

NEWS RELEASE

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When QE = TARP+

Geneva – Geneva, IL – If the widely held view the Fed’s last two rounds of quantitative easing (QE), were to revive economic growth, then why didn’t Ben Bernanke announce QE III in his speech to global policy makers in Jackson Hole last Friday? After all, the economy is growing more slowly than last year when QE II was undertaken. It is also growing more slowly than most economists, including those at the Fed, projected at the start of the year. If quantitative easing really is about growth, wouldn’t QE III be just what the doctor ordered?

We at Brady Investment Counsel disagree with the market’s diagnosis. Our view is both QE and QE II were more about improving bank balance sheets than revving up the economy. Remember as recently as 2008, the banking system was operating with negative capital thanks to bad real estate loans. It is possible the government’s bank bailout Troubled Asset Relief Program (TARP) was insufficient. A TARP supplement or TARP+ was also required to bring bank balance sheets to a point where asset composition was conservative enough for banks to make loans and put their capital at risk - capital supplied in large part by U.S. taxpayers. We base our thinking primarily on the fact that banks neither loaned nor invested the estimated \$1.6 trillion they received from selling certain financial assets to the Fed during QE and QE II. Instead, they simply parked the cash with Federal Reserve Banks and earned modest 0.25% in simple interest.

Quantitative easing is a process by which the Fed attempts to stimulate the economy through purchasing a preset quantity of assets from banks and other institutions. Prior to the Financial Meltdown, U.S. Treasuries were the asset of choice. After, the Fed expanded their menu to include mortgage backed securities (MBS), government sponsored enterprise debt (GSE) and bank loans. The basic objective is to stimulate economic growth by adding liquidity to the system. Theoretically, if banks have a greater

percentage of their assets in cash they are likely to make loans and investments. New loans and investments allow consumers to buy homes and cars and entrepreneurs to create businesses, which energize the economy.

The problem with quantitative easing is it has a significant and well understood side effect: it's inflationary. Think back to your Pricing Theory class and demand/supply charts with price on the vertical axis and quantity on the horizontal. Interest rate is the price of a dollar. Demand for dollars is high when rates are low and demand drops as rates go up. On the supply side, when there are a lot of dollars in the economy its price drops. Price or interest rates rise as dollars become dear. Graphically, the demand curve slopes downward and to the right and the supply curve slopes upward and to the right. The intersection of the two curves drawn on the same chart yields the dollar price at a particular level of supply and demand.

In order to buy a certain quantity of assets, the Fed must effectively print the same quantity of dollars. Creating new cash causes the dollar supply curve to shift parallel and to the right. According to the demand/supply chart, this means the dollar is worth less due to its intersection moving to a lower point along the demand curve. Inflation follows as merchants - both home and abroad - adjust to the depreciated dollar requiring more of them as compensation for goods and services. In short, they raise prices.

Banks are required to hold a minimum amount of reserves. Reserves, also known as capital, are the difference between assets (loans and investments), and liabilities (deposits and borrowed money.) The purpose of bank capital is to protect depositors and lenders from a bank's potential bad loans and investments. If capital is negative, meaning asset value is less than the amount of liabilities; creditors will likely not be repaid in full. Thanks to our fractional reserve banking system - which we would explain but nobody did it better than George Bailey during the run on the Building and Loan in *It's a Wonderful Life* - panic would follow as all creditors would rush to be the first to pull their deposits and loans from banks.

Banks are required to keep a certain percentage of their capital deposited in Federal Reserve Bank maintained accounts. The amount is a function of size: the larger the bank, the greater the capital deposit required. From time-to-time the Fed decreases or increases its bank capital requirement in attempt to speed up or slow down the economy. Up until 2008, banks typically deposited close to the required amount with little excess. This is because banks earn money making loans and investments, not by parking cash at the Fed. Today however, banks hold \$1.6 trillion in excess reserves at Federal Reserve Banks, which again isn't too different from our estimate of the total amount of quantitative easing (QE and QE II) directed at banks since May 2009.

It is tempting to think parking money with the Fed is a great idea; after all, we know what bankers are capable of and don't need another collapse due to their bad loans and investments. However, the reserve account situation makes matters complex because the Fed now pays interest on capital deposited in its Reserve Banks and has since 2006. Therefore, the Fed invests bank reserves it maintains in U.S. Treasuries to earn a return

and meet its interest obligation.

It is important to realize since quantitative easing began the cash deposited by banks with the Fed is the same cash the Fed just paid to banks in exchange for their Treasuries, MBSs, GSE debt and loans. If you are following closely, you understand this is also the same cash the Fed printed out of thin air to carry out QE and QE II. Effectively, through its quantitative easing the Fed is funding our Government's deficit spending by investing bank reserve deposits in U.S. Treasuries. This is the same deficit spending that crowds out productive, for-profit private investment in exchange for your favorite congressman's pet project. Talk about a drag on economic growth!

Last Friday, markets cheered that Ben Bernanke is ready to use another round of quantitative easing to bolster economic growth. We cheered because QE stopped. No immediate QE III plan indicates, to us at least, the Fed feels confident about bank asset composition, capital and earnings power. Combine this with Warren Buffet's recent "vote of confidence" \$5.0 billion investment in Bank of America, the least well capitalized of all the money center banks and we conclude our banking system is on firmer ground than stock prices suggest. A well-capitalized banking system creates potential for more loans and investments and a true revival in economic growth. Something QE and QE II have not produced. To jumpstart the economy, the best news to our ears would be the Fed will charge banks to hold their reserves instead of paying interest to keep them there doing nothing.

Please call with questions.

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