

Reflections®



About this Newsletter

Reflections is a monthly publication written by John Gilbert, CIO, GR-NEAM. Each issue focuses on current capital markets and investment topics. Our clients find it somewhat unique from many investment publications typically received.

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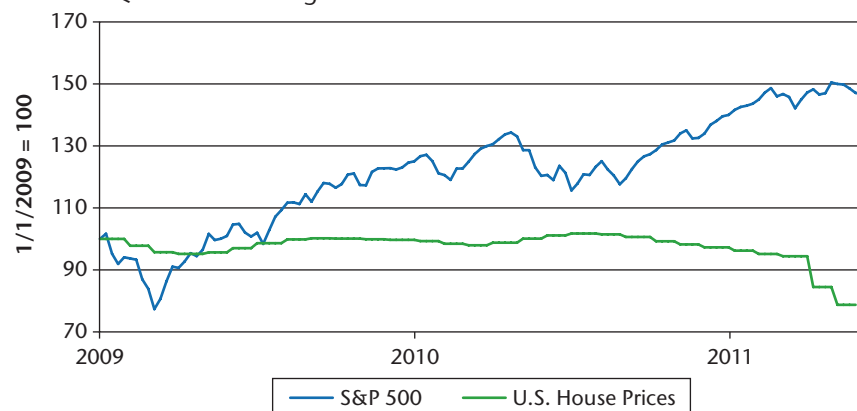
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Unintended Consequences

As the sun sets on the second episode of quantitative easing in the U.S. it is worth reflecting upon certain of its unintended consequences (quantitative easing, or QE, if your attention is not riveted by the daily affairs of the central bank, is the direct purchase of Treasury bonds by the Federal Reserve, with the intention of limiting interest rates). Unintended consequences almost invariably accompany government behavior, and have a troubling tendency to act in a direction opposite the policy makers' intentions.

It is fair to say that the primary intended consequence was aid to the U.S. housing market, keeping mortgage rates low by suppressing the reference rate on Treasuries. The first program of QE began in 2009 and ended in mid-2010. Chairman Bernanke suggested a second round in August 2010 and purchases resumed in November. As Chart 1 suggests, in this respect quantitative easing has been a colossal failure.

Chart 1. Quantitative Easing and Asset Prices

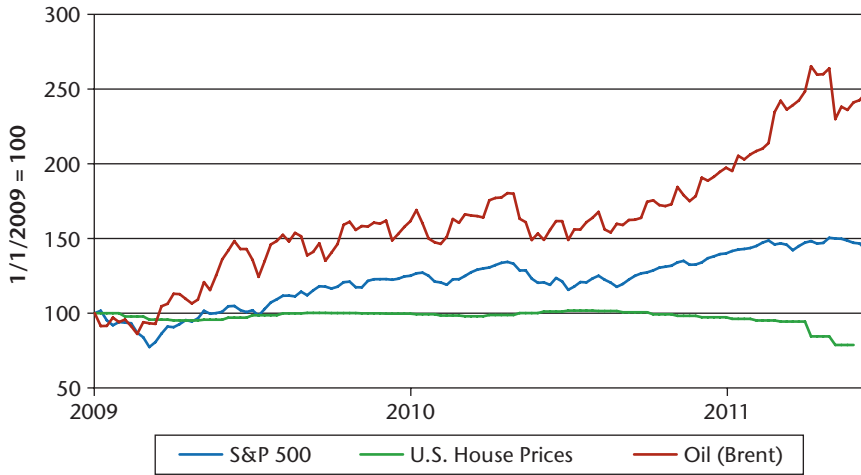


Sources: Bloomberg L.P. and GR-NEAM Analytics

Any such governmental attempt to levitate economic activity is apt to fail, since it cannot include the primary ingredient in the healing process, which is time. History shows that housing contractions are particularly prolonged, for the obvious reason—the assets last a long time.

The unintended consequences, however, are the most important result of QE. They include inflation of the stock market, and in fact, the riskier the stocks, the better. But the big winner has been commodities. In the short to intermediate term, money flows are not driven by valuation, but by belief, and the world in general believes that China will consume every ounce of everything. Oil is a particular lightning rod as Chart 2 shows:

Chart 2. Quantitative Easing and Asset Prices

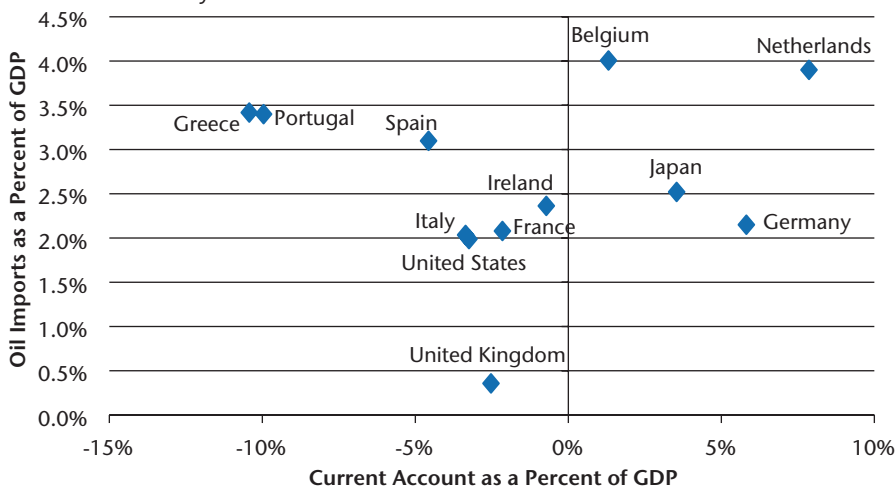


Sources: Bloomberg L.P. and GR-NEAM Analytics

Oil is troublesome among the commodities because its price is affected by another source of governmental intervention in the form of OPEC. Oil prices do not fully reflect the economics of producing the commodity, since OPEC's behavior is asymmetric and favors price increases over price reductions. This is primarily because Saudi Arabia gets only one vote, despite producing about one-third of OPEC's production, and most important, having about 85% of OPEC's spare capacity. So the low cost producer is the marginal producer, which stands economic logic on its head. Furthermore, OPEC does not spend all of its price windfalls, but saves some as foreign exchange reserves, which is a drain on the world economy. So OPEC's surprise decision in June to maintain its production quota, rather than increasing it, was worrisome.

The burden of oil prices is not shared equally. Energy efficiency, and particularly domestic oil production, cause countries to vary in their sensitivity to oil prices. The struggling members of the Eurozone are particularly exposed to oil price increases as show in Chart 3.

Chart 3. Sensitivity to Oil Prices

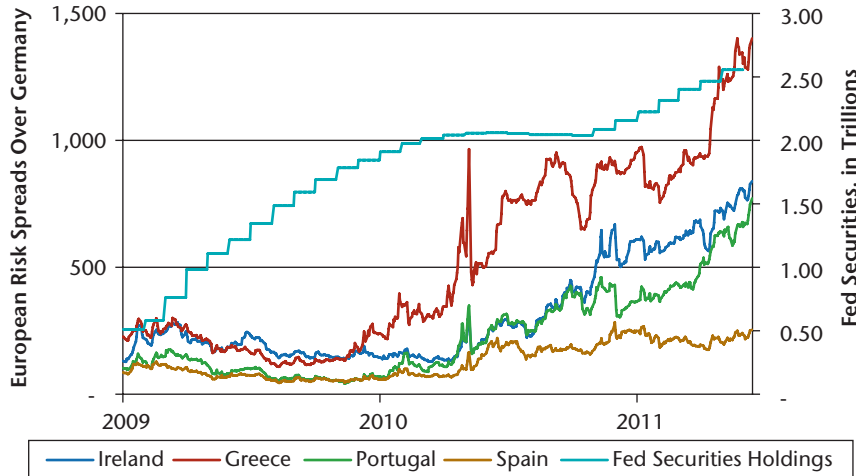


Sources: EIA, IMF and GR-NEAM Analytics

The countries in the upper left—Greece, Portugal and Spain—have a relatively large oil import bill without prowess in exporting other goods to pay for it. This aggravates their general financial dilemma at the moment.

There are many reasons that the peripheral Eurozone countries are in fiscal trouble, centered primarily on their own spending behavior. But rising commodity prices, and oil in particular, make the situation worse. In this regard, an unintended consequence of QE in the U.S. is effectively to shift some of the deflationary impulse from the U.S. housing market to the Eurozone, with oil as a transmission mechanism. The stress among the European periphery has accelerated with the expansion of the Fed’s balance sheet, as shown in Chart 4.

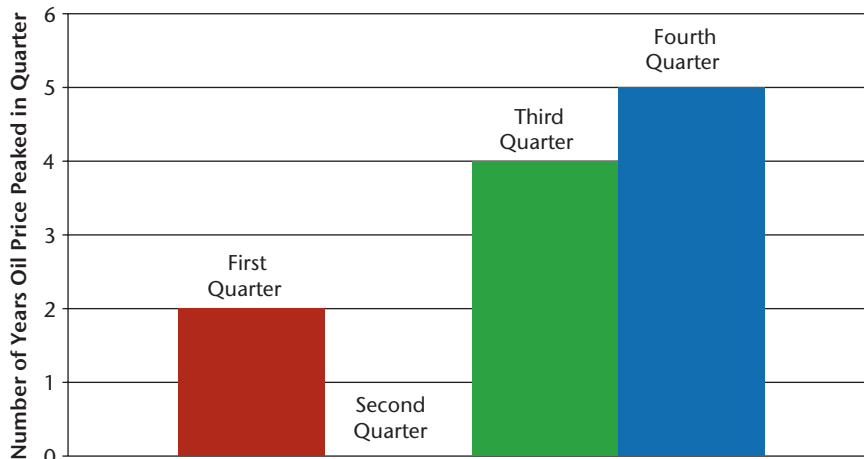
Chart 4. Quantitative Easing and European Risk Spreads



Sources: Federal Reserve, Bloomberg L.P. and GR-NEAM Analytics

The world economy is showing scattered signs of slowing, and lower oil prices would help. OPEC’s June decision is thus troubling. Oil demand rises in the northern hemisphere summer such that world usage rises by one to two million barrels per day. In Chart 5 we show the distribution by calendar quarter of the timing of the highs in oil prices for the years 2000 through 2010.

Chart 5. Oil Price Peaks 2000–2010



Sources: Bloomberg L.P. and GR-NEAM Analytics

In nine out of the last eleven years the high in oil prices was in the second half of the year. With Libyan oil production having fallen by 1.3 million barrels, and OPEC spare capacity prior to that only 3.5 to 4 million barrels, the seasonal increase this year will approach or consume the remaining spare capacity. The result is little or no margin for error in the oil market. A further price spike would threaten economic growth and particularly financial markets, which are not priced in anticipation of such a shock. That is but one scenario in which Chairman Bernanke may be back. This time, however, he is unlikely to be as quick to return, lest he appear to be too permissive a bartender.



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