

QE to Infinity and Beyond - Are We There Yet Buzz?

Economists, strategists and market pundits heatedly debate the use of quantitative easing (QE) and the way it affects asset prices. With the enormous amount of QE this year (\$3 trillion and counting), we are dedicating our second quarter letter to explaining QE and its potential effects on both the economy and portfolios.

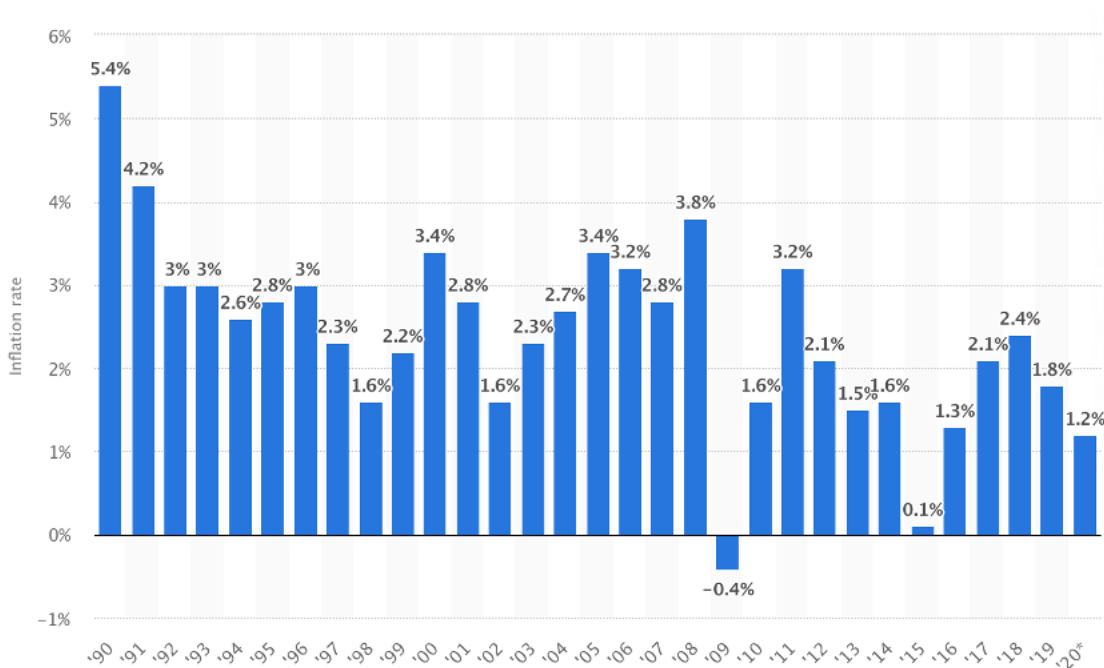
Quantitative Easing (QE) Explained

When the typical monetary 'tool' of lowering short-term interest-rates **failed** to stimulate the economy after the 2008 financial crisis, then Fed Chair Ben Bernanke, instituted **quantitative easing** to help repair the U.S. economy. Instead of merely lowering short term interest rates, the Fed started **actively purchasing longer term U.S. Treasury and mortgage backed securities** from its member banks and, in return, *issuing credit to those banks' reserves*.

Adding credit to banks' reserves typically expands the money supply, makes it easier for banks to lend, and promotes economic growth. **However, economists worry about the potential side effects of QE, particularly inflation and depreciation of the dollar.** Most economists predicted rising inflation after the \$3.6 trillion of quantitative easing from 2008 to 2014 (QE1, 2 and 3), but, as shown in the chart below, **consumer price inflation never materialized. Neither did a falling dollar.**

Unexpectedly, Inflation Rates Fell After QE in 2008

United States:
Inflation rate from
1990 - 2020

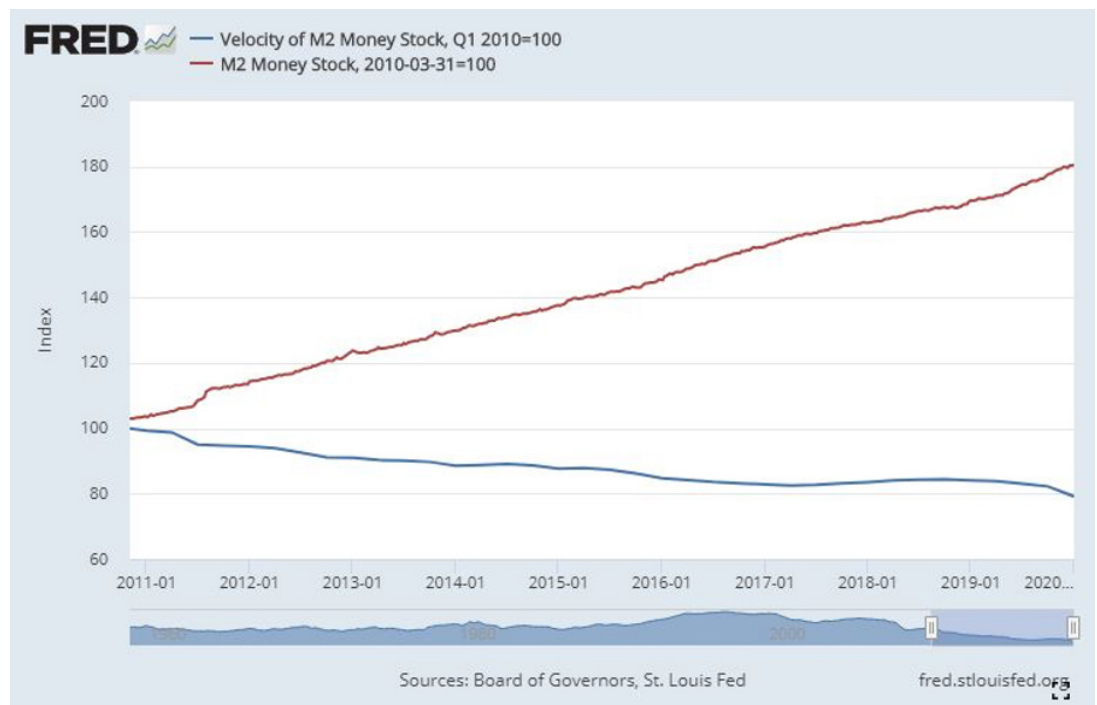


Why Didn't Inflation Materialize After Past Cycles of QE?

Other factors counterbalanced the Fed's QE.

- The technology boom improved business efficiency and replaced labor with machines.
- Outsourcing U.S. production and labor to China, India, etc. reduced costs.
- Much diminished labor union power and immigration kept U.S. wages low.
- Lackluster lending growth from banks muted the effect of money supply growth. Instead, banks paid dividends and bought back stock.
- The velocity of money slowed. Velocity is the number of times the same money is used to purchase goods in a given time period. Both velocity and money supply affect inflation and they can offset one another at times. Please read Willy Brown's clever explanation of how the velocity of money works¹.

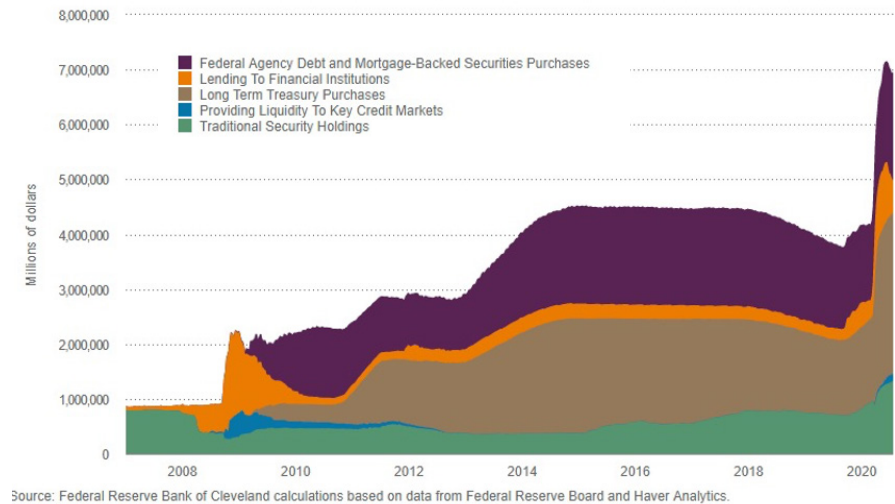
After 2010,
Falling Velocity of
Money *Offset* Money
Supply Growth



2020 and Quantitative Easing Revisited (QE4)

- This year, in a swift response to the Covid-19 shutdown, the Federal Reserve lowered short-term interest rates to zero and instituted QE4.
- So far, the Fed has purchased \$3 trillion of fixed income securities, including corporate bonds, bringing their balance sheet to a grand total of **\$7,127,786,000,000** (or \$7.13 trillion).
- Further, the Fed expanded their future purchasing ability to an *unlimited* amount as Powell currently believes *deflation* is a more dangerous risk than *inflation*. He additionally suggests allowing inflation to run above the 2% target until the economy and employment recover.

Dramatic Increase of Federal Reserve Balance Sheet in 2020



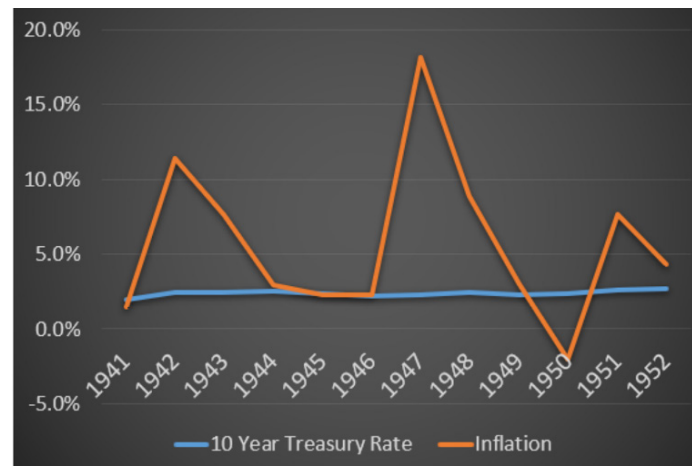
Are We There Yet Buzz?

A Little History...

Some economists believe the sheer size of our corporate and government debt inhibits runaway growth and, combined with high unemployment, will prevent interest rates or inflation from rising substantially. However, there is historical precedent for high government debt, low interest rates and *high* inflation in the 1940's. During this period, the Federal Reserve acted to control interest rates, a concept known as yield curve control (YCC), and inflation skyrocketed. The chart below shows a consistent 2.5% 10-year bond yield (controlled by the Fed), while inflation fluctuated.

Low Interest Rates and High Inflation in the 1940s

10-Year Treasury Rate
(YCC) vs Inflation



Changes are Afoot in the Economy Today

- Political talk of bringing more production back to the U.S..
- Increase in business inventories as 'just-in-time' strategies may not be dependable.
- The dollar which remained strong after past QEs has started to weaken - partly due to the sheer size of Treasury issuance to fund our growing debt and Europe's faster economic recovery from the pandemic.
- Fed curtailment of stock buybacks and dividend payments may encourage banks to lend once the economy recovers, increasing the velocity of money.
- **Unprecedented fiscal spending puts dollars directly in consumer hands** (\$3 trillion and counting).
- In contrast to the prior QEs, money supply (M2) is now growing much more quickly.

Money Supply Growth (Red) is Faster than Ever

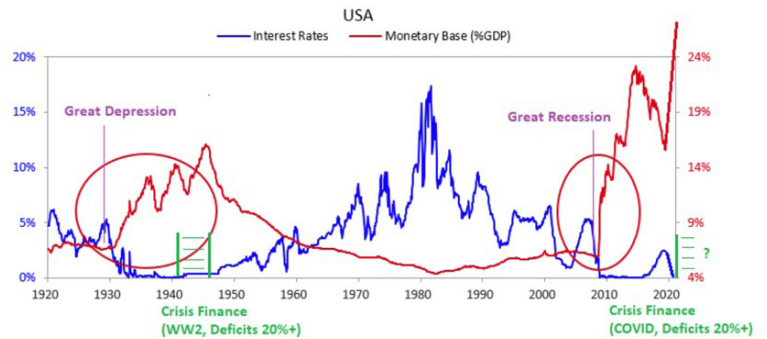


Chart Source: Bridgewater Associates, Updated/Annotated by Lyn Alden

Higher Likelihood of Future Inflation

While it will take time for the economy to recover, especially given the rolling flareups in Covid-19, we may see higher inflation this time around. Low interest rates, controlled by the Fed, combined with higher inflation would act to reduce U.S. real debt levels, the only debt reduction outcome we believe is politically viable.

Our Cocktail for Low Yield, Inflationary Environments

In this environment, we believe a prudent approach to consider would be:

- Higher equity allocations
- Smaller, lower duration fixed income allocations, with a dose of TIPs
- A good helping of gold, and
- A dash of real assets and Emerging Market companies.

If you need a bit of humor after all of this... <https://www.youtube.com/watch?v=PTUY16CkS-k>

Please call us with any questions. We love nothing more than talking about this stuff!

Stay safe. Wear a mask.

Footnotes:

1) A tourist drives into town, stops at a motel and lays a \$100 note on the desk, saying he wants to inspect the rooms upstairs before picking one or the night.

As soon as the tourist walks upstairs, the motel owner grabs the bill and runs next door to pay his debt to the butcher.

The butcher takes the \$100 and runs down the street to retire his debt to the pig farmer.

The pig farmer takes the \$100 and heads off to pay his bill to his feed supplier at the co-op.

The guy at the co-op takes the \$100 and runs to pay his debt to the local hooker, who is dealing with the same economy as everyone else and has been offering her services on credit.

The hooker rushes to the motel and pays off her room bill.

The motel owner then places the \$100 back on the counter and waits for the tourist to come back from checking out the rooms.

Just then, the tourist comes down the stairs, says the rooms are not satisfactory, picks up the \$100 note and leaves.

No one produced anything. No one earned anything.

However, the whole town is now out of debt and can look to the future with a lot more optimism.

- Willie Brown in SF Chronicle April 25, 2020

Contact Us:

Lisa James

lisa@2xwealth.ingalls.net

212-269-7758

Lori Zager

lori@2xwealth.ingalls.net

212-269-7757

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2x Wealth Group is a team at Ingalls & Snyder, LLC., 1325 Avenue of the Americas, New York, NY 10019-6066. (212) 269-7757