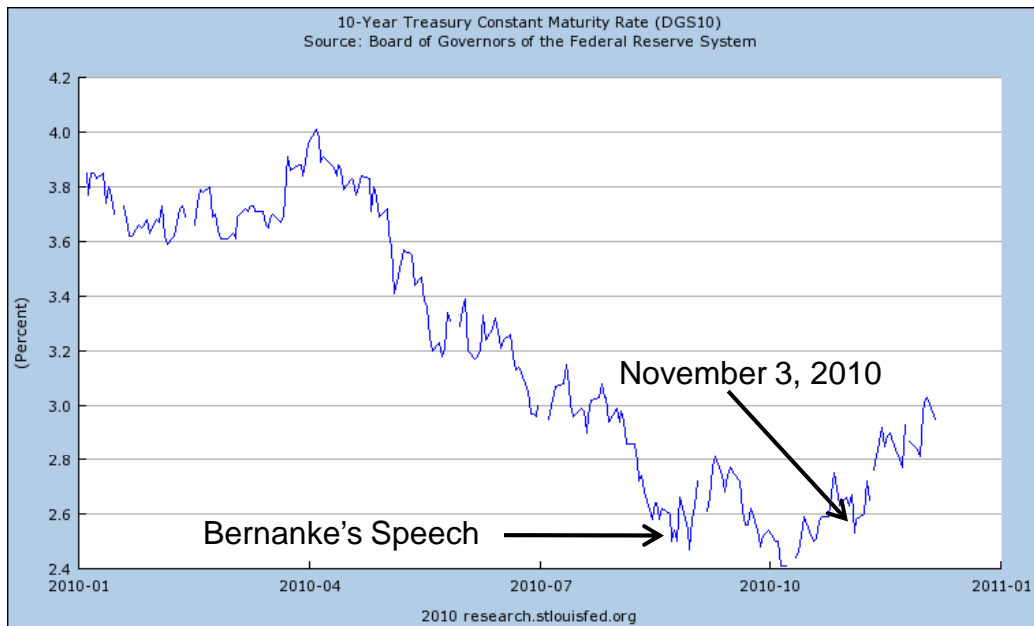


## QE2 Sails Off Course

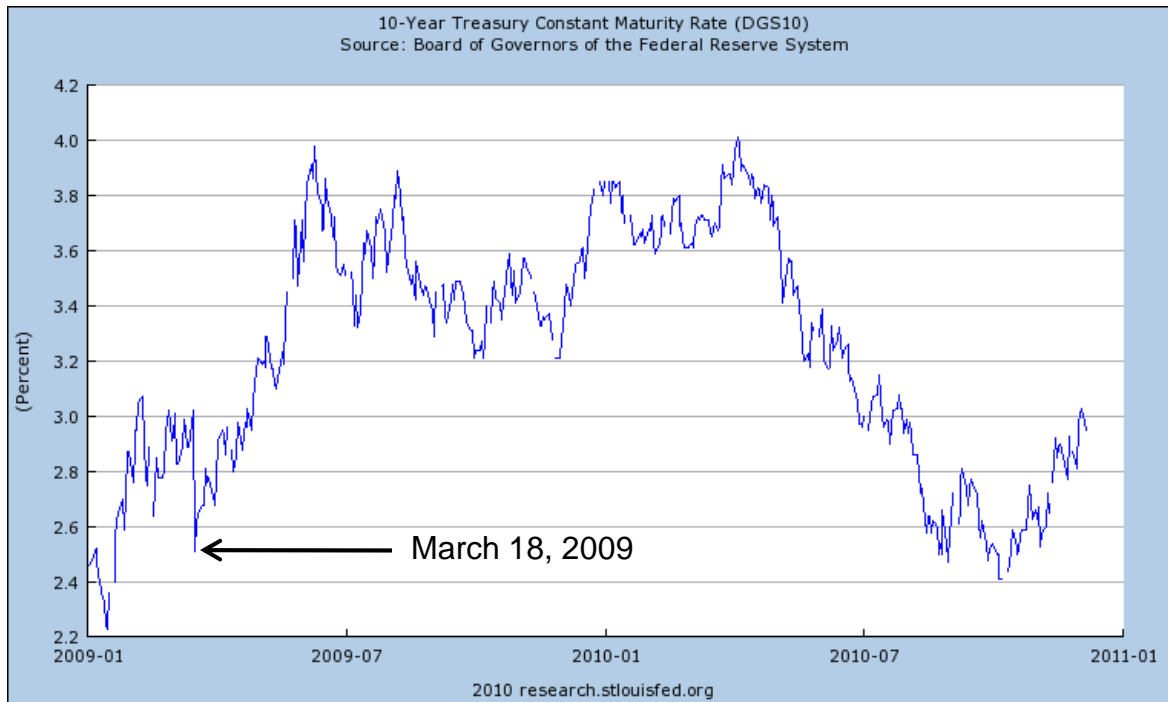
On August 26<sup>th</sup>, Federal Reserve Chairman Ben Bernanke spoke at the Federal Reserve Bank of Kansas City Economic Symposium in Jackson Hole, Wyoming. In his address, Chairman Bernanke outlined his arguments for a second round of quantitative easing citing primarily slow economic growth, high unemployment and subdued inflation. On November 3<sup>rd</sup>, the Federal Open Market Committee announced its intention to purchase \$600 billion of longer-term Treasury securities by the end of the second quarter of 2011, a pace of about \$75 billion per month. This is on top of its commitment to re-invest principal payments from its pre-existing portfolio of mortgage-backed securities. This announcement is now commonly referred to as “QE2”. The Federal Reserve’s stated goal is to drive up inflation expectations while pushing interest rates lower in order to bolster the economy and the financial markets.



Since the Federal Reserve made the announcement on November 3<sup>rd</sup> the interest rate on the ten-year U.S. Treasury note has risen from 2.58% to 3.27% and more than three-quarters of one percent from 2.48% on August 26<sup>th</sup> when Chairman Bernanke delivered his remarks in Jackson Hole.



So if the Federal Reserve's intention is to raise inflation expectations and keep interest rates low for an extended period of time, what happened? Higher inflation expectations do not go hand in hand with lower interest rates. When investors believe that inflation is likely to be higher in the future, they demand higher yields on the bonds they purchase to compensate them for the risk of inflation eroding their purchasing power. The Federal Reserve undertook extraordinary measures to mitigate the financial crisis by expanding its balance sheet by purchasing \$1.7 trillion of Treasuries and mortgage-backed securities from December 2008 to March 2010. It is worth noting that the interest rate on the ten-year Treasury note remains virtually unchanged from where it stood on March 18, 2009 when the Fed began buying \$1 trillion of mortgage-backed securities, agency and U.S. Treasury securities.



There is raging debate as to whether the latest round of bond buying will actually do any good and based on our experience in 2009-10 we have our doubts. The Fed is attempting to increase inflation expectations while managing interest rates lower through its bond buying. In the world of unintended consequences, investors are seeking higher yields as inflation expectations rise. We remain concerned that the Fed is sowing the seeds of higher inflation in the future and believe the longer term impact on the bond market may be significant.

Individual investors have flocked to fixed income funds over the past 18 months as they seek a safe haven and alternatives to historically low short term rates. At the same time, we have continued to reduce the average maturity of our fixed income portfolios as we believe the risks in the fixed income market far outweigh the potential returns. When one sets sail in uncharted waters they often encounter unforeseen obstacles. We plan to keep our eyes focused on the horizon.

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Capital Management

## QE2 Sails Off Course

By Brian Bush

December 2010

### Important Disclosures

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