DAVID WENDELL ASSOCIATES, INC.
INVESTMENT COUNSEL

P.O. Box 21980
325 Corporate Drive
Portsmouth, N.H. 03802
(603) 427-0200
www.davidwendell.com

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What Happens Next?

Every August since 1978, central bankers, economists and others have gathered in Jackson Hole, Wyoming to discuss the hot topics in monetary policy. This year, there were nearly 125 attendees at the Economics Symposium and one item was on everyone's agenda -- the Federal Reserve Bank's current policy of quantitative easing. But as one wag noted, there were more opinions than attendees on what the Fed should do next with its easy-money policy.

Quantitative easing (or "QE") is a monetary policy tool used by central banks to increase the money supply and spur economic growth. They do this by buying government or government-sponsored securities from banks and other financial institutions. With the new funds, the banks have more capital and are able to make more loans. With more lending going on, loans become easier to obtain -- hence the term "easy-money."

Since the financial crisis, the Fed has used quantitative easing to stabilize the financial system. In the process, the central bank's balance sheet has expanded massively, the most ever to-date. Over the past few years, this has created a great deal of confusion and anxiety on Wall Street and on Main Street. Markets around the world were further roiled in May when current Chairman Ben Bernanke indicated that the Fed was considering scaling back its current easing program, sooner rather than later.

Historically, easy-money policies do not have a great record. In the years following World War I, Germany's Weimar Republic kept printing money to pay its bills and saw inflation soar as a result of the increased money supply. According to some sources, the cost of a loaf of bread in 1919 was one mark but four years later it had grown to a wheel-barrel-load of 100 billion marks. This hyperinflation contributed to the country's financial and social unrest during the 1920s, which led to the rise of Adolf Hitler and World War II.

More recently, the easy-money policies of the Federal Reserve under former Chairman Alan Greenspan are seen by many to have been a contributing factor to the financial crisis. We thought this an excellent time to review the crisis, why quantitative easing was needed, and what may be in store for investors.

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As the government's bank, the Federal Reserve is at the center of the U.S. financial system. It sets the nation's monetary policy through two basic tools. For macroeconomic stability, it adjusts the level of short-term interest rates to influence spending, production, employment and inflation. For financial stability, it tries to prevent financial panics and crises and provides short-term loans to help mitigate them when they occur.

In normal times, the Fed adjusts interest rates by buying or selling U.S. Treasury securities in the open market. Purchasing Treasury securities makes them less available to investors and makes short-term interest rates move up. Longer term rates tend to follow and economic growth slows. Selling Treasury securities makes them more plentiful in the market and short-term interest rates fall. Longer term rates tend to follow and economic growth accelerates. These "open market operations" are the Fed's conventional policy tools.

During a crisis, the Fed uses unconventional tools to promote financial stability. For example, during a bank run depositors lose confidence in the bank and withdraw their funds. As more funds are withdrawn, the bank becomes increasingly illiquid. Ripple effects develop as the loss of confidence in one bank spreads to other banks. The Fed can step in as the "lender-of-last-resort" and calm the markets by making short-term loans where needed. The loans increase the liquidity of the banks, restore depositor confidence and help keep the financial system functioning.

Among economists and others, there are disagreements as to whether or not the Federal Reserve actually influences long-term interest rates and whether or not its actions help or hinder the economy. There are also disagreements about the role of government in society. These are based on the different theories of economics. For this newsletter, we are focusing on how the Fed sees its role and the tools it used during and after the financial crisis.

In a series of lectures given last year at George Washington University, Bernanke discussed the decades leading up to the crisis. Basically, both the economy and the financial system were seen as more stable than they had been prior to the 1980s. Technological innovations, such as better inventory management systems, played a role as did, in Bernanke's words, "simple good luck." The fluctuations in the business cycle were less severe with fewer peaks and valleys, and the financial stresses that did occur left little lasting damage.

This period from the mid-1980s on is called "The Great Moderation." Because both the economy and the financial system were relatively tranquil, the Federal Reserve was focused more on the normal policies of targeting interest rates than on the financial stability policies it would need in a crisis.

Housing prices began to soar in the early 2000s but were seen then as a result of a strengthening economy. To spur growth after the recession of 2001, interest rates were lowered numerous times. With lower interest rates, mortgages became more affordable and housing more attractive. Many thought that house prices would keep rising indefinitely.

When the housing bubble burst, very few observers inside or outside the Fed realized how far lending standards had fallen, how much mortgage quality had deteriorated and how complex mortgage-related securities had become. As Bernanke noted:

> *"The really hard thing to anticipate fully was that the effects of the decline in house prices would be so much more severe than the effects of the somewhat similar decline in dot-com stocks. And again, the reason is the way in which the decline in house prices affected mortgages, which affected the soundness of the financial system and created a panic, which in turn led to the instability of the financial system. So the whole chain of events was critical. It was not just the decline in house prices; it was the whole chain."*

In essence, a classic financial panic had developed. Because no one knew where the losses would fall, confidence disintegrated, runs developed and funds were pulled from any suspect financial entity. In turn, there were huge pressures on key firms and financial markets around the world were disrupted.

As a first response, the Fed used its conventional tools to lower interest rates to near zero. But after it became clear the financial system was still stressed and the economy was not responding, the Fed turned to its unconventional tools to help stabilize the financial system. These were massive purchases of Treasury securities as well as the mortgage-related/government-sponsored securities at the heart of the financial crisis.

By purchasing the mortgage-related securities, the Fed essentially removed them from the market and reduced pressure on the financial system. With these securities no longer on their books, financial institutions stabilized and investors became increasingly confident. The purchases of Treasury securities helped the Fed keep interest rates at its target levels.

The first round of purchases took place in 2009. Two additional rounds followed in 2011 and 2012, and in between there was also a special program which lengthened the maturity dates in the Fed's portfolio. This was known as "Operation Twist" and basically gave the Fed more time for its efforts to work. Even though the rounds of purchases are popularly known as QE1, QE2 and QE3, they were not the typical quantitative easing programs of a central bank. In fact, inside the Federal Reserve these programs are called "large-scale asset purchases," or "LSAPs."

In a typical QE program, when the Fed pays for its purchases it injects new money into the financial system, leading to an easy-money environment. In the LSAP programs, the Fed instead paid for its purchases by crediting the reserve balances the banks and financial institutions maintain at the Fed. Increasing the reserve balances helped stabilize the system, and paying the banks and financial institutions interest on their reserve balances helped stabilize them as well. This has been a key area of confusion over the last few years. In its LSAP programs, the Fed did not "print money" as is commonly assumed, and the LSAPs did not affect the amount of money in circulation.

Another common misconception has been that the Fed's LSAP programs increased government spending. But this confuses the monetary policies of the Federal Reserve with the fiscal, or government taxing and spending, policies of Congress. The Fed's LSAP programs did not increase government spending.

So what may lie ahead if the Fed does begin to scale back its current LSAP program? First, it is unlikely that the Fed would cease its programs all at once. Bernanke is set to step down next year and no matter who becomes the new Fed Chairman, the process is likely to be gradual, taking place over the next few years, depending on economic conditions.

The fact that the Fed is talking about scaling back, or "tapering," at all is an indication that it thinks its programs are not needed now as much as they were in the past. This is a great development as it means the financial system is more stable than it has been in years. Moreover, the Treasury and mortgage-related securities the Fed has purchased over the years are, at the end of the day, assets that it can sell back into the markets when conditions permit -- possibly another tool at the Fed's disposal.

The current economic recovery has been the slowest on record, but the financial crisis was the largest since the Great Depression of the 1930s. It should not be surprising that it is taking longer than expected. The important thing is that the economy <u>is</u> improving.

We recently reviewed the results of twenty-five companies we regularly follow and have recommended over the years. Comparing 2009's results to this year's estimated results, this group of companies should increase their revenues an estimated 46%, on average. This top-line growth has more to do with developing new products and services, gaining new customers and increasing market shares than it has to do with the Fed's easing programs.

Compared to the Standard & Poor's 500 Index, our group of twenty-five companies should increase their sales per share an estimated 60% on average from 2009 versus an estimated 23% increase for the average company in the Index. Our group of companies is on track this year to increase their earnings some 94% over 2009's level (versus an 88% increase in the Index) and their dividends about 95% higher than four years ago (versus only 48%).

The point is that we think investors in high-quality, growing companies have little to fear from the end of quantitative easing. These companies have top-notch management teams who have continued to grow their revenues, earnings and dividends per share during the crisis and its aftermath and there is no reason to think they will not continue to do so.

At the end of his lecture series, Bernanke noted that even though new financial crises are always possible, central banks around the world have learned some important lessons. Furthermore, our economy has a highly diverse mix of industries and a robust entrepreneurial culture with flexible capital and labor markets. We remain a technological leader with many of the world's top research universities and we have the highest spending on research and development of any nation. These are comments investors of all stripes should take to heart.