May 2011

## Exit Strategy

"Give me control of a nation's money and I care not who makes the laws."

- Amschel Rothschild

Regular readers know that I dislike central planning and think the United States' Third Central bank should be dissolved. After all, having a central bank was one of the pillars of the *Communist Manifesto!* Only the marketplace is capable of setting interest rates and determine what free people use for a currency. History is full of proof that no small group of people or person is smart enough to control the money supply and the price of money—its interest rate. Why don't we learn from history and stand up this injustice? How many centrally planned economies do we need to see fail before we get rid of our Fed?

The Federal Reserve was given a dual mandate of keeping unemployment low and prices stable. Many economists were shocked to see that they were powerless to do both in the stagflation of the 70s. They simply thought you couldn't see high unemployment and high inflation. Since then, we have had the two serial bubble blowers of the Fed, Greenspan and Bernanke. The Federal Reserve could have let us have a good economic correction in 1998 when Long Term Capital Management (a large levered hedge fund) imploded. Instead, they orchestrated a bailout and printed more money sending the NASDAQ to the moon. The Tech Wreck was much worse than it would have been if the Fed didn't enable the excessive speculation to go on for two more years.

When in recessions, central banks try to spur the economy by dropping interest rates. Once the recession is over, they are supposed to raise them back to keep prices stable. According to the NBER, that recession ended in November of 2001. Instead of recognizing that we were out of recession, the Fed continued to *drop* interest rates all the way down to 1% for almost *three* years. This cheap money inflated house prices by allowing people to borrow at extremely low mortgage rates and helped create the worst recession since the Great Depression.

In mid 2004, the Fed began slowly raising the Federal Funds Rate from one to 5.25% by July of 2006. This started the ultimate watershed decline in houses, then stocks and commodities. They then lowered interest rates all the way down to 0% in January 2009 where we have been ever since.

By January of 2009, TARP had been doled out and the Fed had made very low interest rate loans to everyone from Harley Davidson to Gaddafi's Arab Banking Corp.[1] Why is the Fed allowed to undermine American Foreign policy without the consent of Congress? The U.S. work force and stock market continued to plummet despite the bailouts and ZIRP (zero interest rate policy). Bernanke and Co. couldn't lower interest rates below zero, so they decided to *turn Japanese* and

[1] http://rt.com/usa/news/federal-reserve-gaddafi-owned-bank/

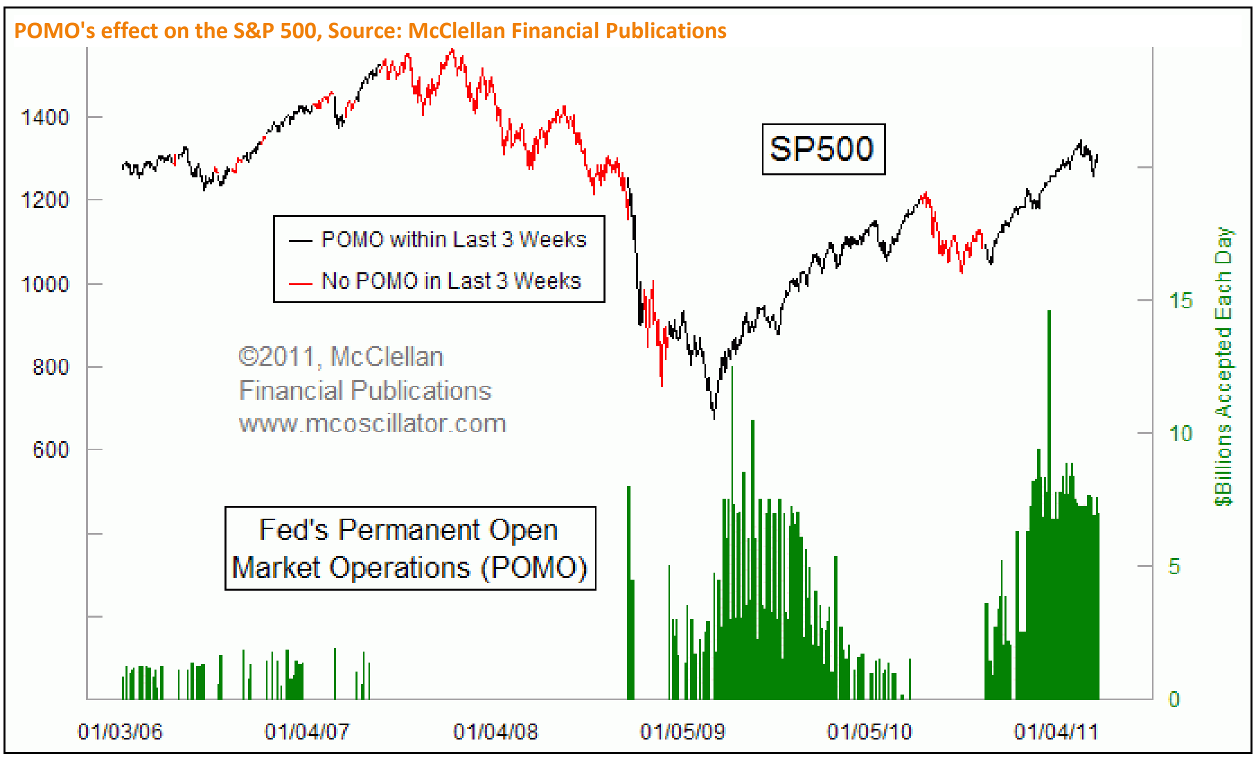
engage in the policy of quantitative easing. The Tokyo Nikkei Average peaked at 39,000 in 1989 and was around 7,500 by early 2009! Quantitative easing was a complete failure in Japan, but I am confident that somehow our genius central bankers who never saw the housing bubble coming in the first place will be able to pull it off here.

In a recent interview famed hedge fund manager, Felix Zulauf, said "We are witnessing the biggest financial market manipulation of all times and its led by a central bank. This is terrible."[2]

**What is Quantitative Easing?**

Quantitative easing or QE is really just a fancy word for money printing. When interest rates are already zero and the central bank wants to continue to lower interest rates, they print money out of thin air and use it to buy government bonds from the primary dealers (big banks). The central bank's intervention artificially lowers interest rates to try and spur the economy.

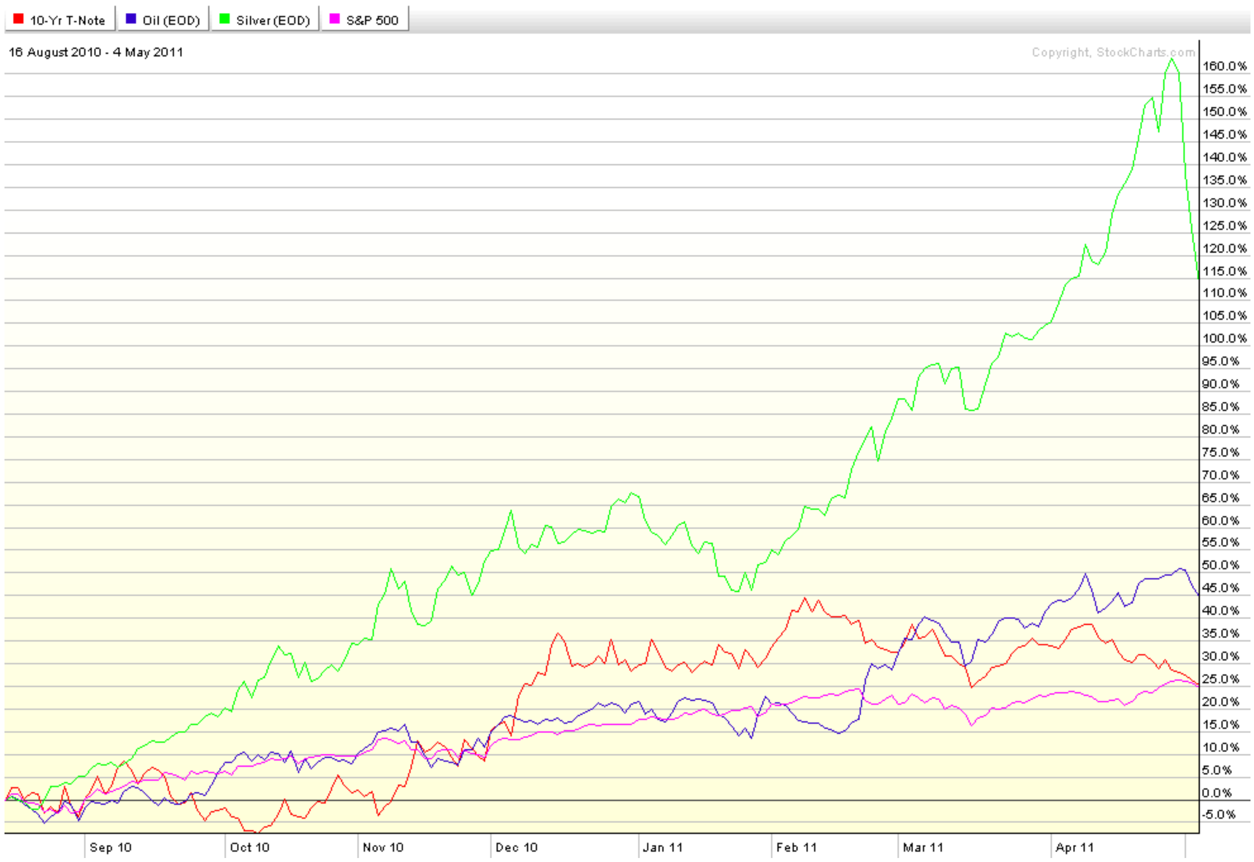
The Federal Reserve started QE1 in late 2008 and decided to massively expand the program on March 18, 2009 to $1.55 trillion. The money printing and FASB's changing of the mark to market rule sent the stock market on an historic run. Below is a chart showing the S&P 500 and the days the Fed prints money using its POMOs. As you can see billions are printed each week to buy government bonds from the banks.




As you can see, there is a very high correlation between money printing and stock market performance. There is also a very high correlation between money printing and commodity prices rising. QE1 ended on April 30, 2010 as can be seen by the chart above. It didn't take long for a "flash crash" and the S&P 500 to correct 17%.

[2] http://financialsense.com/financial-sense-newshour/big-picture/2011/04/30/02/felix-zulauf/spanning-the-globe-with-felix-zulauf

After talking about raising rates and unwinding the QE program, Bernanke did a 180 degree turn and hinted on August 27, that he would engage in more money printing. After many hints in September by various Fed officials, QE2 was officially announced on November 3, 2010. $600 billion more was to be printed out of thin air to try and lower interest rates further to help stimulate the only asset class that Bernanke couldn't make go up—home prices. The chart below shows how much oil, silver, and the S&P 500 have soared by the money printer. The pink line is the yield on the 10 year treasury. The stated purpose of Money Printing 2.0 was to lower interest rates to spur the economy. As you can see, the yield on the ten year treasury has risen almost 25%. If that was the goal, QE2 has been a complete failure.




**Various Asset Classes since 8/2010, Source: StockCharts.com**

On Wednesday, April 27, the Fed said that they plan to stop printing money by the end of June. Many investors are concerned that when the money printing stops, we will see another stock market sell off like we saw last May and June. Other investors point to the sheer enormity of the assets that the Fed holds on its balance sheet and think that the Fed will use the interest and payments it gets from mortgage bonds to keep buying new bonds.

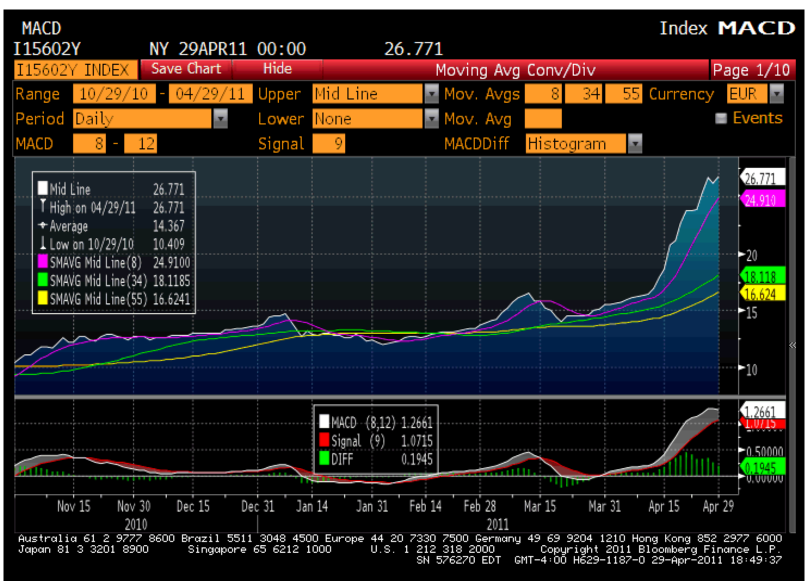
The largest bond mutual fund in the world that typically has around 40% of its assets in U.S. Government Bonds has recently announced that not only does it own **zero** government bonds; they are currently betting that U.S. Government bonds drop. Bill Gross, the fund manager, has raised the question of who will buy the government bonds when the Fed stops purchasing.

It is very difficult for me to see how our government is going to be able to continue running $1 trillion deficits without an extension of quantitative easing. The Fed plans to stop the money printing at the end of June and will probably continue to reinvest the interest and principal payments it receives from its bonds. Will that cause a repeat of the events of April 2010?

**Markets**

I have been amazed at how strong most stock markets and the Euro have been this year. Beneath the surface there are lots of things to worry about like the increasing tension in MENA (Middle East North Africa), surging commodity prices, the U.S. debt, and a plunging dollar. All of these are receiving a fair amount of coverage from the media. It appears that financial reporters have forgotten what started the spring market crash of 2010—Europe.

Below is a chart that shows the yield on two year Greek government notes. Many market participants have known that Greece was a basket case for years, but the markets just didn't seem to care until early 2010. As you can see the yield on two year notes stayed under 5% until 2010. Greek's insurmountable debt problem didn't seem to matter until it did and interest rates quickly shot up to close to 20% in the spring of 2010.




Greek 2 year notes hit 26.77%, Source: Bloomberg, www.acting-man.com

The European Commission, European Central Bank, and IMF put together a bailout to help Greece borrow money at below market interest rates and investors stopped panicking for a short while. Since then, the yield on Greek debt has been increasing steadily to a new high of over26%. They are getting payday lender rates! The market is clearly predicting that Greece will be forced to default on its debt.

In my estimation, they will not be able to grow their economy quick enough, raise taxes high enough, or cut their spending fast enough to be able to pay down their debt. I expect a default or restructuring to occur by this summer. Restructuring debt is a lot like personal bankruptcy. It is simply telling your creditors that it is impossible to pay the amount of debt that you owe them and paying back only a portion of what you owe. After the bankruptcy, it is unlikely that anyone will be able to lend you money, so you will then be forced to live within your means instead of overspending on credit cards. This will be hard for the many Greeks who have become dependent on government handouts.

The Greek Government is already a giant burden on the productive class and a reduction in its wasteful spending will be a great boom to the long term health of the nation. As we discussed in *Europe—More Back Door Bank Bailouts*, it is immoral to tax the citizens of any country to death in order to bail out bankers who knowingly took on risks by buying sovereign debt. The world can no longer tolerate the practice of private gains and socialized losses.

Standard and Poors estimates that there is a 1 in 3 chance of default for Greece and they envision a 50-70% haircut or loss for holders of Greek government bonds.[3] The Athens Composite has broken below its 2009 lows and looks to be discounting considerable pain for the country.


**The Greek Stock Market, Source: StockCharts.com**

There is no way to know exactly where all that Greek debt is held. Clearly Greek banks, pensions, and European banks are holding most of it. Will these institutions be strong enough to take massive losses in the event of default? Will the True Finns party in Finland be able to vote down the recent Portuguese bailout? How much longer will Germans tolerate the undisciplined spending of the periphery? Will the European Central Bank decide to engage in quantitative easing like the Fed and destroy the Euro to bail out debtors? The only given is that current debt levels are impossible to pay. How it plays out is anybody's guess. This should make for some interesting history over the coming months and years.

[3] http://www.creditwritedowns.com/2011/04/greek-haircut-for-debt-restructuring.html

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