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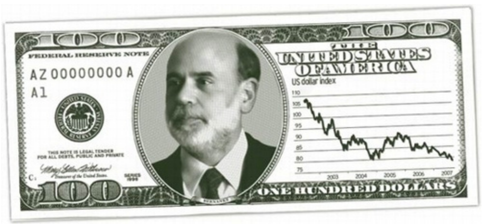

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SPECIAL EDITION—PART TWO—EXAMINATION OF RECENT FED ACTION

- **Fed Chairman Ben Bernanke has announced yet another round of quantitative easing:** A new bond repurchase program has begun, which consists of purchasing agency mortgage-backed securities at the rate of approximately $40 billion per month. This appears to be an open-ended commitment, which will also keep overnight lending rates at a range of 0-.25%.

- **Impact on equities markets:** The Fed has told us what they are going to do. As a result, two outcomes seem obvious to us as money managers: 1) By keeping policy rates low via edict, and short term market rates low via bond purchases, portfolio managers are forced into riskier asset classes in order to deliver positive alpha to their investors; and 2) they can be assured of the consequences, because once the Fed announces action, the Fed must follow through. So goodbye money market funds and hello stocks.

- **As inflation expectations rise the economic downside looks perilous:** In the few days since the announcement, the 10-year US Treasury "breakeven" rate (the spread between regular bonds and inflation-protected bonds) has risen from 2.4 to 2.55%. As portfolio managers are herded into riskier asset classes to generate returns, portfolio quality may suffer. Evidence of such shifts can be seen in the narrowing of junk bond yield spreads (typically junk bonds are defined as bonds with a spread at or above 600 bps). Junk bond spreads have dipped to around 400 basis points ("bps") over investment grade bonds because people are chasing yield and pushing up junk's prices. The most profound impact of Fed money creation is the effect on inflation. Note that by 2015 just over 1/2 of all Federal debt held by the public comes due. How will the government pay down the maturing debt without printing money and raising taxes too? With crop yields in the United States expected to reach multi-decade lows, food inflation will be worsened with the printing of more money because dollar priced commodities will have to rise in price as the dollar's buying power wanes. Portfolio managers are increasing their bets in gold, gasoline, oil (which, at the time of this writing, just broke $100/bbl), and natural gas. We could see $5/gal gasoline as an unwelcomed early Christmas gift. Finally, the hoped for positive effect on the economy of the QE3 money flood will be severely muted, as monetary velocity is at its lowest point since the early 1960's.

- **The Bottom Line:** Chairman Ben Bernanke is a student of the Great Depression and the first ten pages of his book outline the direct causes of that generation's financial meltdown. He has dedicated a good portion of his academic and professional life to educating the world to the perils of withholding monetary stimulus to an economy starved for cash. We think he initiated QE1 at the right time and to the right degree. However, in recent months, the Fed has experienced what the military calls "mission creep". The Fed is now trying to use monetary policy to stimulate the economy at a time when more money supply is counter-productive. Ultimately, this will prove disastrous, as there is no lasting substitute for increased productivity, and increased output of goods and services in the private sector.