Private Wealth Advisory

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The Fed's QE 3 Program

Yesterday the Fed announced QE 3: an open ended program through which the Fed will purchase $40 billion worth of Mortgage Backed Securities every month until it decides that the world is right again.

The implications of this are severe. However, the first question we have to ask is, "why now?"

After all, stocks were already at 4-year highs, food and energy prices were soaring, interest rates were at record lows, etc. On top of this, the Fed *failed* to announce QE 3 for over a year (QE 2 ended June 2011). Why announce it now?

There are only two reasons:

1) Things are in fact far worse behind the scenes than we know (the Fed HAD to do something to get more money into the system)
2) Politics

Regarding item #1, I want to be very clear here. The fact that my timing was off on predicting a European collapse *doesn't mean* Europe will not collapse. Instead it simply means that my timing was off.

With that in mind, we have to look at the Fed's move from an EU perspective. We know that Obama literally pleaded with Angela Merkel to keep the EU together until the election was over.

Moreover, we know that Europe is in a very bad place. Here's a quick 30,000 foot view of Europe in bullet point form. I'm focusing on the country that's in the most trouble (Spain) and the country that is the backstop for the EU (Germany).

All of the following are facts:

Spain:

1) Spain's banking system saw a bank run to the tune of €70 billion in August. The market cap for all of Spain's banks is just €114 billion. So Spanish banks need to raise at least €20+ billion or so per month in the coming months to stay afloat. This is *without* depositors pulling additional funds in September onwards. That's really bad news.

2) Spain's now nationalized Bankia just took another €5.4 billion from Spain's in-country rescue fund. This indicates that once nationalized, problem banks DO NOT cease to be problems.
3) The region of Andalusia is requesting a bailout from the Spanish Federal Government. This comes on the heels of bailout requests from the regions of Valencia, Murcia and Catalonia (none of which want any "conditions" on the funds).
4) Spain has set aside €18 billion to bailout its regions. The current bailout requests already amount to €10.8 billion. That's just from this year alone.

Simply put, Spain has MAJOR problems. And this is *after* the ECB put over €1 trillion in liquidity into the EU banking system to cover three year funding gaps for EU banks.

Despite these measures, Spain has already asked for a €100 billion bailout for its banks from the EU. However, it's *yet* to request a formal sovereign bailout.

The reason for this is Spain doesn't want the EU or IMF to impose conditions on its already troubled economy (youth unemployment at 50% and total unemployment at 25%).

Also, Spain doesn't want IMF and EU bean counters to sift through its book. Case in point, the country just *discovered* another €28 billion in debt on its books. One wonders what else is hidden in the darkness of Spain's officials "numbers."

Germany:

1) The country is now sporting a Debt to GDP of 90% courtesy of its EU bailouts.
2) Germany has committed over €2.1 trillion in backdoor bailouts to the EU.
3) German Chancellor Angela Merkel is up for re-election next year. The EU bailouts will be THE election topic. And she is facing backlash from members in her own party as well as opposition leaders concerning her actions in helping the EU.

So, we see a problem country (Spain) facing a severe bank run, regional bailouts, and more at the precise time that its ultimate backstop (Germany) has put its own solvency into question due to various EU bailout schemes.

I believe that the Fed's decision to announce QE 3 now was in part due to the severity of these issues. One has to remember that a significant number of the Fed's Primary Dealers are based in Europe. The Fed will be feeding them liquidity via QE 3.

Remember, the ECB's recent open-ended bond program requires countries to meet "conditions." The Fed's QE 3 doesn't. So this can be seen in some ways as a potential back-door bailout to Europe in that it will get liquidity into European banks.

Again, I firmly believe that one of the primary reasons the Fed did this was to deal with liquidity issues that are occurring "behind the scenes." The fact the Fed piggy-backed this announcement after the ECB's announcement of its open-ended bond purchasing program makes this a **coordinated central bank intervention**.

Why would the Fed and ECB do this? Because they're scared stiff of what's happening and are trying to shock and awe the markets into submission with terms like "open ended" and "unlimited."

There is only one reason to do this: things are in fact much worse than anyone has admitted.

In this regard the announcement of QE 3 should in fact be cause for serious concern about the stability of the financial system. Again, there is no *logical* reason for QE 3 now. Food and energy prices are high as are stocks. Interest rates are low. US unemployment (based on the official numbers) is not that bad.

So we have to see this QE 3 announcement as a kind of desperate move to support the ECB in its attempt to rein in a European Crisis that is rapidly spinning out of control.

As I've noted in earlier articles to you, the EFSF bailout fund has only €65 billion left in funding. And the ESM (which Germany has ratified) is meant to receive 30% of its funding from Spain and Italy. So Europe was about out of options as far as bailouts go. QE 3 is meant to help Europe get through the US Presidential election at which point a larger program might be announced.

Now on to the second reason for QE 3: politics.

I have to say, the Fed's decision to announce QE 3 now was a real gamble. Mitt Romney has stated several times that he would replace Bernanke if elected. So the fact the Fed decided to announce QE 3 *now* as opposed to any time in the last year should be perceived as a *very* political move.

In plain terms, this is Bernanke trying to juice the stock market (and perhaps the US economy) for all its worth to help Obama's re-election chances. There is simply no other way to perceive this move. Bernanke is doing a "Hail Mary" pass to try and keep his job.

The consequences of this will be complicated. For one thing, with food and energy prices already high (Oil just cleared $100 again). So the Fed is running the risk of increasing the cost of living to the point that voters potentially turn on Obama. The economy is already entering another recession (the recent ISM reading was sub-50 which is recessionary territory). To pile even inflation of top of this is not a wise move.

We also have to consider China and the Middle East.

China's economy is entering a hard landing. With food prices already high, the Chinese Government is desperate to channel the country's frustrations towards an external problem rather than face rampant civil unrest.

Thus far the focus of this has been Japan (the long-standing dispute over who actually owns the Senkaku islands). But with the Fed now announcing QE 3 (which will push food prices even higher), we will see a resurgence in the US/ China conflict: more accusations of currency manipulation, trade wars, and other political issues.

In plain terms, the Fed just handed China another problem (even higher food prices). Don't expect China to ignore this. That's unintended consequence #1.

As for the Middle East, we need to remember that the entire Arab Spring was started when QE 2 pushed food prices to record highs. With anti-Americanism on the rise in the Middle East (see the numerous embassy attacks), the consequences of more food inflation in the Middle East courtesy of QE 3 will NOT be pleasant.

That's unintended consequence #2.

Finally, the Fed's QE 3 program will result in higher operating costs for US companies. Higher operating costs mean lower profits. With companies already lowering their earnings forecasts (in the last month we've seen Fed Ex, Bed Bath and Beyond, Proctor and Gamble, Adobe, Starbucks, and McDonald's do this), the Fed just greatly increased the potential for even more earnings surprises to the downside.

The Fed has also increased the likelihood of more layoffs in the private sector. When operating costs rise, corporations will cut whatever other costs they can. This means ***firing people***. So look for unemployment to actually *rise* based on QE 3.

So, to recap all of this, the key takeaway items from the Fed's QE 3 announcement are the following:

1) This should be seen as a tag-team effort between the ECB and the Fed to try and rein in the European Crisis
2) It's also a clear and obvious political move to attempt to boost the Obama re-election campaign (and save Bernanke's job)

Both of these issues indicate that the Fed is very concerned about issues in the short-term (Europe and the US Presidential election). This should be a big red flag to all of us that things are very likely far worse than we realize.

On top of this, the Fed's move will have severe consequences for the US's foreign relations as food prices add fuel to the fire for conflicts in China and the Middle East.

How precisely these issues will play out remains to be seen, but it's clear none of the consequences will be good (what are the odds the Middle East or China end up grateful to the US/Fed for this?)

So the Fed's decision to announce QE 3 should be seen as a very big negative if anything. True, stock prices will soar. But:

1) Profit margins will shrink resulting in lower profits (which will likely lead companies to lay-off workers to cut their costs).
2) The cost of living will increase globally as well as in the US.

None of these are items to celebrate. If anything the Fed has just added fuel to the fire. The fire was bad enough to begin with (Europe, the US, and China were entering recession). Adding higher inflation to this mess isn't going to do any of us a lick of good.

I'm currently working on a new portfolio of investments that will profit from this new investment landscape. I do not think it's wise to buy anything today as risk-on assets are sharply overbought and should stage a pullback.

Moreover, it's never a wise idea to load up on new investments before a weekend, especially when so many major issues are moving forward. There are too many surprises that can occur while the markets are closed.

So I'll have another update to you next week concerning which investments to focus on. For now, the most obvious items to look into are Gold and Silver bullion. But I'll have more for you on Monday.

Until then…

Best Regards,

Graham Summers

PS. I'm going to be posting this update to my full client list. However, the next update featuring specific investment ideas will only be available to paid clients ***Private Wealth Advisory*** and ***The Perfect Trade***.