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By Greg Gann

Quantitative Easing Explained in Plain English

Every country has a central bank. The most fundamental role of a central bank is to control the speed of a nation's economy, mostly by setting interest rates. To stimulate growth, ordinarily the central bank would lower interest rates, thereby encouraging expansion through loan activity. When the economy has heated up too much, and to keep inflation in check, normally there would be a policy shift to raise rates. This process requires a lot of forecasting and juggling. The strategies which central banks are using today to ward off another grea recession are unprecedented and of historical proportions.

Our central bank in the United States is known as The Federal Reserve (The Fed), and it is chaired by Ben Bernanke. The Fed and numerous other central banks today are engaged in an economic experiment (yes, it is an experiment) referred to as quantitative easing (QE). Here is how QE in essence works.

The Fed, which is a private entity with quasi-governmental authority, is literally buying assets such as mortgages and other holdings fro large private banks including JPMorgan, Bank of America, and Wells Fargo. It provides the banks with cash which is retained in a reserv account for the bank. So the bank removes the mortgage from its balance sheet and transfers the mortgage onto the Fed's balance shee In the exchange, the bank is credited cash and that cash earns interest which is credited by the Fed as well. Since September, the Fed has been buying "assets" from banks and crediting their reserve accounts in the amount of $85 Billion per month.

Where does the Fed come up with the cash to buy these financial instruments from banks, you ask? It calls the U.S. Treasury and says print us the $85 Billion each month until we tell you to stop and then the Fed wires the funds to the banks. The rationale for this is to boo demand for financial instruments because the greater the demand for these instruments, the lower the ensuing interest rates which will prevail in the marketplace. The Fed is the largest buyer of these financial instruments today. The Fed is arbitrarily creating demand. Whe there are more buyers for financial instruments which pay interest, then the seller doesn't have to pay as much interest to induce more purchasers to buy. And, conversely, when there are fewer purchasers, the seller has to pay higher interest to entice more buyers. It is in this way that our Fed and other central banks are seeking to maintain low interest rates to stimulate economic activity.

One of the consequences however of printing so much money and raising the monetary base, is that the currency loses value and eventually can become debased. If the U.S. dollar loses too much value, then our creditors, such as China, may decide that we are a greater risk and could curtail their lending. China lends us dollars to pay our debts and we are obligated to repay the debt in dollars. So, the value of the dollar is undermined, there could come a point where the Chinese and other lenders decide it's not worth lending to the U.S. and/or demand higher interest rates. Even just a half point increase in interest rates would substantially increase U.S. debt service obligations and hence budget deficit. Trying to navigate these opposing forces is like pulling on a very thin string. It would be nearly impossible to get it just right.

The point is that economics is never a precise science. It is not quantum physics. And, there is often an equal and opposite reaction for every action as well as unintended consequences which cannot be examined in a test tube. No one, that's right, no one, knows how all o this will transpire once the Fed reduces and/or stops its massive purchases.

What is known is that the Fed was established in 1913. It took from 1913-2007 for the Fed to create a balance sheet of approximately $1 Trillion. By the end of the current calendar year, as a result of the Fed's monthly purchasing activities, it is estimated that that the Fed's balance sheet will have ballooned to $4 Trillion. That equates to a four-fold increase in just six years from a balance sheet which had previously taken 94 years to establish. All of this has resulted in the yield on a ten year Treasury note at the time of this writing of approximately 1.7%. Think about that for a second. Simultaneously in a month during which the stock market has reached all-time highs investors are lining up to buy ten year paper from the U.S. Treasury which is yielding less than inflation. So, clearly not everyone has bought into the notion that QE is the panacea. Furthermore, unemployment has remained stubbornly high even in the midst of all of this monetary stimulus.

Notwithstanding the disparity of opinions about the efficacy of QE or the unintended consequences, just two weeks ago, The Bank of Japan (BOJ), the central bank for the country, propelled the QE bandwagon by announcing its new mandate to double its bond buying program. This is for a nation whose total debt is almost 2.5 times its GDP, and twenty times its tax revenue. Kyle Bass, principal of Hayman Capital, and one of the infamous strategists who hit a home run betting against subprime loans, points out that the BOJ is monetizing at a rate of 75% of the Fed for a country whose economy is only one-third of the United States. Consequently, the value of th Japanese Yen has depreciated drastically since the policy announcement.

A weaker currency augments exports because the net cost for the importers is reduced as their currencies strengthen, in this case agair the Yen. But, while increased exports is obviously advantageous for a nation, there are no free lunches and often a zero-sum gain. For instance, Kyle Bass predicts that Japan's monetary policies and economic challenges will result in Japanese retirees losing up to half the life savings. Plus, it is difficult to achieve real gains when so many countries are racing to the bottom simultaneously, resulting in what many consider the precipice of a great currency war.

The other great challenge and perhaps unintended consequence of easy monetary policies which have resulted in historically low interes rates is that bond prices which have served as a conservative anchor since 1982 when interest rates peaked at close to 20%, provide re headwinds looking forward. When interest rates decrease, that strengthens the price of bonds. However, increasing interest rates weake bond prices. That is because new bonds would be issued typically paying out higher interest rates than older bonds that were issued wh rates were lower. All things being equal, I'd rather own a newer bond paying higher interest than the older bond with the lower rate. So, t induce us to purchase the old bond with the lower interest rate, we would demand a discount.

The 401k money which for numerous Americans was cut in half twice over the last twelve years to become the notorious 201k was nonetheless buoyed by rising bond prices. Investors do not have those tailwinds today with interest rates currently at rock bottom. When interest rates do begin their inevitable ascent, that will wreak havoc on the one major investment asset class which has had remarkably superior performance over the last thirty plus years.

Even ignoring all the challenges and what I consider inevitable financial catastrophe in the Euro zone as well as geopolitical risks associated with Korea, Iran, the Middle East, and Africa, I take the position that today represents a crucial period in world economic histo to diversify away from allocations primarily to stocks and bonds. Real, hard assets and investment strategies which can profit when traditional markets devalue need to be well understood and incorporated. In a world flush with economic experimentation, what worked i the past will not necessarily be a winning formula for tomorrow. New ideas and innovative financial products are more critical than ever. Today's market is not your father's Oldsmobile. Feel free to call us to arrange a phone consultation to see if you may be a candidate for comprehensive review and how the strategies that are helping our clients might help you.

*Source: Byron Wien, Vice-Chair Blackstone Group, LP. Bloomberg TV Interview 3/5/13