them to retrofit loans made years ago to their current capitalization structures. In both cases, traditional banks and Wall Street banks, monetary policy has created the conditions whereby lending activity contracts. For the traditional firms, ZIRP has reduced the cost of funds (again, at the expense of savers who would spend the money) so much that these banks can reduce their overall loan portfolios



and still turn a *larger* profit. This is still true even as spreads have compressed in the last six months, banks are still seeing greater profitability with lower total lending exposures. This belies the academic viewpoint of loose monetary conditions.

The continued favor of the large banks through repo funding is also producing distortions. Most of the financial firms on our list use Fed funds for marginal funding, as it was intended. The Wall Street banks, including Goldman Sachs and Morgan Stanley, use Fed funds and repos as volume funding sources. The top seven Wall Street banks use Fed funds and repos to fund an average of 13.93% of their total financial assets (not including Wells the average is 15.75%). In total, these seven banks total \$1.1 trillion in Fed funds liabilities. The other ten banks on our list that use Fed funds have accessed only \$27 billion combined (a ratio of 40 to 1).

This unprecedented funding means that the largest Wall Street banks are the primary recipients of monetary policy while the Key's and Regions of the world have to drastically cut back loan exposures. Wall Street firms get

larger while the rest of the banking system shrinks.

This dichotomy of access also favors the transition from loans to securities. Partly due to the accounting changes and partly due to the funding differentials, the Wall Street banks are, in essence, diverting their marginal funding sources from traditional banking to securities-type activities. This is not surprising considering the lack of profitability due to principal losses in lending coupled with obscenely low rates of returns vs. the massive, outsized profitability from securities trading. So in this one aspect the Fed's policies *are* creating risk-taking behavior. Unfortunately, it is the wrong type of risk for the economy.

The systemic reduction of exposure to lending undercuts the most basic function of the recovery. Until conditions revert to some sense of normalcy (probably only after another banking crisis) the lack of true risk-taking will remain a fundamental problem. Without being able to produce a decent return on riskier assets banks will continue to favor liquidity. Monetary policy is obstructing the natural economic order and the small actors will continue to suffer for it.



## Conclusions

The dangerous experiment of QE 2.0 is designed to stimulate economic activity through negative real interest rates. That is the Fed's primary goal, above all else. Through negative rates the Fed hopes to make safety expensive, thereby introducing incentives to spend over save, take on risk over liquidity, and "stimulate" the real economy. The mechanism for transmitting this intended distortion (and QE is nothing more than forced distortions of normal economic functioning) is inflation expectations.

By creating these inflation expectations, the Fed hopes that 1) spending activity rises as consumers seek to purchase goods (mostly) before prices increase, 2) the US dollar falls relative to other currencies, undercutting the current trade imbalance with an expansion of exported goods, 3) push business within the supply chain to create more inventory, adding to domestic manufacturing growth (with the weak dollar), and 4) push investors into riskier assets, turning positive price action into a wealth effect.

This report has addressed each of these four policy goals in turn. Part 1 showed the fallacy of hoped-for spending increases from consumers since households are under pressure from a distinct lack of funds for spending (this includes both Fed goals #1 and #4). With asset and wage incomes depressed the only sources of spending growth has come from real declines in household mortgage outlays and lower taxes. It is exceedingly difficult to see just how QE 2.0 will change the spending dynamic for the good. It is rather easy to see how QE 2.0 can make household spending growth even more difficult. Any increase in energy and food prices will take away the flexibility households have gained through lower housing expenses. The fact that commodity and energy prices have surged since August does demonstrate the stirrings of inflation expectations (see the negative TIPS rates), but in a way that may eventually have a devastating impact on household finances.

Part 2 addressed the disparity in foreign exchange and one-sided wealth creation. It is really tempting to use floating currency exchanges to correct the imbalance in order to foster a more equal exchange, except that devaluation of the dollar is a short-sighted approach to a very long-term problem.

Again, we can see how QE 2.0 will likely lead to a lower dollar (absent any new blow up in Europe to ignite another run to relative safety in the US). But a lower dollar does not create a functioning Chinese middle class. Changing the rate of exchange makes US goods cheaper relative to other currencies, but who is going to do all this buying? China (the largest source of trade imbalance) does not have the right population to purchase American exports. American companies have been trying for more than a decade to break into the vast Chinese marketplace. US companies were openly talking about opportunities in China during the dot-com bubble, yet they have been nowhere near as successful as they advertised (just like their ability to predict the economy).

In terms of comparative advantage, China has an advantage in cheap, unskilled labor. The US has an advantage in the high-value service and manufacturing sectors. Unfortunately, the unskilled Chinese laborers have little use for American financial innovation and tourism opportunities. Instead, changing the exchange equation will make Chinese goods more expensive without creating a marketplace for US goods. Since there is little competition for those Chinese goods, that expense will end up as import inflation felt by US households.

This is especially true for energy goods. Again, there is little to be gained by devaluing the dollar relative to the energy exporters since they have no chance of reciprocal exchange. The only real trade initiative that could be undertaken with a modest chance of increasing US exports is military technology (the Russian option).



The real problem with China is that there is no existing capacity to create competition for their manufacturing. If it was as simple as choosing between Chinese goods and Vietnamese, there is some value in forcing concessions. Until that point, we are stuck with China as a manufacturer. Even if a suitable alternative is found, it will take years to create infrastructure and bring manufacturing capacity up to the Chinese level. And in doing so it may unleash massive inflationary forces on the country trying to do it.

We have been down this road before since China largely replaced Japan as the world's premier exporter. That transition was a precursor to the current imbalance, except that Japanese reluctance to reciprocal trade was largely cultural. Once China began to replace Japan, all that capacity built is now largely redundant. Since it was never fully idled and restructured, the country has languished in its lost decades. And that means that the Japanese are not a likely source of potential buyers for American exports since most of Japanese capital is used to keep the entire system from falling apart.

That leaves Europe as the only hope for a dollar-driven export surge. Except that Europe is largely broke. And the part that isn't broke is only solvent because of *its* export economy. So the lower dollar shatters the only portion of Europe still able to buy American services (maybe a few goods too). The currency wars are the logical response to the illogical attempt at remedying a long-term problem with a shortsighted solution. Square peg meet round hole.

Devaluing the dollar leaves American households poorer and increases the likelihood escalation in a trade war that is already beginning. So again, QE 2.0 is not likely to accomplish its goal in this respect.

In Part 3 we looked at the inventory cycle and risk-taking since both are related. What we find is absolutely no willingness to take on risk, except by manufacturers and wholesalers. Since they are closest in proximity to commodity inflation expectations in action, it is little

wonder that the first signs of trouble start there. We take a very dim view of this bottom-up inventory push rather than a final demand-driven top-down pull. In a normal economic recovery we would expect to see inventory accumulate with retailers first which is not happening outside of autos. Given the GM/Ally/Chrysler disgrace, much of the auto buildup cannot be termed as economic risk-taking.

In the banking system the Fed has succeeded only in making economic loans too expensive to hold and grow. The main effect of ZIRP has been to make *deleveraging* profitable. The cost of funds has fallen far faster than the stickier use of funds, meaning banks experience incremental profitability with less total assets. It is fair to say that ZIRP has been the single largest factor behind the lack of credit growth. Since liquidity is still the name of the banking game, the flattening US Treasury curve will only push banks into longer maturities or up the risk scale into sovereign debt (see Stanley, Morgan). This is hardly the kind of risk-taking that a sustainable recovery is founded on.

By embarking upon QE 2.0, Bernanke appears increasingly desperate. We have already seen his talking down previous expectations and moving back the goalposts (remember ZIRP was supposed to stimulate growth in the real economy not just save it from disaster). He talks about stimulating credit and housing while completely ignoring the huge hole in credit and the renewed decline in house prices and volumes.

The real desperation shows in his willingness to proceed despite rising internal opposition. In 2008 and 2009 there was little dissent since nobody really knew what to do. Now there is real, credible resistance that has empirical, unambiguous evidence that Bernanke's monetary policy does not work as advertised.

In a speech on November 8, 2010, Dallas Fed President Richard Fisher said<sup>9</sup>:

“In sum, I asked that the FOMC consider that we might be prescribing the wrong medicine for the ailment from which our economy



suffering. Liquidity and abundant money are not the binding constraints on the economic activity we wish to see. The binding constraints are uncertainty about income and future aggregate demand, the disincentives fiscal and regulatory policy impose on ridding decision makers of that uncertainty, and the reluctance, given those disincentives, of those who have the power to create jobs for our people to invest in undertakings that would create them.”

Worse for Mr. Bernanke, Fisher finally admits:

“For the next eight months, the nation’s central bank will be monetizing the federal debt.

This is risky business. We know that history is littered with the economic carcasses of nations that incorporated this as a regular central bank practice.”

Fisher goes on to note that Bernanke believes that he has done all his homework and is confident the Fed won’t mess up too much, so Fisher is willing to defer, for now, to Bernanke. But within this speech is a stern warning that the Fed is no longer monolithic. That its Chairman is willing to risk an open and public split speaks volumes to his assessment of the economic climate. It must be truly dire in order for him to risk destroying the only real tool a central bank and fiat regime has: faith in it.

In reconciling himself to his subservient role to Bernanke, Fisher rationalizes QE 2.0 as a “bridge to fiscal sanity”. The Fed’s debt monetization, in his mind, might be breathing room for the new Congress to address fiscal imbalances and regulatory disincentives. I believe this way of thinking is exactly what is wrong with monetary and fiscal policy in the US and beyond. What fiscal policymakers need is not more wiggle room; they need to find themselves at the end of their rope (figuratively).

Our economy needs to enforce discipline on every single actor big and small. So much lip service is paid to some intangible and indefinable idea of uncertainty. Uncertainty is nothing more than a lack of market discipline. What is needed right at this moment is for businesses and investors alike to know without any sliver of doubt that government and businesses and consumers are being forced to regulate themselves. With the threat of illiquidity and bankruptcy never far away, economic actors will behave as if their survival depends on maintaining sound and sustainable habits. And that brutal market discipline is what makes investors less uncertain about investing, makes banks less uncertain about lending to households, makes businesses less uncertain about future growth. **Discipline leads directly to long-term sustainability and high quality wealth.**

QE 2.0 moves us further in the wrong direction. It removes even more market enforcement in favor of political hocus pocus, “nobody loses” nonsense. To return to sustainability and long-term growth, discipline must be enforced on everyone, including the Fed. In June I wrote:

“The more intervention we get the less faith the interventions engender. Currency barbarity is the only way to demonstrate that true economic power no longer resides in those that made this mess in the first place. By taking away the fool’s option of money printing, the discipline that is enforced on companies, individuals, governments and economies will be reassuring in a way that no genius academic plan could ever be.”<sup>10</sup>

As to the consequences of QE 2.0, we believe this new monetary amplifier will produce exactly the wrong responses for the reasons contained within this report. It’s as if Chairman Bernanke has lined up in the wrong direction, ready to heave one to the wrong endzone. The only question is whether the rest of his teammates will tackle him before the damage is done, and the game lost.



## Endnotes

<sup>1</sup> ACM's March 2010 Special Report, "Channel Distortions From The Fed", Page 22.

<http://research.acminstitutional.com/Series3-2.html>

<sup>2</sup> "What the Fed Did and Why: Supporting the Recovery and Sustaining Price Stability", Ben S. Bernanke. Washington Post, November 4, 2010.

<http://www.washingtonpost.com/wp-dyn/content/article/2010/11/03/AR2010110307372.html?hpid=topnews>

<sup>3</sup> Sources of Government and Private Income are taken from the BEA's National Income & Product Accounts, Table 2-1.

<http://www.bea.gov/national/nipaweb/TableView.asp?SelectedTable=58&Freq=Qtr&FirstYear=2008&LastYear=2010>

<sup>4</sup> Changes to Revolving and Nonrevolving Consumer Credit are taken from the Federal Reserve Consumer Credit Survey, Release G.19.

<http://www.federalreserve.gov/releases/g19/current/g19.htm>

<sup>5</sup> See #3, Table 2-1.

<sup>6</sup> Flow changes in Assets are taken from the Federal Reserve Flow of Funds, Release Z.1.

<http://www.federalreserve.gov/releases/z1/>

<sup>7</sup> *ibid.*

<sup>8</sup> "GM Sales Rise 3.5% in October as Economy Freshens", USA Today, November 3, 2010.

<http://content.usatoday.com/communities/driveon/post/2010/11/gm-october-sales-up-35/1>

<sup>9</sup> Remarks before the Association of Financial Professionals, San Antonio, TX, November 8, 2010. Richard W. Fisher, President Federal Reserve Bank of Dallas.

<http://dallasfed.org/news/speeches/fisher/2010/fs101108.cfm>

<sup>10</sup> ACM's June 2010 Special Report, "Why Quantitative Easing Cannot Work", Page 22.

<http://research.acminstitutional.com/Series3-4.html>

Atlantic Capital Management of Florida, Inc., is an SEC registered investment advisor. Atlantic Capital's Form ADV, Parts I & II, are available upon request or online at [www.adviserinfo.sec.gov](http://www.adviserinfo.sec.gov). Atlantic Capital's Disclosure Statement is also available upon request. All research and analysis is done by ACM staff. All Special Research Reports are for educational purposes ONLY. These reports do not take into account specific investment criteria of individual clients. All opinions expressed are current opinions as of the date indicated on the reports and may be changed without notice. Information obtained from various sources is believed to be reliable but ACM makes no guarantee of the accuracy or completeness of such information. No investment recommendations are given or implied. Past performance is no guarantee of future results.

© 2010 Atlantic Capital Management.



**ACM INSTITUTIONAL SERVICES**  
580 VILLAGE BLVD, SUITE 315  
WEST PALM BEACH, FL 33409  
1 (888) 810-1588

[www.acminstitutional.com](http://www.acminstitutional.com)