

# Bernanke Strikes Again; QE2 sends margin debt soaring to new highs

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Interest rates are the Fed's main tool for implementing policy, but when interest rates are already at zero and activity is still weak, then the Fed may try other unconventional strategies to rev up the economy. Quantitative Easing (QE) is one such strategy. In practice, it works like this; the Fed purchases some type of financial asset (stocks, bonds, mortgage-backed securities) which adds to the money supply thereby creating (in effect) negative interest rates. The Fed believes that this "monetary easing" can stimulate the economy.

The Fed is currently in the process of purchasing \$600 billion in US Treasuries from the big banks while at the same time recycling the proceeds of \$300 billion from maturing mortgage-backed securities (that the Fed already has on its balance sheet) into reserves at the banks. This may sound complicated, but it's really not. In essence, the Fed is reducing the supply of financial assets and, thus, pushing more liquidity into riskier assets, like stocks. As a result, the S&P 500 and the Dow Jones Industrials have climbed roughly 11 and 12 percent respectively since the program began.

So, is the Fed mainly responsible for the recent uptick in stock prices?

In large part, yes. Here's how Nomura's global macro strategist Bob Janjuah puts it:

"I strongly believe QE2 added over 250 points to the S&P based on where it closed the year....We think QE1 and QE2 have failed the real economy in the US at the expense of pushing up asset prices in financial markets. (eg house prices vs. stocks) Most American families own a home, but most Americans do not own a meaningful amount of stocks. Bernanke's solution seems to rely on the US public buying into another round of bubble blowing and on the idea of trickledown economics.

...We think QE3 will be both unavoidable and a grave policy mistake in the hard landing outcome. We think it (QE3) is unavoidable because under this outcome, where we expect a significant slowdown in global growth in H2, driven by an EM (Emerging Market) slowdown and an end to the global super-cycle in manufacturing, it is the only "stimulative" policy option left, and Bernanke and Obama both seem fixated with stimulus, at any cost it seems....("Bob Janjuah - told you so America", Ft Alphaville)

So, Janjuah lays out the basic case against QE2, which is, that while it pushes stock and commodities prices up, it provides very little relief for underlying economy. In other words, Bernanke is just blowing bubbles instead of addressing the fundamental lack of demand.

QE has been the most controversial policy in the Fed's history, and for good reason. The policy is seen as a direct intervention into the markets. Bernanke denies this, but at the

same time, he boasts that QE2 has raised stock prices and strengthened the recovery. So, which is it; either the Fed is meddling in the markets or it is not?

Also, Bernanke continues to say that the economy is close to a “self sustaining recovery”. But if that’s true then why are interest rates still below the rate of inflation (which provides a subsidy to the banks for borrowing from the Fed), and why has the Fed announced that it will not end QE2 on schedule (at the end of June) but will continue to recycle funds from maturing bonds into the purchase of more Treasuries? Here’s the scoop from Bloomberg:

“Federal Reserve Chairman Ben S. Bernanke may keep reinvesting maturing debt into Treasuries to maintain record stimulus even after making good on a pledge to complete \$600 billion in bond purchases by the end of June.

The Fed chief’s top two lieutenants said this month the economy and inflation are too weak to warrant the start of a monetary-policy reversal. Investors and economists including David Kelly at JPMorgan Funds see that as a signal the Fed will keep its balance sheet at current levels by replacing about \$17 billion a month in maturing mortgage debt with Treasuries.

Ending the reinvestment policy and the \$600 billion program at the same time would be like quitting stimulus “cold turkey,” said Kelly, who is based in New York and helps oversee \$400 billion as chief market strategist at JPMorgan.” (“Bernanke May Sustain Stimulus to Avoid ‘Cold Turkey’ End to Aid”, Bloomberg)

This shocking policy reversal by the Fed suggests that the economy is still so weak, that the ventilator and feeding-tubes must remain in place to forestall another disaster. In fact, JPM’s own economist David Kelly candidly compares the economy to a drug addict who can’t cope without his “liquidity fix” from the central bank. While that seems like a fitting metaphor, it also illustrates the shortcomings of QE2. Clearly, the program was never intended to reduce unemployment, stimulate demand or trigger a rebound in the real economy. It’s just another multi-billion dollar handout to the investor class so they can make the payments on the Jaguar or add another Chagall to their art collection. Here’s an excerpt from an article by Professor Alan Nasser on Counterpunch that sums it up pretty well:

“Ben Bernanke’s second round of bond buying, QE2, has been a grand flop. Housing sales and prices are falling at an unhealthy clip, foreclosures and bankruptcies continue to mount and QE2 has had no measurable impact on the dismal employment picture. Nor should we expect it to. A study by the highly reliable Macroeconomic Advisors indicates that even an additional \$1.5 trillion bond purchase by the Fed would reduce unemployment by a mere two tenths of one percent. (J. Hilsenrath, “Fed Fires \$660 Billion Stimulus Shot”, Wall Street Journal, November 4, 2010)...” (“Putting People to Work”, Alan Nasser, Counterpunch)

See? Bernanke has been pulling the wool over our eyes from the get go. QE2 was never intended to lower unemployment. The real goal was to buoy stocks with the hope that inflated asset prices would increase the “wealth effect” and trigger another credit expansion. But that hasn’t happened because consumers are up to their eyeballs in debt and still deleveraging.

While it’s bad enough that QE2 has made billions in profits for the same scoundrels who blew up the financial system, the program has other hidden costs as well. For example, how much damage will the economy sustain when Bernanke ends QE2 and the stock bubble pops? And, for those still in doubt, there’s more and more proof that stock prices are pretty

“frothy” already. According to BusinessWeek: “Robert Shiller calculates that the Standard & Poor’s 500-stock index is trading at 23 times earnings normalized over the past 10 years, compared with a historical average of 16.” (“The Granddaddy of All Bubbles?”, Peter Coy and Roben Farzad, BusinessWeek)

And then there’s this from Marketwatch:

“There have been only four other occasions over the last century when equity valuations were as high as they are now, according to a variant of the price-earnings ratio that has a wide following in academic circles. Stocks on each of those four occasions would soon suffer big declines.” (“History bodes ill for stock market”, Mark Hulbert, Marketwatch)

So, why are stock prices so high? Is it because the economy is doing so well or because the Fed’s zero rates and bond buying binge has ignited a flurry of speculation that’s pumped up prices?

The uptick in margin debt—which is presently at its highest level since 2008—is particularly disturbing. It means that the big banks and hedge funds have been increasing their debt-load to buy equities. But haven’t we seen this movie before? When investors borrow tons of money to buy stocks, it always ends badly. When the bubble bursts, over-extended investors rush for the exits, and the market crashes. Bernanke should be doing everything in his power to avoid this scenario, but, instead he keeps pumping more gas into the balloon. It’s madness.

Here’s a clip from Gluskin Sheff’s David Rosenberg who explains the debt-fueled stock buying frenzy that Bernanke has sparked with QE2:

“If there is one sure way to tell that the Fed has managed to create and nurture a speculative-led rally in the equity market, look no further than what is happening to investor-based leverage growth – it’s exploding off the page. Yes, that’s right. Debit balances at margin accounts skyrocketed \$20.7 billion in February. Only two other times historically have we seen leverage rise so much so fast and both times it was during a manic phase – during the tech bubble of the late 1990s and the credit bubble just a short four years ago.” (“Surging margin debt and the instability QE2 has created”, Pragmatic Capitalism)

When investors start borrowing boatloads of money to buy stocks, then the “big crash” cannot be too far off. A sudden decline in stock prices can quickly turn into a full-blown rout as margin calls send investors racing for cover and debt deflation dynamics pull the economy back into another slump.

Bernanke created this problem. And when the markets implode, it’s Bernanke who should be held responsible.

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