Vol. 6, Issue 29
Sept. 14, 2012

Something to Think About

OAKWORTH CAPITAL BANK

COMMON CENTS

Yesterday, the Federal Reserve another round of what it calls 'quantitative easing.' This is an academics way of saying: "buying bonds with money the Fed created as though out of thin air." Obviously, the former sounds a little more sophisticated and mysterious than the latter. Shoot, if Larry the Cable Guy were to describe quantitative easing, he would say something along the lines of: "You see, it's when these guys buy up all this stuff and pay for it with money they just made in the back room. I don't care who you are; that's funny right there."

But what does whatever you want to call actually do?

When the Fed buys bonds from the financial system, it takes those securities and gives the financial system cash. No duh, right? As far as balance sheets go, Bank A essentially exchanges one asset for another, with no real change to the bottom line. However, now it has this extra money that needs to do something, anything.

The bank can either buy another security, make a new loan, or keep it in cash. Since I would argue the highest and best use of bank capital is to make quality loans, the Fed is essentially goading the banking system to do just that. In so many ways, it is saying: "Take the dern money and do something else with it. Hanging onto that bond wasn't really doing anyone any good."

Now, if the bank lends the cash out, it flows into the economy and generates activity of some sort. In the process, the money supply grows, and all is well with the world, until it isn't. If the bank buys another bond, that would help drive down interest rates, as the demand for debt increases faster than the supply. As we all know, the prevailing wisdom is low interest rates will encourage borrowing. Finally, if the bank simply leaves it in cash, it will get whatever the Fed is willing to pay the bank for it. Currently, this rate is around 0.25%, so it ain't much. It is the modern day equivalent of the proverbial 'coffee can,' and no one really gets much benefit out of it.

Given the fact the Fed has purchased around $2 trillion, we will call it that, in bonds over the last several years, what have banks been doing with all this, well, new money?

Since the end of 2007, the Fed has grown its balance about $1.928 trillion. That is a lot of money it has basically pumped into the banking system. For their part, from December 2007 to July 2012, banks have increased their 'cash assets' by around $1.528 trillion, and their securities portfolios by another $204 billion. Combined, that totals $1.752 trillion, meaning only about $177 billion of the new money found a home doing anything other than sitting in cash or in a new bond.

Of that $177 billion, about $350 billion, yep, went into the nebulous "other loans & leases" category, which includes things like 'reverse repurchase agreements' and loans to foreign banks and/or governments. Basically, the money didn't really flow into the US economy.

All told, when you sum up all the bond buying the Fed has done over the last several years, what has been the primary result? Well, a bunch of extra cash on the collective balance sheet of the banking system. For all intents and purposes, that has been the end result. Obviously, a bunch of idle cash doesn't do much for economic activity, and it hasn't.

Inside this issue:

Political leaders can help change the psychological climate which affects the quality of relationships among people.

Ehud Olmert

Something to Think About, *cont.*

So, why another round of bond buying? Why did the Federal Reserve announce it was going to buy billions of dollars worth of mortgage backed securities between now and the end of the year? After all, the previous attempts to pump cash into the economy basically ended back where it started….at the Federal Reserve. It all seems so pointless, doesn't it? I mean, what is the point?

If the banks aren't lending the cash they already have, what is the point of giving them even more cash? Hmm.

Hey, the folks at the Fed aren't dummies. Yeah, they might be academics, and not really bankers; but they can read a balance sheet better than the next guy. They know what is going on in the banking system, and know this new cash will probably mostly sit in cash or other forms of short-term securities, but mostly cash. They know banks aren't going to start really extending credit only to have the Fed tighten at some point in the future AND start selling the bonds it has purchased over the last several years. On top of the deleveraging private sector, bankers don't want to fall too in love with what they undoubtedly consider 'hot money' to some extent. Then there is the simple fact a huge segment of the banking industry is still trying to rebuild its capital, meaning they can't turn on the credit spigot even if it were so inclined to do so.

So, again, why would the Fed undertake what is being called QE3?

Frankly, I think it is psychological. Oh, you could ask everyone one at the Fed, from Ben Bernanke to the custodial staff, and they wouldn't publically admit as much, but there is no other rational explanation, and these are rational people. Sure, they might make some noise about elevated unemployment and sluggish near-term growth, but where the rubber meets the road, why did the Fed decide to buy some more mortgage backed securities?

I submit because everyone wanted it to do so, and Bernanke and the rest didn't want to see what would happen if they didn't deliver. In truth, it could have been ugly; literally wiping out hundreds of billions, if not trillions, in global market capitalization. So, what is the path of least resistance? Shoot, buy a few hundred billion in mortgages and let it sit in cash! Big whoop. As John Belushi said in "Animal House": "grab a brew...don't cost nuthin." Bump as much cash as you want into the banking system! It is just going to sit right back at the Fed earning no more than 0.25%!

It is so easy, with so few concrete results, and, yet, it makes everyone so happy! Why not? Would you want to be responsible for wiping out Widow Jones investment account? Particularly since she shifted into stocks to generate some sort of absolute return because YOU have set the overnight borrowing rate as low as it is, and she can't get anything on her accounts at the bank?

Of course you wouldn't! Who would? I mean it would take some real brass to tell people the truth: "Gang….listen….we have pumped an additional $2 trillion into the financial system, and gotten no result. I mean we have the foot through the floor when it comes to monetary policy, and we really can't do much more than what we have already done. Hey, we are big boys and girls, and we at the Fed have your back if all hell breaks loose again. However, until such time, you all will just have to figure this bad boy out for yourselves. Now quit staring at the ground and twiddling your thumbs, and go out there and make something happen. This isn't our problem any longer."

How do you think the markets would like that dose of reality? I don't think they would. Why? Well, because they are expecting the Fed to have all the answers and to bail them out whenever they start to tire. So, to save what could have been, who knows, $1 trillion global market capitalization, the Fed spent $300 billion on securities it didn't need, knowing the banks would simply sit on the proceeds. In investment terms, it is a slam dunk; I mean really the best thing to do. However, in terms of just about everything else, it was a cop out. We all know it, and so does the Fed.

Of course, no one there would ever, and I mean never ever a million times, admit as much publicly.

So, let me leave you with a snippet or two from an email we sent our wealth management clients yesterday. I think it pretty much sums up how we really feel about QE3, in case you couldn't tell already:

> But what does it all mean?
>
> Frankly, it doesn't mean all that much in the short-term except for higher prices for paper securities, particularly financials and precious metals ETFs and mutual funds. The rest of the markets will get a lift from

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the rising tide, and energy stocks might surprise to the upside as well. Yep, that is about it.

You see, banks create money in the economy by lending out reserves. If banks don't lend out reserves, well, they don't create money. If the Fed purchases a bunch of bonds with newly created money, it doesn't mean it will end up in the economy. All that new green stuff could just as easily sit in reserves in the financial system, waiting to be deployed. If it just sits there, earning 0.25% at the bank for Bank XYZ, it really doesn't do much of anything….except provide the potential for increased liquidity, lending, and economic activity.

Imagine not being a hunter, and buying a bunch of shotgun shells in the hopes maybe someone will take you on a bunch of dove hunts the next Fall. That is the overall short-term economic impact of QE3.

In the meantime, we will be happy we recently added to the silver and energy holdings on our system, and are currently running with the lowest level of "cash & money markets" since we opened the firm in 2008. As a result, unless something dramatic happens between now and the end of the month, you might like what you see when you open up your quarterly statement.

So, sit back; relax; heck, grab your favorite beverage, and watch as central banks around the world help us to feel good about things again.

You know, it is kind of weird. We create wealth by debasing the currency. Hmm. Soma, anyone?

Important Economic Releases

Release	Survey	Actual	Prior	Comments
NFIB Small Business Optimism (Aug)	91.4	92.9	91.2	This week's data didn't suggest the need for heroic life-saving measures from the Federal Reserve...at least not to me. However, it is what it is. The data suggested and bespoke a modest, mediocre economy. It didn't portend a massive collapse or anything along those lines. In aggregate, I would give this week's economic data a B-. Yeah, that is about right...well, maybe a C+. However, as we all know, the Fed decided another round of extreme measures was necessary. You know, it is kind of funny: how do you get the US economy off life support IF you are constantly putting it on it? If you an answer, please share it with me.
Wholesale Inventories (July)	0.3%	0.7%	-0.2%	
Producer Price Index (Aug)	1.2%	1.7%	0.3%	
Initial Jobless Claims	370K	382K	367K	
FOMC Rate Decision	0.25%	0.25%	0.25%	
Consumer Price Index (Aug)	0.6%	0.6%	0.0%	
Advance Retail Sales (Aug)	0.8%	0.9%	0.6%	
Industrial Production (Aug)	0.0%	-1.2%	0.5%	
Capacity Utilization (Aug)	79.2%	78.2%	79.2%	
U of Michigan Confidence (Sep P)	74.0	79.2	74.3	

Tables & Data Points

STOCKS	Dow Industrials	S&P 500	NASDAQ	Russell 2000	Nikkei 225 (¥)	DJ STOXX 50 (€) Price
12/31/10	11,577.51	1,257.64	2,652.87	783.65	10,228.92	2,792.82
12/31/11	12,217.56	1,257.60	2,605.15	740.92	8,455.35	2,216.55
8/23/12	13,057.46	1,402.08	3,053.40	806.00	9,178.12	2,429.17
8/30/12	13,000.71	1,399.48	3,048.71	808.64	8,983.78	2,403.80
9/6/12	13,292.00	1,432.12	3,135.81	837.95	8,680.57	2,524.95
9/13/12	13,539.86	1,459.99	3,155.83	856.12	8,995.15	2,543.22

BONDS	3-Mo UST	6-Mo UST	2-Yr. UST	5-Yr. UST	10-Yr. UST	30-Year UST
12/31/10	0.13	0.19	0.60	2.01	3.30	4.34
12/31/11	0.01	0.06	0.24	0.83	1.88	2.90
8/23/12	0.10	0.13	0.26	0.70	1.68	2.79
8/30/12	0.10	0.13	0.26	0.66	1.62	2.75
9/6/12	0.10	0.13	0.26	0.68	1.68	2.80
9/13/12	0.10	0.12	0.24	0.64	1.72	2.93

OTHER	Prime	Fed Funds	3-Month LIBOR	Gold/troy oz.	Oil—WIT/brl.	$/Euro	JPY/$	$/GBP	CAD/$
12/31/10	3.25	0.25	0.30	1,421.40	91.38	1.337	81.19	1.559	0.994
12/31/11	3.25	0.25	0.58	1,566.80	98.83	1.296	76.99	1.551	1.017
8/23/12	3.25	0.25	0.43	1,669.60	96.27	1.256	78.49	1.586	0.994
8/30/12	3.25	0.25	0.42	1,654.80	94.62	1.251	78.63	1.579	0.993
9/6/12	3.25	0.25	0.41	1,703.20	95.53	1.263	78.86	1.593	0.983
9/13/12	3.25	0.25	0.39	1,769.50	98.31	1.299	77.48	1.616	0.968

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