

January, 2011

## Raking Snow

Last month, we had a big snowstorm in Paris. In Chicago, this amount of snowfall would be about as noteworthy as a governor being referred to as “embattled.”

In Paris, however, it's unusual to have enough snow to worry about removing the stuff. It was the most snow I had ever seen in Paris. Apparently, not many Parisians had seen snow like this either. It was being referred to as *La Tempête de Neige du Siècle* (The Snowstorm of the Century). Perhaps this was a little dramatic, given the infancy of the current *siècle*.

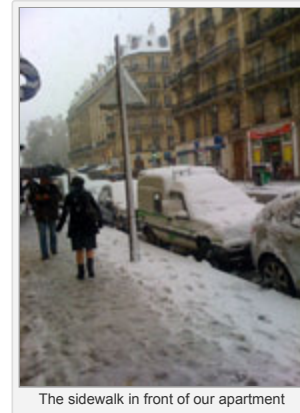
Nonetheless, for Parisians, Lots-O-Neige created a dilemma. They didn't have the tools to deal with it. Things just had to be shut down until nature could take its course. As a result, perhaps I shouldn't have been surprised to see a woman trying to clear the sidewalk with a garden rake. Some people just can't get the hang of procrastination. It was working about as well as you might imagine. But, and this is important, she wasn't making matters worse. She wasn't trying to solve the problem of having too much snow on her sidewalk by adding snow to her sidewalk.

That would be either dumb...

...or (from our Department of Redundancy Department) “a government solution.”

As I explained last month in [Weimar? Why More? Why Not?](#), our Fed chairman has embarked on a massive money printing scheme referred to, euphemistically, as “Quantitative Easing” or, less euphemistically, as “Debt-Monetization.” I just call it “Queasing.”

Like the Parisians, we're in the midst of an economic storm the severity of which hasn't been experienced in nearly a century. Normally, when the economic weather gets bad, the Fed lowers the Fed funds interest rate to try to encourage borrowing, spending, capital investment and hiring. This is the shovel they've always used.



The problem for the Fed is that they lowered the interest rate to 0% over two years ago and the snow keeps falling. Since the rate can't go BELOW zero, the Fed is **Coincés!** (stuck, jammed, cornered, trapped, boxed-in, and stymied). Ben Bernanke is a Parisian without a shovel! He could do what most Parisians did and wait it out, letting nature take its course.

Instead, he's going after it with the rake! That rake is the above-mentioned Queasing.

Last month, we discussed what queasing is and how the Fed thinks it might work. This month we'll look how I think it might not.

In fact, I'm concerned that queasing may aggravate our economic crisis instead of alleviating it.

## RAKING SNOW A PLÜMB PERSPECTIVE EDITORIAL

It may be helpful for readers to review last month's editorial. Alternatively, you may want to watch this month's Video Review ([Quantitative Easing Explained](#)). It covers many of the salient points (and it's hilarious).

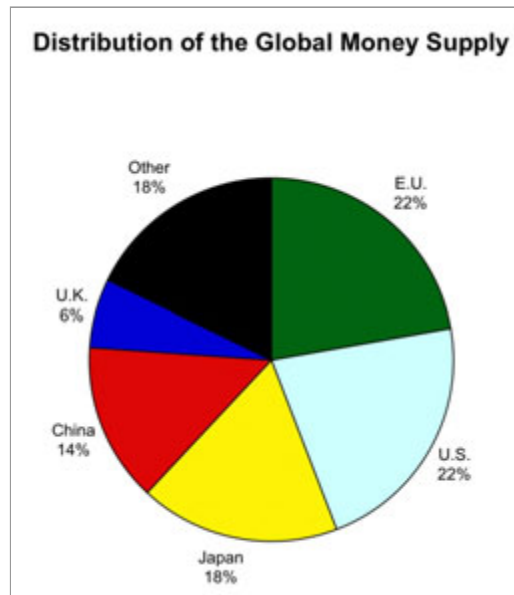
Historically, the number of times debt-monetization has worked is equal to the number of times I have uttered the phrase, “How is your kale prepared?” It hasn't happened. Pondering whether it will work this time seems like a waste of analytical energy. It seems more productive for our portfolios to assess the most likely ways it will go wrong. Specifically, the global economy may not follow the desired script in terms of the dollar, interest rates, inflation, or debt burden reduction. In this editorial I'll address the first two:

1. Why queasing may not reduce the dollar's exchange rate.
2. Why queasing may not reduce interest rates.

## The Problem Of Other People's Problems

First of all, other countries have their own problems and are just as susceptible to queasing's siren song. Which countries might be seduced by queasing's whispered promise of a quick fix that kicks their real problems a little further down the road?

This pie chart shows the breakdown of the world's currencies:



The top five currencies (the dollar, the euro, the yen, the renminbi and the pound) comprise 82% of the world's money supply. Let's look at them individually:

**Japan:** Japan's median age is about seven years older than America's. As such they have been a step ahead of the U.S. all along this path. Japan's stock market peaked in 1989; their real estate market peaked two years later. They've been going into debt trying to stimulate their economy ever since. The result has been that the Japanese stock market has dropped an average of 6% per year for the last 21 years. GDP growth over the same period has been only about 1% per year.

In Japan, however, they've been able to rely upon **domestic** savings to finance the deficits caused by their failed attempts to stimulate their economy. Despite low interest rates, Japanese savers have been willing to buy Japanese bonds. This has enabled the Japanese government to run their **debt-to-GDP ratio** up to a phenomenal 196% (second only to Zimbabwe). But these **Japanese savers** are aging. Now they need to tap their retirement savings and the government is going to need to find another source of funds for its deficit spending. Enter queasing!

*The Bank of Japan announced on Tuesday (10/4/10) that it "decided to implement a comprehensive monetary easing policy" which included both a reduction in the interest rate from 0.1% to "around 0 and 0.1%" and, more radically, examining the establishment of a ¥5000 billion or \$60 billion asset purchase program. The Bank of Japan is being highly unorthodox, as it has allowed for the possibility of purchasing commercial paper, exchange-traded funds and even real estate investment trusts, something no central bank in a major economy has been doing.*

**Eurozone:** The euro faces a different set of problems. Like the Japanese, the Europeans are getting a little long in the lederhosen and facing an ominous demographic problem replete with entitlements they can't afford to honor. More immediately, the problems that the European Central Bank ("ECB") faced with Greece last year have not gone away. In fact, they are worse and spreading. Having a common currency means that a one-size-fits-all monetary policy is, by definition, applied all the countries using that currency, regardless of the differences in economies, cultures, policies and problems. For the Germans, the hyperinflation of the Weimar Republic is still fresh in the nation's collective conscience. It's not very politically acceptable for them to have to print euros to bail out Greece. And, from the Grecian perspective, the austerity being forced on them to stay in the euro currency is equally unpopular. Imagine if voters in fiscally responsible states like Texas and Tennessee had to bailout their profligate neighbors in Illinois and California. On second thought, don't imagine it. Just send your money to us here in Chicago.

It looks like Ireland, Spain and Portugal are going to be the next countries to put the European Central Bank to the test. In a poll as notable for its phrasing as for its results, last week's WSJ question of the day was "**Which country is most likely to reignite Europe's sovereign debt crisis?**" For readers scoring at home, Ireland was an overwhelming favorite followed by Spain, then Portugal. The French, disappointed by their exclusion from the top three, plan to take to the streets for yet another demonstration. The protest is scheduled to take place during the very next non-holiday-shortened workweek, which I believe occurs in late-February. The last option in the poll, "**Debt crisis won't reignite crisis**" garnered the same number of votes as the option "**Green Party candidate will succeed Kim Jong-il as the Supreme Leader of North Korea.**"

The ECB has vowed not to follow the path of queasing, but they said the same thing about the Greek situation and wound up coming up with €500 billion at the 11<sup>th</sup> hour. With the next debt crisis at the doorstep, I question how many bailouts the Germans can stomach before a major restructuring of the euro arrangement becomes a necessity. I don't envision the euro going away, but I can see the number of member countries shrinking

significantly, or the euro dividing into two currencies. As the euro goes through this transition phase, I expect its value to vary significantly against the dollar, independent of the Fed's queasing.

The Fed's queasing just makes things more complicated for the ECB. Harkening back to the delicate language of diplomacy perfected by the Germans during WWII, a couple of weeks ago German Finance Minister Wolfgang Schaeuble offered [these thoughts](#) on the Fed's plan:

*With all due respect, U.S. policy is clueless. (The problem) is not a shortage of liquidity. It's not that the Americans haven't pumped enough liquidity into the market.*

To improve America's monetary credibility, Schaeuble intimated the Fed needed to start thinking outside-the-box about measures that might be more effective than quantitative easing...like a bake sale, a car wash, or a pancake breakfast.

For her part, German Chancellor Angela Merkel just chose to keep her mouth shut as President Obama explained the Fed's queasing plan to her:

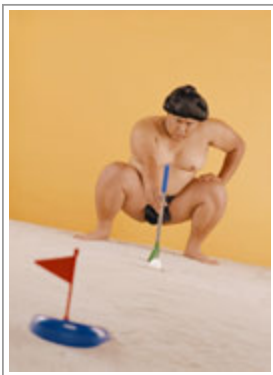


**China:** The Chinese have tied their currency, the renminbi, directly to the dollar. As such, the Fed's monetary policy effectively becomes China's monetary policy. China's dollar peg reflects their reliance on exports to the U.S. to support the industrialization of their country. The Chinese are slowly and deliberately allowing the renminbi to appreciate. They will only do so when, and if, it is in their best interest. As the U.S. floods the world with dollars, I have no doubt that the Chinese will match this policy by printing more renminbi. Ironically, I am equally certain this renminbi printing will, once again, result in certain politicians wanting to label **China** a currency manipulator. For their part, the Chinese want to know what the heck Bernanke is thinking:

#### [China Says Fed Must Explain Bond-Buying or Endanger Recovery](#)

*The U.S. "owes us some explanation on their decision on quantitative easing," [China's Vice Foreign Minister] Cui [Tiankai] said. We hope the U.S. "will adopt a responsible position on that matter," he said.*

**United Kingdom:** The U.K. has many of the same problems as the U.S. – high unemployment, low economic growth, too much debt, an aging population and entitlement promises that can't be met. To Britain's credit, they are at least making attempts at austerity. They've announced £40 billion in emergency budget cuts, going so far as to make the [long-term unemployed do some charity work in order to continue receiving their checks](#). At the same time, however, the Bank of England also has a £200 billion queasing programme in place.



Witnessing all of the major currencies of the world queasing simultaneously, is not any prettier than it sounds. Some of the phrases you'll hear bandied about are "currency war", "competitive currency devaluation" and "beggar thy neighbor policies." Since they're all printing more of their own currency, the main effect is just to increase exchange rate volatility without anyone gaining a competitive advantage. It exacerbates uncertainty, makes trade more difficult and expensive, and causes global prices to rise for the goods that are in short supply. Trying to guess which currency will perform best is like trying to guess which sumo wrestler will look best in Capri pants.

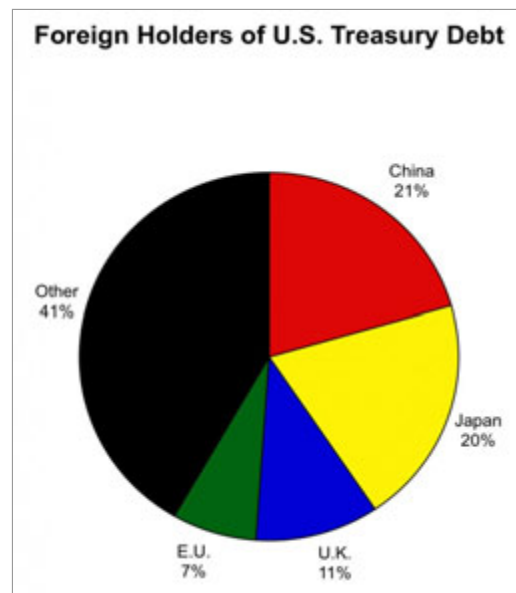
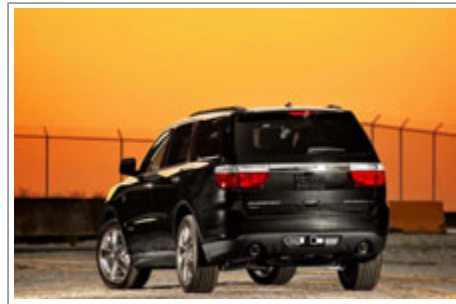
The problem for the Fed is that if all the other major currencies are queasing, too, it defeats part of the goal of queasing in the first place. The dollar may not devalue at all, in which case it doesn't help U.S. export industries, nor does it encourage U.S. consumers to buy domestically produced goods.

## Car I Mooch, Car I Mooch, Can I Use Your Durango?

Imagine my buddy has a nice new Dodge Durango. Pretend I've made a habit out of borrowing his car on the weekends because I don't have enough money to buy my own car. In fact, I've become so accustomed to relying on the fact that he'll always lend me his SUV, I've built my lifestyle around the assumption that I'll always be able to use it. I've convinced myself that his quality of life depends on me giving him the opportunity to loan me his Durango. If I don't borrow it, who will?

Now imagine that as I look out over the coming year, I realize that my social calendar is going to be pretty full. Plus I've made a commitment to really practice my golf game. This means I'll need to borrow his Durango more often. When I tell him this, I also let him know that I've got a new policy with my money. I'll no longer be replacing the gas I use. I think this would also be a good time to let him know the car's been looking pretty dirty the last few times he dropped it off. Just for good measure, I think I'll accuse him of being a car manipulator. How do you think my plan will affect my friend's automotive generosity?

One piece of advice that's always worked well for me is to refrain from poking my banker in the eye. As shown in this chart, the yen, euro, renminbi and pound are not only the four next largest currencies in the world; Japan, the Eurozone, China, and the U.K. also happen to be the four largest foreign holders of U.S. government debt.



In the coming year, the U.S. government plans to spend another \$1 trillion it doesn't have. We will probably need to continue to borrow from these countries if we want to keep living beyond our means. To the extent that the Fed's queasing devalues the dollar:

- It directly harms the export industries in these countries.
- It makes things (like oil), which are currently priced in dollars, more expensive for them.
- It reduces the purchasing power of the Treasury bonds they already own.
- Finally, if they want to keep their currency stable against the dollar, it forces them to engage in queasing as well.

None of this seems especially "clue-ful" for a nation that's been granted the privilege of printing the world's reserve currency. In fact, the cluelessness of it makes my behavior with my friend and his Durango seem positively enlightened. Talk about poking our banker in the eye! Our monetary policy is like an episode of the Three Stooges.

Queasing by the Fed could end up reducing the enthusiasm of the rest of the world to finance U.S. profligacy. If this happens, the extra demand for treasuries created by the Fed's purchases would be more than offset by reduced purchases by the rest of the world. This would cause interest rates to rise rather than fall. Back on the miniature golf course (see the "What's The Economy's Handicap" from [last month's editorial](#)), instead of putting the ball toward the hole, Ben could actually wind up putting it away from the hole. As my long-suffering golf partners can attest, I have on occasion been alarmingly maladroit with the flat stick. Still, to the best of my recollection, I have never putted the ball in the exact opposite direction of the hole.

## The Best Laid Plans Tried Twice By Ben

The media has dubbed this attempt at queasing "QE2" because it's the Fed's second attempt to use queasing to interfere with the natural resolution of our economic irresponsibility. If you want a nice summary of how well QE1 worked, check out this article: [Fed Confirms: QE2 on Tap... Despite Dismal Failure of QE1](#).

Alternatively, you can assess the effectiveness of QE1 by reading just about any recent article about the economy.

I expect QE2 to be an even bigger disaster. In this editorial, we've discussed why other countries may not stand idly by and cooperate with this scheme. Instead of lowering interest rates and the dollar, it could have just the opposite effect. The response of the rest of the world to the Fed's queasing could cause major currency volatility, trade frictions, reduced demand for U.S. debt, higher interest rates and a quantum leap to a new level of financial uncertainty and economic danger.

In the next editorial, we'll discuss queasing's impact on inflation and the likely efficacy of debt-monetization.

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