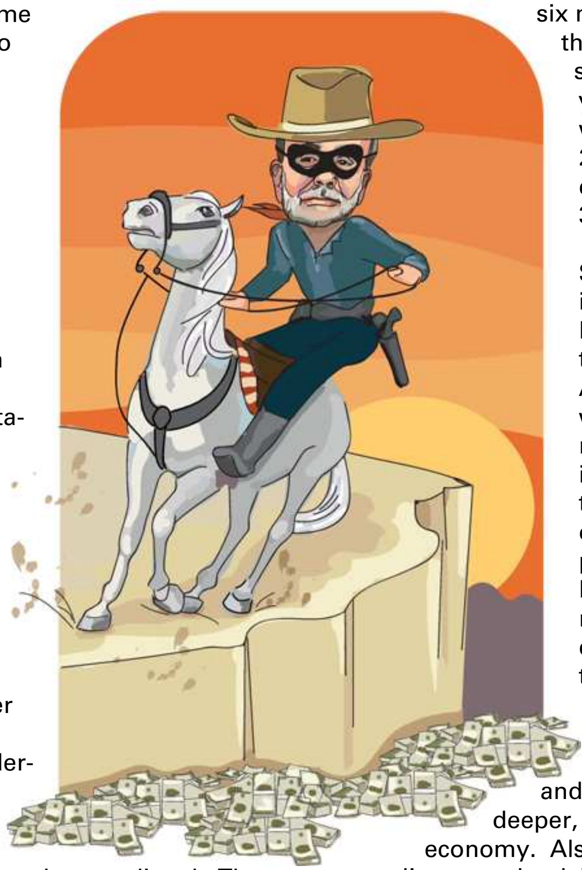
Investment Watch

2nd Quarter, 2011

QE2 Ends Today—Now What?

Ben Bernanke, the Chairman of the Federal Reserve, pulls back on the reins as ***QE2*** moseys to the end of its days on June 30th. This second round of Quantitative Easing was a controversial Fed stimulus program which over the last eight months flooded the financial system with liquidity by regular purchases of $600 billion of longer-term US Treasury bonds using newly minted money. Although it seemed the Fed had run out of ammunition with near-zero interest rates, an economic slowdown this same time last year forced the Fed's hand to adopt extraordinary, unconventional tactics to kick start the economy.



Federal Reserve officials warned that ***QE2*** would not be the silver bullet to magically cure our ailing economy. But late last year, merely the announcement of ***QE2*** seemed to spur the economy out of a soft patch with the GDP jumping 3.1% in the 4th quarter. With this surprising strength optimism grew. Then the *disaster-riddled* 1st quarter lowered our expectations and transformed our optimism into pessimism. Forecasters, even the best like Macroeconomic Advisors, were ambushed by unexpected economic dislocations forcing them to slash their 2nd quarter growth projection from 3.5% to a meager 2.0%.

So here we are again mired in another soft patch almost exactly like the one last summer that triggered ***QE2*** wondering—Now What? ***QE3***? Not likely. Detractors quickly point out ***QE2*** wasn't the silver bullet cure for the economy, but it also wasn't the scourge they predicted. The Fed's goals were to stimulate the economy by holding down interest rates and avoid Japanese style deflation. With interest rates low ***QE2*** exerted added downward pressure on the dollar. The dollar's slide is both good and bad. A weaker dollar makes U.S. goods more attractive abroad which promotes exports and growth here at home, but at the same time, makes our imports more expensive fueling inflation for the U.S. consumer.

QE2 has also taken potshots for inflating commodity prices which have caused social suffering and political disruptions. Unquestionably the surge in demand due to global growth has produced supply shortages. The world's poor and developing countries are hardest hit because they spend much more of their income on food and energy. The United Nations believes that these higher food and energy prices are here to stay. But recently global efforts to reduce oil prices by releasing 60 million barrels from strategic reserves and plunging corn prices, due to a U.S. Agriculture Department report that famers planted a surprising, near-record crop this June, may keep prices down for a while.

Economists reckon that the recent economic headwinds are mostly temporary. The supply disruptions caused by the Japanese earthquake and tsunami, political unrest in the Middle East, severe weather at home and abroad, and high food and energy prices have all dampened the recovery. The economy has only grown at a 2% pace during the first six months of the year, the slowest since the recovery began. Most forecasters see a rebound in the second half of the year including The Federal Reserve who expects growth to average 2.7% - 2.9% for 2011. Which means the economy will have to giddy-up to a 3.5% clip for the rest of the year.

Some prognosticators believe the Fed is too optimistic. However, Chairman Bernanke isn't a tenderfoot and knows that every trail has some puddles. Although he is confident our economy will start to gallop, he admits this recovery is uneven across sectors and is also frustratingly slow. He concurs that many of the current economic disruptions are transient and if they pass our ride will be a little easier. Let's hope he's right and that the recent price declines in food and energy have a permanent footing in this unusually uncertain time.

The trail to recovery both in housing and employment will be much longer and the puddles along the way may be deeper, stickier and longer-term drags on our economy. Also the federal deficit and the political wrangling over the debt ceiling could be deal breakers if our congressmen don't play their cards right.

The Fed's mandate is to promote sustainable growth to promote maximum employment while maintaining stable prices. The Fed Chairman will not change horses midstream as he rides ***QE2*** into the sunset. As long as inflation stays subdued, Bernanke will dig in his spurs doling out almost free money with near-zero interest rates to encourage economic growth. If he's right and the current headwinds dissipate, you may hear in the distance *"Hi-O Silver Away"* and this frustrating slow recovery may actually begin to feel like one.

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