Investment Watch

3rd Quarter, 2012

Whatever It Takes!

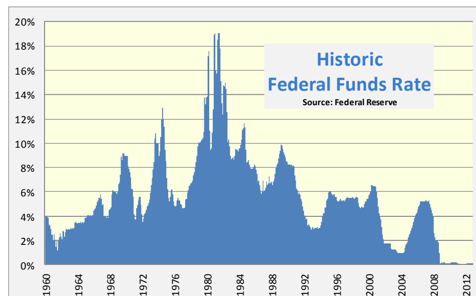
Our Federal Reserve, frustrated by the persistently high unemployment and our anemic economy, has vowed to do ***Whatever It Takes*** to stimulate growth. At their September meeting Fed Chairman Ben Bernanke got his way with an 11 to 1 vote to undertake the most ambitious stimulus program yet - **QE3,** an open-ended commitment to print more money to buy $40 billion of mortgage-backed securities every month and a promise to keep interest rates low for as long as it takes to see significant improvement in the job market.

It has been five years since the subprime credit crisis nearly caused the entire collapse of our financial system. The Fed has not only employed their conventional tools, but now is using extreme, unorthodox monetary policy actions to promote growth.

The Federal Reserve System, which serves as our nation's central bank, was created in 1913 in response to a series of financial panics with the enactment of The Federal Reserve Act. To carry out the Fed's *"dual mandate"* to maximize employment within the context of price stability, Congress created our Federal Reserve System's structure composed of:

1) The Federal Reserve Board of Governors consisting of seven members appointed by the President and confirmed by the Senate,
2) Twelve regional Federal Reserve Banks located in major cities throughout the nation and
3) The Federal Open Market Committee (FOMC) composed of the seven Fed Governors and the twelve (only five vote) presidents of the Federal Reserve Banks.

The Federal Open Market Committee (FOMC) is charged with setting monetary policy. They meet eight times per year to set key interest rates, such as the ***Fed Funds Rate,*** the overnight rate at which financial institutions can borrow. The Fed uses the Fed Funds Rate to directly influence short term interest rates. Lowering the Fed Funds Rate has been the major tool used to juice the economy by lowering short-term borrowing costs, thereby making overnight money cheaper. The previous chart shows how in December 2008 the Fed lowered the Fed Funds Rate to almost zero in response to the credit crisis. This near-zero interest-rate policy has depressed short-term interest rates to near-zero levels. The Fed is committed to keep rates exceptionally low "*at least through mid-2015*."



In addition to this direct intervention, the Federal Reserve can engage in ***open market operations***, generally to supply reserves to banks. The Fed buys or sells government securities in the open market to drain or add to banking reserves. Back in 2008, the Fed began using these open market operations in an unconventional way—printing money to purchase toxic mortgages which flooded the economy with cheap dollars. Now dubbed QE1, this was the first round of ***Quantitative Easing***.

Quantitative Easing introduces newly printed money into the money supply. Generally this expansionary monetary policy involves purchasing short-term government bonds. But with short term rates near zero, normal methods won't work. The Fed is using Quantitative Easing to purchase longer maturity bonds to lower longer-term rates. QE1 was followed by QE2 and Operation Twist expanding the Federal Reserve balance sheet from $750 billion before the crisis to $2.8 trillion today.

FOMC minutes announced QE3 on September 13th - the Fed is concerned that the economy may not grow fast enough to create enough jobs to reduce unemployment and may be adversely affected by the global slowdown. They "*agreed to increase policy accommodation by purchasing additional agency mortgage-securities at a pace of $40 billion per month…expect that a highly accommodative stance on monetary policy will remain appropriate for a considerable time [even] after the economic recovery strengthens and currently anticipates low levels for the federal funds rate are likely…through mid-2015*"

Fed Chairman Bernanke's predecessor Alan Greenspan would intentionally use wordy, vague and ambiguous talk dubbed "*Greenspeak*" to prevent overreaction to policy changes. Now Bernanke's Fed strives for transparency and in fact, wants to instill confidence in both businesses and the public that they can rely on the Fed to do ***Whatever It Takes*** to support growth. Unconventional, unprecedented actions for uncertain times. Let's hope they work!

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