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# DOUBLE BUBBLE

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* QE2 will ultimately drive long rates higher
... and is unlikely to stimulate employment

* Federal Reserve influence on long rates is eroding
... the Fed is no longer the only elephant in the room

* The banking system may benefit as the lender-of-"next"-resort
... remediation to replace shadow banking damages

U.S. monetary policy is not only confronting a daunting liquidity trap, it is also driving U.S. indebtedness into a global box canyon, almost certainly marrying a declining U.S. dollar to higher long-term interest rates.

American optimism tends to trump these economic realities. This is a form of denial, but it may be helpful as we try to recover from our deep, structural imbalances. This denial is particularly potent in debt and equity markets, which have been in a default rally since late August, awaiting a political shift to the right and the prospect of further Federal Reserve intervention. We now know the composition of Congress and the quantity of future quantitative easing (QE).

Economic fundamentals do not fully support this rally's strength. Within US equities markets, the financial sector has been tellingly sidelined. Few investors want to fight the Fed in the face of further quantitative easing, but omitting the financials suggests shallow economic conviction. In our view the Fed is simply inflating another bubble as it drives investors out of government bonds.

This time the bubble isn't in U.S. housing. Home prices have already collapsed, and are very unlikely to return to bubble levels, regardless of how low Treasury rates fall or remain. All the Fed can accomplish, at the moment, is an abnormally favorable rate environment that may be cushioning any tendency for further housing weakness. The Fed is feared as the elephant-sized buyer of US government debt, among other assets, by creating the necessary currency. But this policy may face new limitations from emerging market disciplinarians, as we will discuss. The Fed is no longer the only elephant in the room.

To most observers, this can't end well. Previous decades saw bubbles, of course, but only the 2001-2005 housing bubble collapse had the potency to spawn our "Great Recession." In retrospect, the reason for such wide-ranging devastation is clear: Housing was the largest financial asset class in the world, not just the U.S., and prices plummeted faster and farther than they had for a century - even surpassing that of the Great Depression.

Disturbingly, the newest prospective bubble is in the $8.5 trillion U.S. Treasury market - the only other financial asset class rivaling the $11.5 trillion mortgage market.

Financial stocks are highly sensitive to distortions in asset pricing in general, which helps explain why they led the stock market down, and also why they initially led the market recovery. In stark contrast the financial sector is now hesitant as it confronts this next bubble. Dodd-Frank, Basel III, and FASB uncertainties also add weight and compound a fundamental decline in financial product demand. Lending and structured finance are still soft, as they usually are during a recession, asset management has seen ongoing outflows, and trading volumes have ebbed.

While the political class cannot grasp it, credit and lending lag the economic cycle. There are nascent signs of loan growth. These signs are weak at the moment and primarily in the commercial credit sector, faithfully mirroring the weak economy with a lag. But we argue that structural damage to "shadow banking" could revitalize balance sheet lenders even without stronger economic momentum. Consumer spending remains soft but eerily buoyant, considering dwindling personal income. Spending has been heavily biased toward non-discretionary items, however, and incomes have been primarily supported by government.

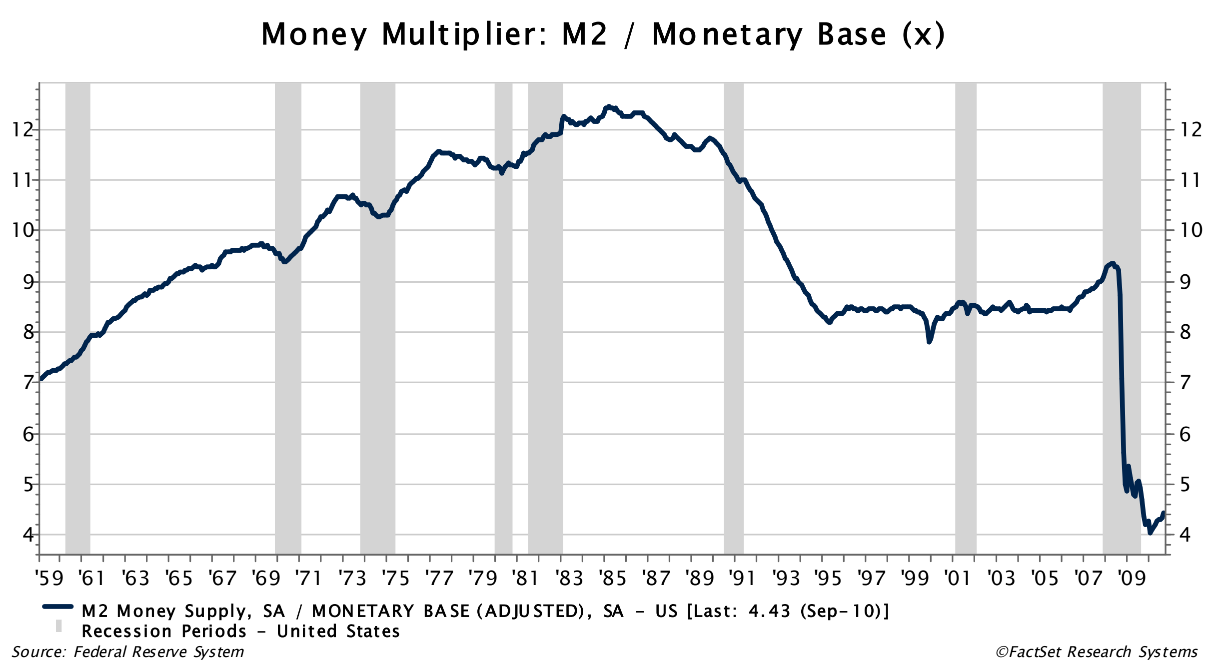
Jobs data continues to be wholly inadequate for optimism. September's decline in the Payroll Survey, and the insipid gain in private payrolls were accompanied by two more disappointing indicators: Both the unemployment rate and hours worked were flat. If there was any organic, grass-roots uptrend in jobs, the former would likely rise as more workers entered the job search base, and the latter would initially rise in conjunction with labor demand. Another historically consistent lead indicator, construction jobs, remains weak, a telling and ominous reality. Consumers are achieving minimal de-leveraging, other than from outright debt forgiveness, and understandably show no proclivity to re-lever. Consumers are smart.

Two observations continue re-surfacing in our strategic outlook: 1) The increasing impotence of U.S. monetary policy in the new global order, and 2) the persistent, extraordinary disarray of the U.S. credit markets, as government intervention failed to shift from stopping the liquidity panic (that many argue it started) to restoring and building confidence in the private sector. The former is almost all bad. The latter is economically damaging as well, but with gross neglect principally in secondary markets, coupled with modern financial instrument paranoia, a quite promising future may be forming for traditional balance sheet lenders.

**Monetary Impotence?** In stark contrast to its proud 2008/9 role in stopping a liquidity panic, the Fed has not been so successful as economic white knight in the follow-through phase of the recovery cycle. It should not have been expected. At the risk of over-simplification, we view monetary policy as a potent brake and fiscal policy as a potent accelerator. Sticking to the automobile metaphor, judicious application of fiscal policy (the balance between tax and spending) can make the car move as long as the brakes are off. Taking the brakes off does little without the accelerator pedal. In its defense, the Fed primarily commands the left pedal. (Having a tank of gas also helps.) As fiscal policy has never been useful in braking runaway inflation, monetary policy has never overcome the famous "pushing on a string" limitation. We should not criticize the Fed. As any driver knows, you need both pedals.

Markets have become increasingly addicted to the curative properties of QE. This is completely understandable when there is nowhere else more compelling to place faith and fate. Sadly, recent experience with accommodative monetary measures only highlight their limitations, and should correspondingly raise further doubts about central bank powers operating in a governmental vacuum.

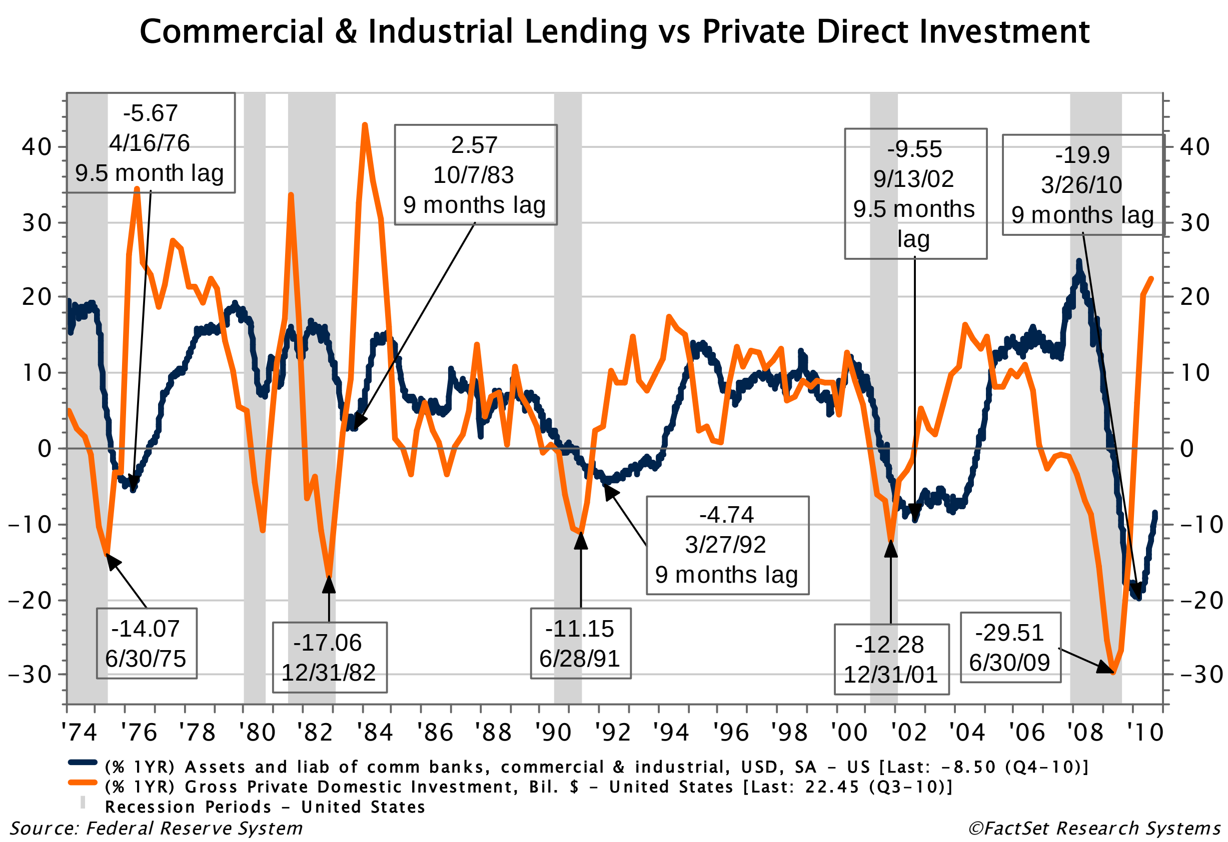
This brings to mind some uncomfortable parallels to the sugar-high from government stimulus during the Great Recession (see our "Government's Supporting Role" - May 5, 2010), and more disturbing parallels with our meteoric housing bubble between 2002 and 2006. In the current case the Fed, without a rational and competent fiscal partner, has been uncomfortably alone and forced to follow a zero interest rate policy (ZIRP) and another round of QE, probably overdosing on both. Monetary stimulus has spectacularly failed for nearly two years, as broader measures of the money supply clearly decoupled from the monetary base.




**Quantitative Easing - Ineffectual and appropriately restrained**: Essentially alone on the economic battlefield, the only quasi-independent watchdog for economic balance understandably may not want the market or the population to think the government arsenal is empty. But the second round of quantitative easing that was blatantly heralded by the Federal Reserve since August, remains a growing puzzle among financial professionals, and is well betrayed by discord within the Fed itself.

Following two years' of Fed Funds effectively at zero, and the Fed's $1.7 trillion balance sheet expansion largely from the direct purchase of mortgages and Treasuries, it makes sense to rethink what the Fed actually aims to achieve. The common and simplistic political invective is to get banks lending again to create jobs. This view is hopefully laughable by now, at least for the financially aware. Internally, even the Fed itself is presumably doubtful that such a linkage exists. Two years of supply-side rhetoric for spurring credit from the political arena is particularly amusing coming mostly from those who generally eschew all other renditions of "supply-side" economics. The refrain that credit creates jobs has become numbingly preposterous, and apparently continues to stun the business community.

**Is QE aimed at increasing bank credit to create jobs?** The Fed cannot seriously believe this. Demand for business credit is obviously missing, not the supply of money nor the level of interest rates. There is ample proof of this: 1) The latest NFIB Research Foundation survey found that 77% of small businesses are having their credit needs met, and 92% indicate access to credit is not their principal problem anyway. 2) Commercial credit line utilization rates are at all-time lows for those who have credit. 3) Bank lenders have been fiercely competing for business loans, and credit pricing (the spread, not just the level) has been driven down for many quarters. 4) The business expansion and investment cycle always leads the credit cycle, not the reverse. The following exhibit clearly shows this lag, which is generally in excess



of nine months. Moreover, even longer lags are found outside commercial and industrial lending. Despite many popular misconceptions reinforced by the bubble, consumers typically consider their capacity to service debt before they borrow. They wait for their income to rise before taking on additional debt. Unforeseen events, such as recessions and job loss, may make it seem otherwise, but single-family mortgage lending has consistently lagged the homebuilding cycle by an average of seventeen months. It has been historically axiomatic that credit lags the economy.

Monetary easing glaringly fails to drive credit expansion, because it can't and never has.

Credit expansion never drives employment, because it can't and never has.

**Is QE aimed at supporting the housing market?** The logic breaks down here as well. Housing remains in a serious slump for far more severe and structural reasons than the level of mortgage rates. 1) The significant oversupply of homes is only increasing with legal and process challenges delaying a rising wave of foreclosures. 2) The sheer number of homeowners with no or negative equity remains unaddressed. 3) Mortgage approvals are far more restrained for the short term. 4) A far bigger obstacle looms: Finding a model to satisfy the future funding for a mortgage market disconnected from its primary supply – securitization pools.

Additional quantitative easing could artificially depress the 10-year "risk free" interest rate, or more probably restrain its tendency to rise, but the impact on home sales would appear to be minimal, if at all, as affordability measures are higher than any time in recent memory. While refinancing demand might benefit from lower long rates, it is dubious that new home purchase demand would be sparked by the hypothetical 10-15 basis-points-per-$100 billion spent from the Fed buying "extra" bonds. Affordability is already at an extreme high. Reducing consumer leverage and increasing incomes would be far more effective and important, and little progress has been made on either.

**Can QE at least keep long-term rates low?** This is largely unquestioned, *but it should be*. When the largest holdings of longer term government bonds are foreign, this time it really may be different. The Fed's intended $75 billion monthly purchase of long-term Treasuries for eight months is only slightly larger than net official foreign purchases, which have averaged $60 billion per month over the last six months. (Since total foreign purchases are often routed through other intermediaries, it is safe to assume net foreign purchasing has been even higher.)

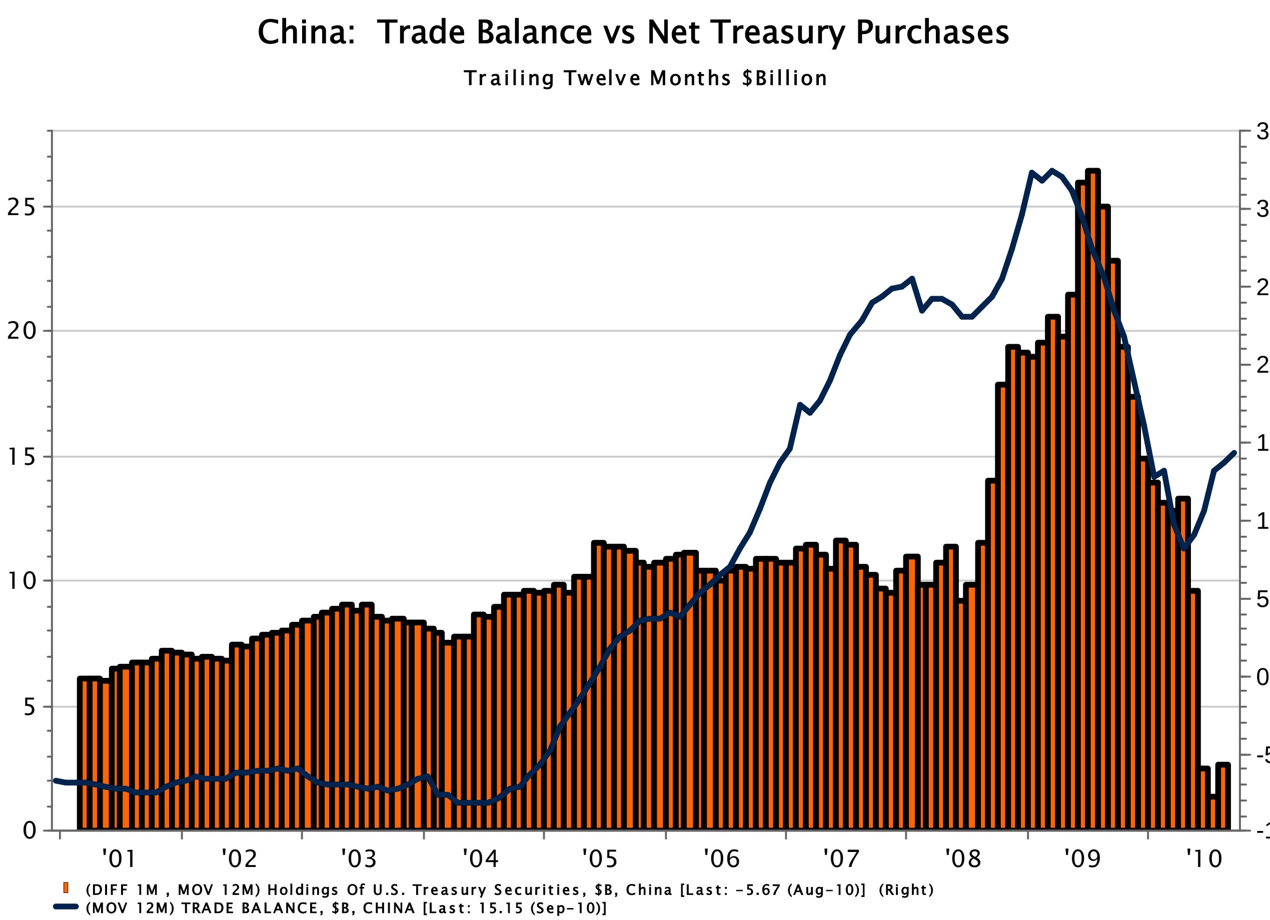
The explosion of emerging market current accounts began over a decade ago, and reflected a monumental reversal in global liquidity. On countless occasions we have cautioned that this was a true "Black Swan" moment, as the size of their hard currency reserves were unprecedented, exceeding $6 trillion at their peak. The amount held in U.S. dollars, proportional to our money supply and GDP, overwhelms any time in history since the early nineteenth century – when the U.S. was itself an emerging market! Looking back over a decade of unusually low U.S. interest rates, with a persistent and puzzlingly flat yield curve until the housing bubble burst, abnormally accommodative money (plentiful and easy credit) was over-driven by heavy emerging market buying at Treasury auctions as much as (and probably more than) an overly accommodative Fed.

Cassandra's have always feared a foreign desertion of U.S. dollars, as it could rapidly shrink demand in an ever-rising supply of U.S. Government bonds and bills, driving U.S. interest rates sharply higher and/or the USD lower. This has been often and effectively countered by the fact that we are the world's reserve currency, and therefore the largest pool for safe storage of the world's excess reserves. Where else can they store such massive liquidity?

This entirely misses the Black Swan lesson. After almost a full decade of global GDP growth attributable to emerging markets, the emerging world is now an adult elephant that can easily influence our Government debt auctions. Those in denial still assume U.S. Government debt will continue attracting official reserves, ignoring 1) the degradation suffered by the USD from profligate spending and 2) likely drainage of hard currency reserves for infrastructure spending by emerging markets. The latter is especially overlooked. Emerging markets how comprise 61% of direct foreign holdings of long-term U.S. Treasury Bonds, sharply up from 29% 15 years ago. In nominal outstandings, emerging market holdings of long-term Treasuries expanded twelvefold over this period! It certainly seems to make good sense to differentiate emerging market interest in Treasuries from that of other industrialized countries.

China represents nearly half of the emerging markets' position, and expanded roughly 45 times in nominal terms! China has already sold virtually all of its short-term Treasury bills between March 2009 and March 2010. It certainly makes particular sense to focus on China.

China's current holdings exceed QE2 in size, and have been going in the wrong direction. While the spin on China's attendance and interest in Treasury auctions suggests continued buying, the pace has softened notably, particularly when examined in context of China's trade balance - their principal source of hard currency reserves. The following graph shows both, averaged on a trailing twelve month basis. Net U.S. Treasury purchases have continued to plummet for four months while China's trade balance has stabilized



and rebounded.  On a net basis, China's cumulative trailing twelve month's Treasury buying has actually been negative for several months, a low point for more than a decade.   We believe part of the decline is simply new hard currency reserve drainage for incremental infrastructure purchases.  In addition to commodity stockpiling, China is building dozens of nuclear power facilities and high-speed rail systems. Components for these projects are mostly sold for hard currencies, as are many commodities.

Relative to trade balance trends over the last two years, China's recent and sharp decline in net Treasury purchases represent a $20 billion monthly shortfall from its previous norm.  That amount alone countermands over a quarter of the planned QE2.  Since China is the largest Treasury participant among emerging markets, it typically influences other emerging market countries, most experiencing similar acceleration in domestic infrastructure needs.  This pattern is reflected in the average, official monthly net buying of all emerging markets, which has shrunk to a meager $4 billion over the last six months.

Therefore, before concluding the effectiveness of quantitative easing, we must now consider how all the moving parts work in a global economy.  Before this Black Swan decade, the U.S. domestic economy, through sheer dominance, remained relatively insulated from global influences and behaved almost entirely as a closed model.  Today, the Fed is no longer the only elephant in the room.

**What the Fed didn't say**:  The Fed has long history and experience setting short-term interest rates.  There are no bigger elephants that would dream of taking on the Fed in overnight funding.  Period.  The Fed can also influence long rates, but cause and effect are less direct, and more expensive.  The cost of manipulating long rates entails printing money, which ultimately degrades currency, which ultimately demands higher interest rates.  While the Fed has addressed balancing its actions against inflation, it has been silent on the U.S. dollar.  However, they are inseparable.

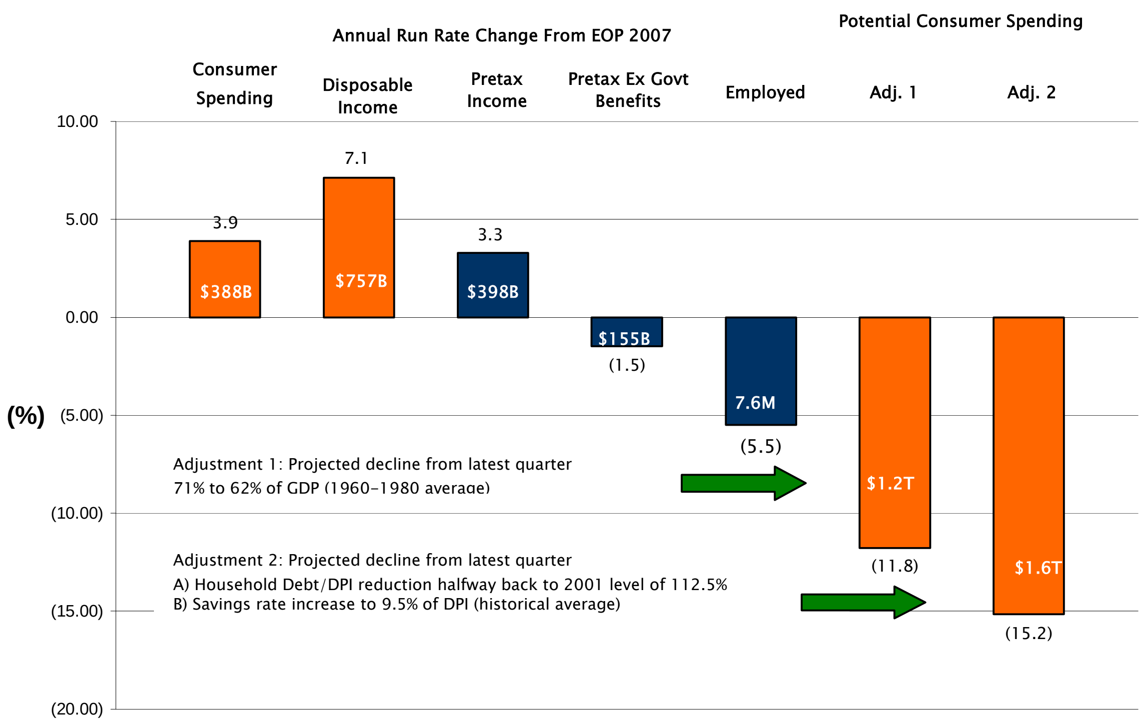
The Federal Reserve has contemplated QE2 within the "dual mandate" of price stability and full employment, but another of its founding purposes is worth remembering:  Currency protection.  This mandate faded from prominence long ago, has been largely outsourced to Treasury after the 1946 Employment Act, and failed to resurface after the dollar was set free from gold backing in 1971.

It is axiomatic that increasing the global supply of U.S. government debt should demand higher rates of interest.  Buying it incrementally from central bank money creation cannot change that, nor the consequent decline in the U.S. dollar among world currencies - especially emerging market currencies. This, in turn, will directly inflate prices of all goods and services with foreign content that are consumed in the U.S., increasingly so considering our vastly shrunken domestic manufacturing capacity.  Therefore, the Fed should really be worried about balancing imported inflation against defending the currency with higher rates of interest.

**A little inflation isn't a bad thing?**   Monetary policy should be viewed through many prisms, and the deflation-versus-inflation lens has unfortunately become quite popular.  Among other factors, consumer spending and corporate investment react to future price expectations.  The big fear over deflation, of course, is not that things get cheaper, but that buyers know it and wait for it.  Inflation arguably does the reverse.

At the moment, the pendulum has not convincingly swung far enough to suggest deflation. Fearing deflation is quite rational, however, based on excessive consumer leverage, sluggish income growth and the degraded net worth of households. Our updated analysis of the future drag on consumer spending, shown below, is still quite sobering. Using the quarter prior to the recession as a baseline, as of the second quarter of 2010 consumer spending is up 3.9%, considerably less than the 7.1% advance in disposable (after tax) income, while almost in line with pre-tax income. Subtracting government transfer payments, however, reveals a 1.5% decline in core income, with the employed base still down 5.5%, the worst decline since the late 1940s.

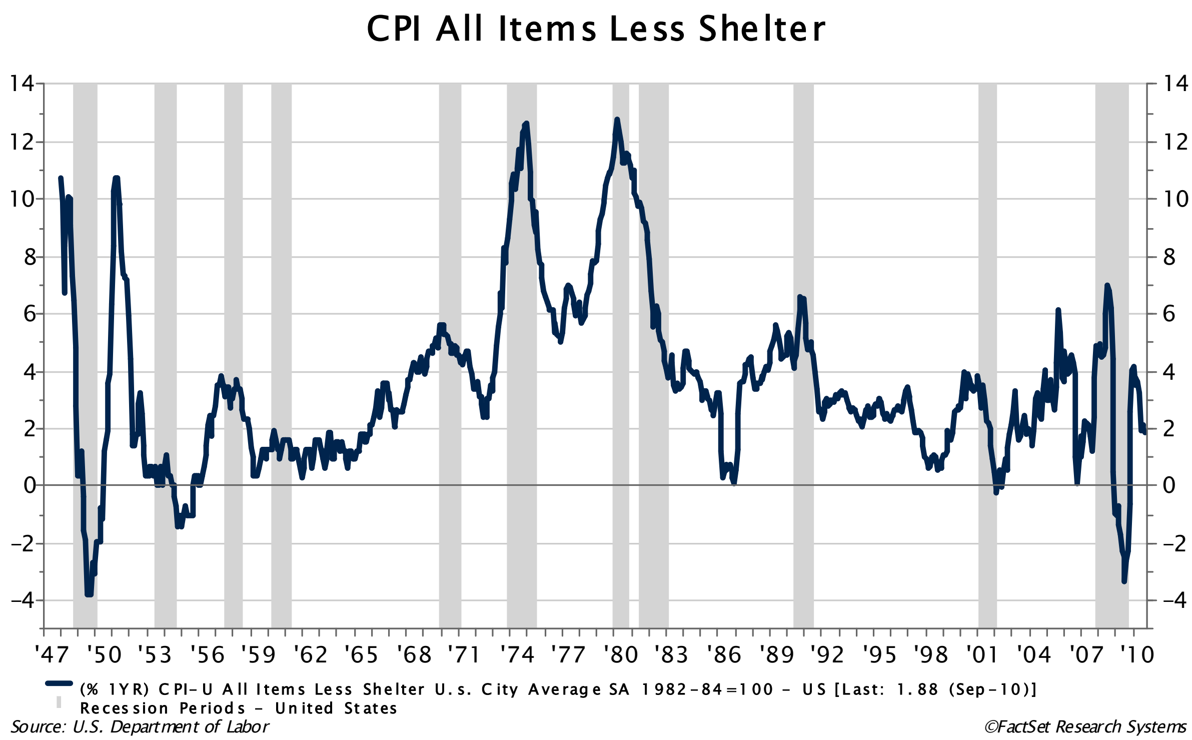
## Consumer Spending Headwinds




The bars to the far right in the exhibit represent a "call" on consumer spending, should 1) the level of spending as a component of GDP return to its earlier historical average, or 2) the personal savings rate return to its historical average and consumer leverage have a reasonable correction (halfway back to where it was after the prior recession). Either calculation suggests double-digit potential adjustments downward in consumer spending over time, which would reflect a high single-digit decline in GDP over time. Both would be astounding damage, which is why we continue to remain very cautious about the U.S. economy and view the next few years as facing clearly structural, not cyclical issues and hurdles.

Yet inflation, depending on how you adjust it, is holding up rather well in the sense that little evidence of the dreaded deflation has surfaced. This is in blunt contrast to the bleak outlook for US consumer spending, and would argue against additional monetary easing. Since recent Fed statements have repeatedly included the phrase "data dependent," we should be prepared for a course change either way.

The Fed frequently focuses on "core" inflation, which is the headline CPI less food and energy. The latter two variables are removed because of their volatility. While this makes sense, it also removes two of the most important variables determining true inflation. As an alternative, we leave them in and remove shelter. Our reasoning is two-fold: Volatility may make for very un-smooth graphics, and a hard-to-glean longer term trend line. But, by arcane and abstract modeling, the shelter component has been a consistently unsatisfactory measure that distorts the actual trend line of another, important component. Consider that, while headline CPI remained below 3% for most of the housing bubble, when prices were inflating consistently in double-digits, the shelter component was clearly understated. As housing prices were collapsing, headline CPI actually averaged over 3%, which makes no sense. We think it is more helpful to remove shelter and then try looking through the food and energy volatility, which we show below. While there is considerable volatility in the graph, the most recent year-over-year data sits on




the 2% line, which also looks to be a reasonable reading of its decade average, and is almost double the 1.1% so-called CPI "headline" number for September, and nearly triple the 0.7% year-over-year CPI "core level. Moreover, considering the rapid expansion in emerging markets, energy and food prices are certainly biased for upside. The inflation versus deflation quandary is quite striking.

**QE in summary**: Fiscal and monetary stimulus are both logical and important tools for navigating a recession and mounting a recovery. But they must be carefully balanced. Once recovery is in place, the economy becomes increasingly vulnerable to excessive monetary slack with the unintended consequence of inflation. Removal of monetary ease must neither be abrupt nor late.

History suggests these two tools are asymmetrically parabolic in effect. In simple terms, as we previously mentioned, fiscal policy is an effective stimulant, but a poor brake. Monetary policy is a powerful brake, but a weak accelerant. That is why, in our view, Chairman Bernanke continues pleading for someone to use the other pedal - fiscal policy - in this stalled car. Waiting for the political high season to close, it is understandable why the Fed wanted to telegraph at least one of the control levers is being applied by a seasoned driver. But the midterm elections are over, and the Fed has chosen additional easing, recognizing neither fiscal discipline nor fiscal stimulus are likely.

All of the above argues for caution. We are clearly inflating a debt bubble, and those blowing air must at least be ready for gum on their face. The Fed has encouraged the belief that our high unemployment is cyclical, not structural. If after more QE there is limited change in unemployment, the Fed will have to rethink strategy, or retreat. It would then need to confront whether enduring monetary withdrawal symptoms is better than risking the longer-term inflationary disease. Failing to do so would only continue degradation of the U.S. dollar, and heighten external pressures for higher rates. The Fed obviously knows this risk. Either it is waiting for a new hand from the dealer in the form of more responsive and responsible fiscal policy, or simply stalling for more time to see if the economic engine begins running on natural fuel.

While the Fed may be sincerely attempting to stimulate the real economy, equity and debt markets are simply trying to get out of the way. Either way, without evidence of job growth, this is another bubble, and rising long term-rates will be the most prominent result.

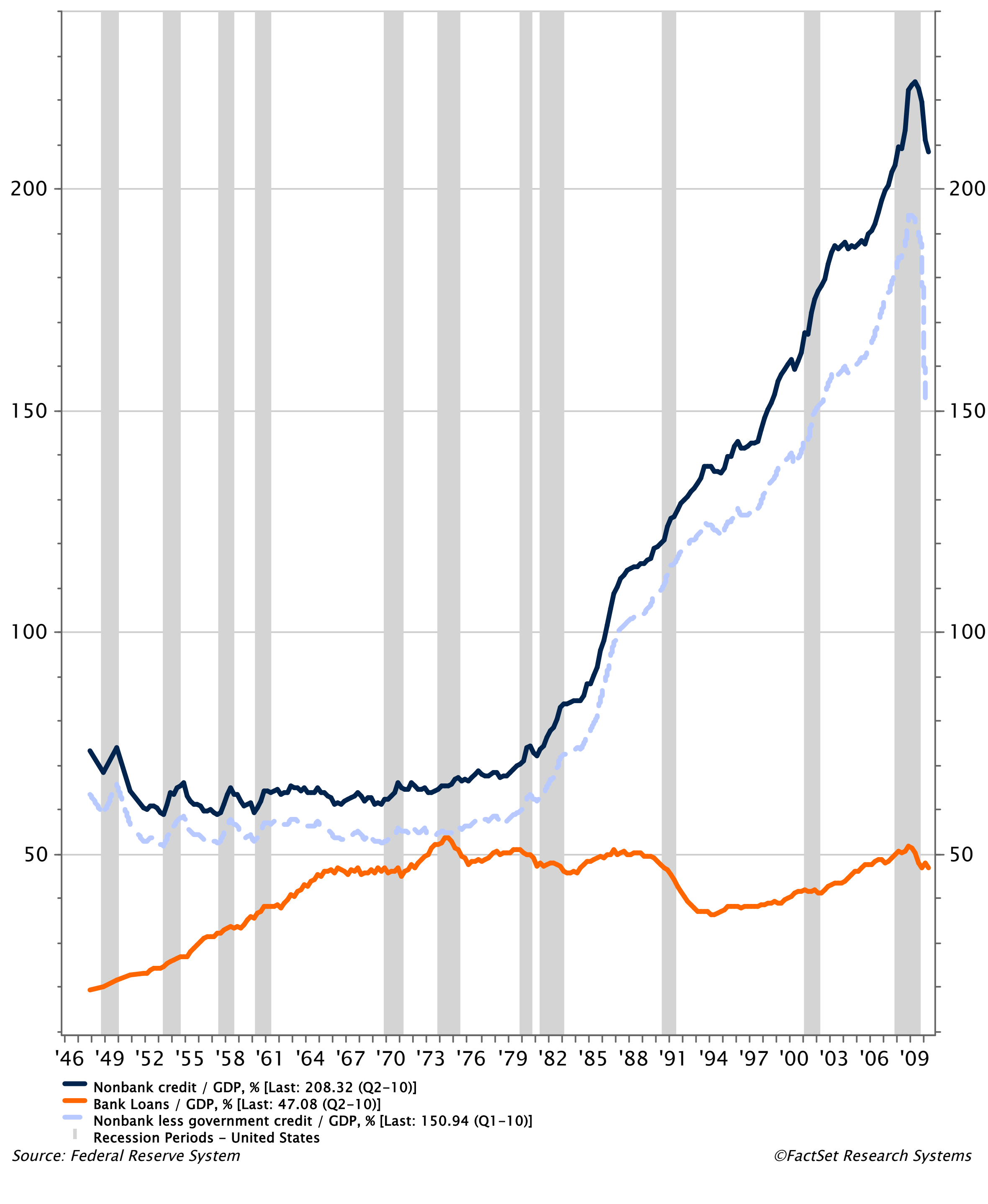
**Where will future credit and/or refinancing supply come from in the U.S.?** This is an extremely important question that has great, and probably positive consequences for our banking system. Even if we assume new demand remains sluggish for some time, outstanding credit must be renewed. Taking all credit sources together, excluding the bond market, the Flow-of-Funds tables from the Federal Reserve indicate total domestic credit outstanding from the financial sector is $37 trillion.

Commercial and savings banks makes up only one-fourth of this total, including their holdings of securities, which are largely asset-backed bonds or Treasuries!

There is no other country of size in the world with that little credit from bank balance sheets, which is testimony to two decades of mushrooming "shadow banking." Comprehending what this means and putting it in context only requires a simple graphic depicting bank credit and non-bank credit in relation to GDP, which we have assembled below for the last sixty-five years. From the end of World War II into the mid-1970s, bank credit outstanding rose from approximately 20% of U.S. GDP to approximately 50%, where it hovered for a decade. After World War II non-bank credit began declining relative to GDP but more or less averaged 65% until the early 1970s. By the early 1980s, non-bank credit began a meteoric rise to over 220%. Bank credit ultimately slipped to under 40% in the mid-1990s but gradually returned to 50% over the same time period. About midstream during our recent recession, bank credit slippage was actually quite minimal.

Overleveraging occurred outside the U.S. banking system, and it was non-bank credit that plummeted after the financial crisis spread. In the exhibit we further separate private credit from that extended by

## Bank Credit vs Non-bank Credit as % GDP




*Source: Federal Reserve System* *©FactSet Research Systems* government. Private non-bank credit, a.k.a. "shadow banking," plummeted even more dramatically. (See definitions below for categorization details.)

A remarkable fact: Over the course of roughly the last eighteen months, shadow banking credit shrank as much as the entire banking system has in total outstandings!

The TARP-ing of banks had minimal effect on banks, in retrospect. Some still argue they were bailed out by necessity, but the ability of the largest to raise capital on a massive scale to offset credit losses and build unprecedented future loss reserves, strongly suggests a liquidity panic may have been in the making, but insolvency was never remotely a risk for the vast bulk of TARP recipients.

The above exhibit should succinctly identify the broken arm in the U.S. financial system. It was clearly not the banks; it was the secondary markets component shadow banking that provides the bulk of the funding for credit to consumers and homeowners and a large part of the commercial real estate sector.

The plunging credit line depicted was driven almost entirely by precipitous drops in mortgage pools and ABS issuers, which by March of this year had fallen by $3.5 trillion and $1.7 trillion respectively since yearend 2007, just before the onset of the Great Recession. The massive decline of these two private sector sources of non-bank credit, by 77% and 38% respectively, has been initially replaced by the combined expansion of the GSEs and the Federal Reserve's own balance sheet, which rose 131% and 191% respectively over the same period. Finance companies and other private, non-bank components of shadow banking also fell, but with considerably less magnitude.

Hence, despite the prospects for a weak or even declining economy, the vast shrinkage in shadow banking strongly suggests the possibility for re-intermediating the banks as the next, logical and necessary step to shore up future credit capability, particularly to lessen the need for government funding of the mortgage market, but also to rebuild other asset-based financing and consumer credit.

The residential mortgage market is by far the largest occupant in shadow banking. While the direct role of government in funding these loans only recently rose to include the Federal Reserve's balance sheet, it is doubtful that the public sector will remain the only support for home buying in the future. Conversely, we have no illusions that the bulk of first mortgages would ever move back onto bank balance sheets.

We will leave the reader to consider which areas of credit could best fit back in commercial banking, supported by deposits. However, we note that some anecdotal evidence of such "next-resort" lending, while nascent, is nonetheless appearing. During the second quarter, for example, a few bank managements indicated renewed interest in credit cards and re-entry in auto finance.

The investment strategy message for financials is therefore that an earlier, and perhaps larger than expected growth in traditional earning assets is in the making. This would not emanate only from consolidation and market share gains within the banking system as failures (albeit mostly small ones) continue. This would not be only the gradual return of cyclical credit demand. This would also be a broad scale, potential re-intermediation of secular dimension.

While rising interest rates are normally associated with weaker valuations for equities in general, there is no evidence that higher rates have hampered the performance of bank equities relative to the market. In fact, when rates are rising from extreme lows, the reverse is true.

This could start looking like1970s banking soon, and be a launching point for the well-capitalized.

**Definitions used from Flow of Funds series Zl of the Federal Reserve**:

**Bank Credit** (Domestic depositories)

Savings institutions
U.S.-chartered commercial banks

**Non-bank Credit - Private**

ABS issuers
Brokers and dealers
Credit unions
Federal, state and local retirement funds
Finance companies
Funding corporations
Life insurance companies
Money market mutual funds
Mortgage pools
Mutual funds, closed end funds and ETFs
Private pension funds
Property-casualty insurance companies
REITs

**Non-bank Credit - Government**

Government-sponsored enterprises
Monetary authority

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