October 15, 2012

I am stuck on Band-Aid brand 'cause Band-Aid's stuck on me!
From Johnson & Johnson's Band-Aid brand T.V. jingle

In September, the Federal Reserve, led by Chairman Ben Bernanke, announced a third asset purchase, or quantitative easing, program, aka "QE3."[1] Under the program, the Fed will purchase $40 billion per month of mortgage-backed securities. Unlike QE1 and QE2, which specified the cumulative dollar amounts of securities to be purchased ($600 billion each), QE3 is purposely open-ended in quantity and duration. The Fed has linked the program to the health of the labor market. Here is the relevant section of its announcement: "*If the outlook for the labor market does not improve substantially, the Committee will continue its purchases of agency mortgage-backed securities, undertake additional asset purchases, and employ its other policy tools as appropriate until such improvement is achieved in a context of price stability."* In other words, the Fed has just applied the biggest economic band-aid ever!

While the Fed has singled out the labor market as its indicator of economic health, there are numerous contributors to our overall economic malaise, including:

1) Unemployment itself, both a symptom of economic weakness and a contributor to economic weakness through lower consumer demand;
2) Consumer and financial deleveraging, depressing consumer demand;
3) Asset deflation, particularly in real estate, aggravating deleveraging;
4) Shrinking government spending at local, state and, increasingly, federal levels;
5) The fiscal cliff/federal legislative paralysis/politics;
6) Demographic shift to an older population;
6) Global weakness led by a European recession and a slowing China; and
7) Sluggish business confidence and investment.

On a combined basis, I think it is fair to say these factors create an intimidating backdrop and support the concept of an aggressive policy response. Individually, however, they expose the limitations of the Fed's policy tools. QE3 does not specifically address any of these factors. Instead it attempts to create a favorable environment in which they can be solved or managed. Like QE1 and QE2, it is a broad tool that will have both positive and negative impacts.

On the positive side, the Fed's mortgage purchases may help provide liquidity and place downward pressure on interest rates. Additional liquidity and lower interest rates may foster a better environment for new private and public financing or refinancing. A positive environment for financing may promote higher asset prices, easier balance sheet adjustments, improved economic activity and new investment. Lower interest rates may induce savers and investors to take on more risk with a growth-oriented approach, which may support more economic activity. Lower interest rates may also put downward pressure on the relative value of the U.S. dollar, which may promote higher exports. Finally, the Fed's proactive policies may provide some level of psychological comfort to the various players in the overall economy.

[1] The Federal Reserve's announcement can be read in full here:
http://www.federalreserve.gov/newsevents/press/monetary/20120913a.htm

On the negative side, lower interest rates reduce the income and purchasing power of savers and investors. Promoting debt financing may create distortions in investments, lending, asset allocations and markets and may pull future demand into the present (aren't all of these part of the reason we are in our current situation?). Lower interest rates may reduce the relative value of the U.S. dollar, which may lead to higher import prices, especially commodity inflation. The expansion of the Fed's balance sheet through asset purchases or additions to the money supply may also lead to domestic inflation. And, with QE3, the Fed is one more option closer to no options left.

To a large degree, I believe the Federal Reserve is using the QE programs to help give our economy the time it needs to mend itself. The steep build up of consumer and financial debt that culminated in the implosion of our real estate bubble cannot be fixed overnight and there is little the Fed can do to fix it directly. So the Fed, under Ben Bernanke's leadership, has chosen to err on the side of proactive policy to try and help prevent another economic downturn in general and to avoid further asset deflation in particular. For now, the QE band-aids seem to be helping. At some point they may not. Hopefully, our economy will be in better shape when they have to pull the last one off. (This won't hurt a bit.)

* * * * * * *

I have attached a chart on the next page that provides an enlightening view of the U.S. economy from the perspective of new home sales. You can easily view the progression from steady sales, to boom, to bust. The bad news is that a large piece of our economy is still missing in action. The good news is that new home sales, and all the work and products that go into them, may finally be moving from an economic headwind to an economic tailwind.

* * * * * * *

Finally, one of the cornerstones of Peak's approach to personal wealth management is "control what you can control." With the political campaign season in full swing, I recommend an excellent interview I saw on CNBC last week that speaks to this same approach at the federal government level. It included former Senator Alan Simpson (R-WY), former Clinton White House Chief of Staff Erskine Bowles (D) and CEO and Chairman of Goldman Sachs Lloyd Blankfein. Simpson and Bowles, you may recall, were the co-chairmen of President Obama's commission on reducing the national debt. The interview was refreshing in its frankness and pragmatism. I believe some variation of the Simpson and Bowles plan, which includes both higher overall federal taxes and spending cuts, will eventually be adopted (I do not see any other path). The only question is whether politics will delay its implementation until after another financial crisis. The interview is available online at: http://video.cnbc.com/gallery/?video=3000121899, or search for "Blankfein, Simpson & Bowles, CNBC video."

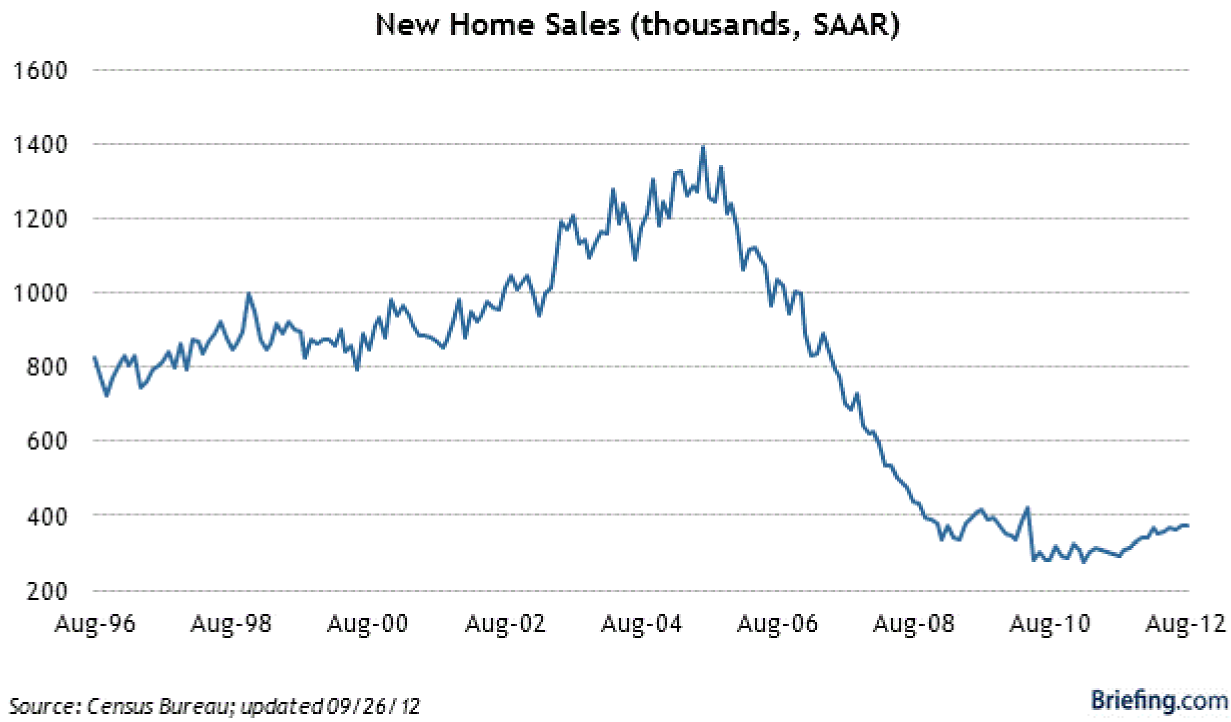
* * * * * * *

We encourage you to contact us if you know someone who could use Peak's help in his or her financial life.

We appreciate your business.

John N. McCorvie, CFA

New Home Sales



SAAR = seasonally adjusted annual rate.