

End of Quantitative Easing – Now What?

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2011 Outlook

GDP GROWTH:
3.0%

UNEMPLOYMENT:
9.0%

INFLATION:
1.75%

FED FUNDS RATE:
0.35%

Every once in a while we run across information which explains what is happening around us in a way either we never thought of or so crystallizes our thought process that we wish to memorialize the discovery. With this in mind, lead portfolio manager of the Scout Small Cap Fund, Tom Laming and I provide data analysis to explain recent economic changes.

We have suspected the Federal Reserve's asset purchases have had something to do with the rally in the nation's stock markets since the bottom of the markets in March 2009. Commodity prices have likewise risen during the same period. We have not been able to evaluate this analysis until lately. Our gestalt belief that some of the upward movement during the last two years has been driven at least partially by Fed activity is now measurable.

This analysis was started by Bloomberg Analytics. We have taken it a little further. The Federal Reserve has launched two significant economic efforts (QE1 and QE2) of purchasing outstanding treasury obligations. The thought behind this activity is that fresh capital would be redeployed back into the financial system, raising asset values and creating what we economists call excess wealth effects. In these effects, investors who own stocks and other asset classes will eventually spend money (through consumption) due to rising asset values and feeling wealthier. We have seen studies during periods of time that these effects do take place. As consumption rises, Gross Domestic Product (GDP) growth rates accelerate and final demand escalates. This is one of the desired effects of the Fed's QE1 and QE2 exercises.

Has it Worked?

Now, it may be coincidence, but the data we have assembled indicates that much of the reason asset values have raised during the last two years can be partially attributed to the Fed's asset purchase activity. We have segmented our analysis down into three time periods.

The first time period under observation is from March-to-October 2009. During this period, the Fed repurchased \$300 billion in outstanding treasury notes, which represented what is now being called QE1. Also during this period of time, the S&P 500 Index rose by 34.0 percent in value. Commodity prices (as measured by the Commodity Research Bureau (CRB) Index) rose by 19.6 percent in value. The world celebrated this significant move in the markets, but when was the economy going to recover?



The Fed then decided to take a wait and see attitude toward additional asset purchases. From October 2009-to-August 2010, the Fed was not making any asset purchases. The stock market rose by 2.7 percent in price during nearly a full year and commodity prices fell by 1.2 percent. In other words, while the Fed's asset purchase program was on hold, so were returns in the stock and commodity markets. The economy continued its recovery phase as GDP growth started becoming positive, but unemployment trends remained punk.

In August, at the Jackson Hole Economic Meeting hosted by the officials of the Kansas City Federal Reserve, Ben Bernanke announced the process we now know as QE2 - the Fed's purchasing of \$600 billion in outstanding treasury notes to infuse fresh capital into the financial system. The stock and commodity markets renewed their upward shift in prices. Since this program was launched, the stock market has risen by an additional 24.4 percent in value, and the CRB Index has risen by 37.0 percent in price.



The Name of the Game

Since the end of March 2009, the stock market has risen by 61.0 percent in value and commodity prices have risen by 55.0 percent. A whopping 95 percent of the return in stocks during this period of time occurred while the Fed was busy with asset purchases, while 102 percent of the upward move in commodity prices had taken place while the Fed was busy with the QEs. To say this program worked appears to be an understatement, if the purpose was to escalate asset values. Some may say that this is simply a coincidence. We doubt this to be the case, as we attest that Ben Bernanke believes this type of move in asset values was not just expected, but desired by the Fed.

Where We May Be Heading

This all could be a coincidence. Perhaps stock values and commodity prices would have risen as much without the Fed's engineering activities. However, the correlation coefficient of the stock market's and commodity market's movements as compared to the Fed's repurchase activities is stunning. A full 90.0 percent of stock price and commodity price movements can be attributed during the Fed's asset repurchase activity.

In addition to the outright correlation of stocks and commodities to the Fed purchase programs, what about the high level of correlation between commodities and stocks? Is this high level of correlation normal? Data dating back to 1982 indicates the current level of correlation between the S&P 500 and the CRB Index is at historical high levels. Currently, the one-year level of correlation between commodity prices and stock prices is 0.50. During the last 29 years, the average level of correlation has been 0.09. In other words, the correlation between commodity prices and stock prices is more than 5x higher than normal. In fact, the last two times correlation coefficients between commodity prices and stock prices have been nearly this high was in 1982 and 1994. It is interesting to note that stock prices during the next five years after 1982 and 1994 were extremely robust. Another coincidence, but still of note.

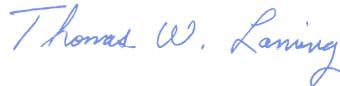
Sustainability of Economic Growth – Is the Fed Going to Get its Wish?

The question that needs to be asked: Does the economy have the ability to sustain gains in final demand without Federal Reserve activity? If the Fed steps away from additional asset purchase activities, will the economy continue to grow? Some of the data that we are monitoring, such as sentiment indicators and employment data would suggest the economy is growing, but that growth is not accelerating at a meaningful rate.

The Fed is nearing completion of its stated purchase program under QE2. What happens to the sustainability of the bull market if the Fed backs away from additional asset purchases? We believe that while the bull market may continue, the stock market may be at some degree of risk of waffling as QE2 is completed. We are not yet seeing ample evidence of growth in aggregate consumer demand which would lift the U.S. economy on a trajectory to significantly lower the unemployment rate on a sustained basis. QE3, anyone?



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