What Does Quantitative Easing 2 Mean for U.S. Treasury Investors & Traders?

By Thomas H. Wilkins, CFA
Joseph Jekyll Advisers LLC

- Tuesday, November 9, 2010, 9:30 AM -11 A.M
- At The University Club, at the corner of 5th Avenue and 54th Street, 7th Floor, New York City

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- ChinaStakes

Shanghai, China
November 03, 2010

2:15 PM, Washington Time, the QE2 Moment

By Thomas Wilkins, CFA

At the above time, on Wednesday, November 3, 2010, world financial markets should know how the Federal Reserve Board intends to implement its Quantitative Easing, known as "QE2." The effect on the U.S. market should be heavily influenced by the action by the Federal Reserve Board. International markets may be impacted as the US dollar may depreciate in exchange markets and other currencies may see increased demand

Who Was Joseph Jekyll and What Does He Have to Do with Quantitative Easing?

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Jekyll Island, Georgia was named after Joseph Jekyll

- He never came to Georgia, but without his help in Parliament, the struggling Colony of Georgia, starting without slave labor, could easily have failed.
- He was on a House of Commons committee to investigate the atrocious crimes inflicted on debtors who rotten in prison. We will be talking about debtors today.
- Joseph Jekyll Advisers LLC honors this 18th century Englishman.

The Idea of the Federal Reserve

- In 1907 several banking firms in New York collapsed as depositors make a “run on these banks.”
- One hundred years ago this month (November, 1910) Wall Street representatives met secretly in the secluded, private resort of J. P. Morgan on Jekyll Island and thrashed out the intellectual foundations of a U.S. central bank.

100 Years Later

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What Did the Federal Reserve Not Do on the day after the November 2, 2010 Election?

- Anyone want to be interactive with today's discussion?

What the Federal Reserve Did Not Do on Wednesday, November 3, 2010

- Did not Stop Paying interest on required and excess bank reserves held at Federal Reserve Banks.

What do you think is important about that question?

- Anyone?

Background on interest on reserves

- Immediately after the Lehman Brothers bankruptcy, Congress accelerated from October 1, 2011 to October, 1, 2008.

- Previously, bank reserves received no interest on their required and excess reserves against specified deposit liabilities. These reserves must be held in the form of vault cash or deposits with Federal Reserve Banks.

What is the most common way to describe the economic effect of these reserves?

- Answers requested from the audience to test if we are all on the same page.

Opportunity Cost or Tax?

- Since these bank assets earned no interest, bank lost the opportunity to earn interest on some alternative asset.
- 10% of a banks specified deposit liabilities earned no interest.
- In describing this issue, the Federal Reserve has referred to this procedure as a “tax” and by paying tax on deposits, eliminates this “tax.”

What rate Does the Federal Reserve pay on these reserves after 10/2008?

- Anyone?

Current Rates Paid on Required and Excess Reserve by Federal Reserve

- Interest Rates Paid on Required Reserve Balances:
  - 25 Basis Points
- Interest Rates Paid on Excess Reserve Balances
  - 25 Basis Points

Compare 25 Basis Points on Reserves to

- 5 basis points on one month Treasury Bills
- At last check, all the Treasury Bills from 1 month out to 1 year were less than the interest paid by the Fed on reserves.

So did the previous Quantitative Easing end up in the economy?

- A great deal of the Federal Reserves' payment for Mortgage Backed Securities and Treasuries ended up in Fed's own balance, not the economy, as Reserves.
- Any surprise in the next two charts?

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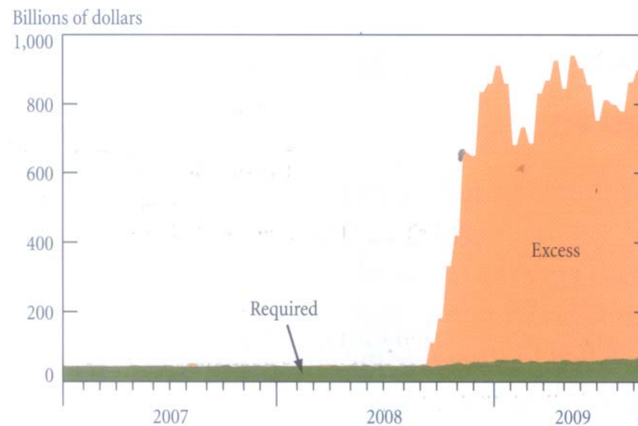
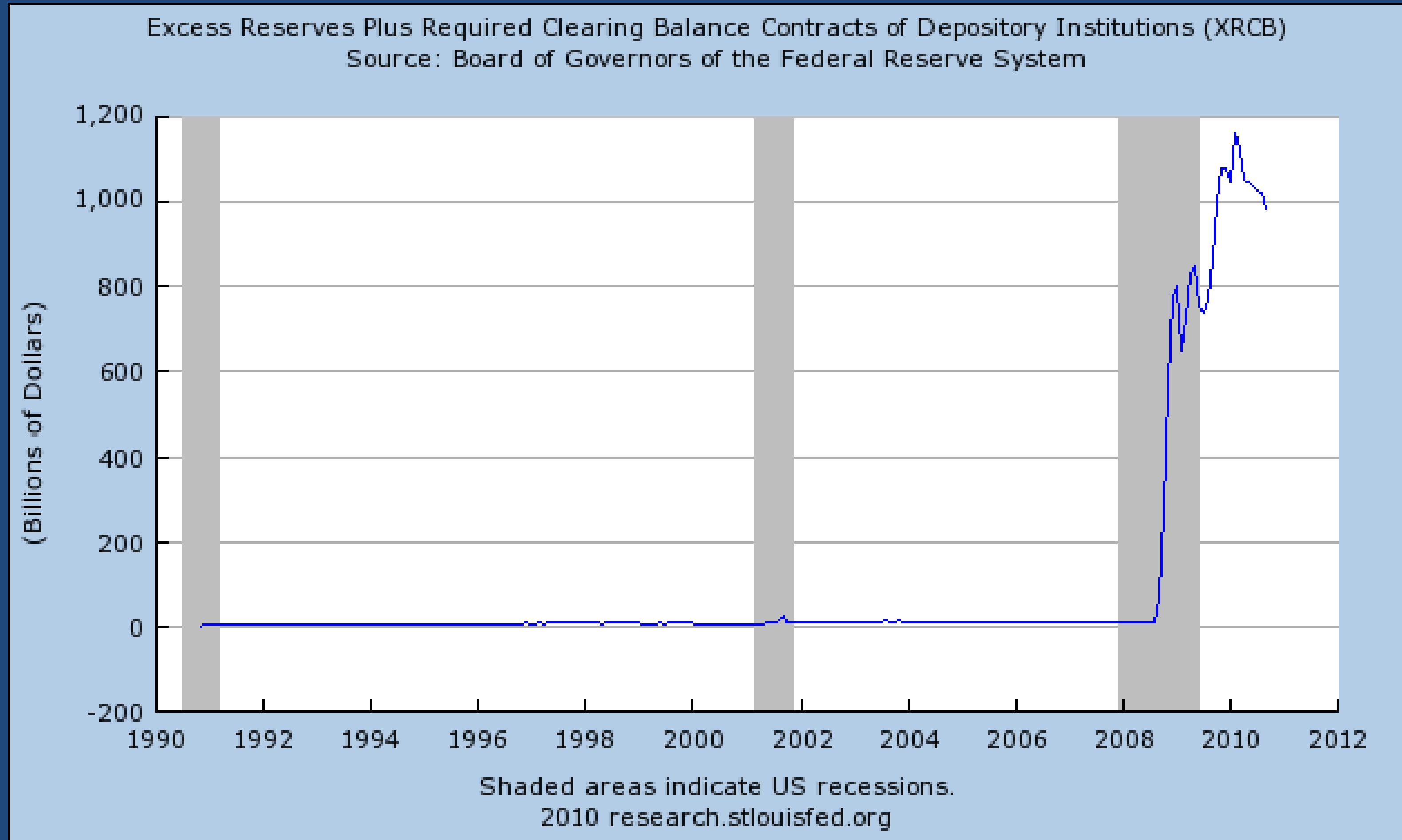
What Does Excess Reserves Tell You?



What does this tell you?

Data last updated 10/29/2010



This tells us that

- Isn’t it fair to say that paying interest on excess balances permits the Fed to increase the liquidity of the financial system. As a result:
- Most banks do not need to reduce these excess reserves several reasons:
    - Corporations are flush with liquid assets.
    - Individuals are deleveraging
    - Banks are resolving there problem loans.

What is the effect of having the rate for reserves higher than the 1 month T-Bill rate?

- An incentive to keep liquidity at the Federal Reserve.
- It does not stimulate lending through the 10 to 1 multiplier effect of the 10% reserve requirement.

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Ancient Régime and New Régime

- Without interest on reserves and opportunity cost, the multiplier went on and on until excess reserves were eliminated. The money multiplier was functional.
- With interest paid on reserves and market interest rates are lower than the rate paid by the Fed, the incentive to eliminate opportunity cost and lend out excess reserves disappears and the multiplier effect is dysfunctional

Monetary Base

- **Contrary to the opinions of many people, the monetary base is not money. Inflation is expected by many who argue that the monetary base has expanded significantly. Economist Milton Friedman's mechanism from money to inflation has been misunderstood by these people who reason that an increase in the Federal Reserve's balance sheet is axiomatic for inflation.**

Monetary Base, continued

- **The “money multiplier” is effectively zero. M2 is now growing at one of the slowest paces in many years.**
- **Also, when people pay down debt, this decreases the money supply. While debt in Washington has increased, private debt has gone in the other direction this year.**

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Effect of Build up of Reserves

- Under the new regime, the large increase in the monetary base does not axiomatically spill over into the money supply.
- Inflation is also constrained by excess supply of labor, of factories, office space, warehouse and retail outlets.
- Due to the reduction in home values, and because bank lending uses a great deal of real estate as collateral, then it is reasonable to expect a continued slowdown in credit creation for “an extended period of time.”

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Review: The Equation of Exchange

$$MV = Py$$

M= Money

V= Velocity

P = Prices

Y= Real economic output

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Separating the parts of MV=PY

- Money growth is nowhere near growth rates experienced in the past.
- Velocity tends to fall when inflation is expected to decline.
- From the above, PY is expected to increase slowly.
- Bonds should perform well in this environment because the large forces discussed above are helping bonds.

Pop Quiz

Why do bond prices change in opposite direction from the change in yield?

Choose one answer below:

1. **Because people want safe assets.**
2. **As discount rates increase, bond prices increase.**
3. **Because bond prices are the present value of cash flows. As discount rate increases, the present value of coupons and lump sum payout decreases.**
4. **Bond prices do not represent present values but future values of cash flows.**

Why do bond prices change in opposite direction from the change in yield?

- Because bond prices are the present value of cash flows. As discount rate increases, the present value of coupons and lump sum payout decreases.

The 4%   US Note due 8/15/2018

- **Is up 12.7% year to date.***

- **And paid out interest yielding 3.9% based on 12/31/2009 closing price.**

- * Based on 11/4/2010 closing price.

Capital Gains

- A 30 year bond appreciating when the market changes from 3% yield to 2% yield gives more capital gains than a 30 year bond appreciating in a market changes from a 10% yield to a 9% yield.
- Therefore, even at current yields, bonds can still show significant capital gains.

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But will Bonds Outperform other financial assets going forward ?

- Yes, it is possible to see good gains in bonds over the foreseeable future, but will their performance surpass the performance of other instruments?
- In the past, gold was considered an inflation hedge. But now without inflation, gold is outperforming bonds and the stock market.
- If increased liquidity is not spilling over into the money supply as we have discussed, then what outlets can it find?

Let’s add a sub title to today’s talk:

What Does Quantitative Easing 2 Mean for U.S. Treasury Investors & Traders?

And Why Studies of Monetary Policy Are An Excellent Tool for Gold and Silver Investing

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Where can Liquidity Go?

- Assets with somewhat limited supply increases are ideal targets when liquidity swells the financial system.
- Gold and Silver are perfect beneficiaries for heightened liquidity.
- The study of monetary policy is a prerequisite for performance in precious metals because of everything mentioned in the previous slides.

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The QE2 Moment

- On November 3rd as in the financial crisis of 2008-2009, the markets should see increased liquidity in the banking system. But as new loans are required to spread these reserves into the real economy, the transmission process of converting reserves to checking accounts is expected to be slow due to the obvious reasons about a slowly growing economy. The bottom line is:
-
- This increased liquidity is expected to show up more in financial markets, especially bonds, gold, silver and stocks than in new loans which are one supposedly objective for improving the economy.
-

What is the rationale for Gold and Silver Now?

- The growth of liquidity is slightly neutral on economic activity.
- The money supply is not causing inflation.
- Liquidity seeks outlets.
- The outlet is in financial markets.
- Many European banks have gotten out of gold over the past decades. Central bank supply is declining. Export economies are likely candidates to put a portion of their trade surpluses into gold. Whereas they may not tell us that they are doing this, it is reasonable to expect.
- The Federal Reserve is lending long term (via purchases of bonds) but borrowing short term through the reserve market. Is this an accident waiting to happen, making gold the best insurance policy to protect against "the feared accident waiting to happen."
- Due to the skepticism in the bond market, even though some maturities should increase in value, the positive factors in the gold and silver market are much stronger than the positive factors in the bond. Accordingly gold and silver should outperform the bond market.

Going forward, can we expect:

- Does monetary history to repeat itself?
  - After many wars, deflation occurs, sometimes for short periods and sometimes for long periods. Can this cycle be altered?
  - Aren't budget cuts at both the federal and state level is expected?
  - Discuss the 1951 accord between the US Treasury and the Federal Reserve.
  - Could we return to a pre-1951 regime? Or are we already there, but not recognized ?
  - Does the Fed have three mandates, rather than two…price stability, employment maximization, and making sure there are no failed auctions for Treasury debt?

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Recap of my argument

- As long as interest paid on excess reserves is greater than equivalent money market rates, the banks will be holding large amount of excess reserves with the Federal Reserve.
- These excess reserves should not be creating large increases in the money supply.
- Inflation should not be a problem. Recall Friedman's dictum: "Inflation is a monetary phenomenon.

Recap of my argument, continued

- Large reserve balances expected to remain at the Federal Reserves. The Fed's cost on its liability (i.e., reserves) is 0.0025% but its current yield on its assets, i.e., US Treasuries, is much higher.
- The Fed is making money.

Recall of my argument, continued

- Negative repercussions:

  Increase in debt but no debtor's prison as in the 18th century.

  "Extended period of time" sounds Japaneseque.

  Positive Benefits:

  Refinancing of corporate debt home mortgages improves income.

  PE ratios on stocks should increase due to lower discount rates of future earnings. The PE ratio on 10 years US Treasuries is 40. Stocks are cheap compared to bonds.

  Wealth effect

Recap of my argument, continued

- Grid Lock in bank reserves which spells over into the financial markets, namely, bonds, commodities and stocks.

- Improvement comes after improvement in the financial markets.

- It is not inflation which is driving the gold and silver markets, but liquidity.

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