INVESTMENT UPDATE NEWSLETTER

ALLEN TRUST COMPANY

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Deeper Into the Labyrinth

Others apart sat on a Hill retir'd,
In Thoughts more elevate, and reason'd high
Of Providence, Foreknowledge, Will and Fate
…And found no End, in wand'ring Mazes lost.

John Milton, Paradise Lost

Autumn is becoming the season not just for crisp apples, a new locker at school, major league pennant races and cool mornings hinting of colder to come, but also time for the Federal Reserve to roll out blockbuster interventions, or at least telegraph their imminence. Unveiled today, here's the latest from Dr. Ben Bernanke's laboratory:

- Operation Twist (last year's big idea) will be extended: The Fed will keep buying long-term Treasuries to keep a lid on distant interest rates.
- The Board of Governors plans likewise to keep short-rates pinned, promising zero% interest rate policy well into 2015.
- As a new gambit – drum roll, please – the Fed will buy up $40 billion per month in mortgage-backed securities (MBS). What's more, they'll do this for as long as they think necessary, without any cap on the cumulative total. (Remember mortgage giants Fannie Mae and Freddie Mac? Well, they've been wards of the federal government for four years now anyway, so where better than the Fed to bury their liabilities' final remains? Our central bank as conceived a century ago probably wasn't meant as a potter's field for failed enterprise; but such innovations prove Bernanke's genius for some.)

Fed action comes with costs. Some are knowable: e.g. $40 billion/month. Some are unknowable: $40 billion/month for how long? Some are heartening: people solvent enough to refinance their home loans can lighten the load (even if the savings go toward fueling their cars at $4/gallon). Some are disheartening: Those same lower rates punish people who have long saved responsibly only now to boggle at how little income their nest eggs avail them in Bernanke's zero-rate world.

Most of all, Dr. Bernanke operates on the assumption that his bank's capital is infinite, and so these efforts can be expected to achieve their immediate intended effects by brute force. Their second-, third- and fourth-order effects, however, fall ever more outside the Fed's control. Unintended consequences can spoil the best of intentions (though likely the Chairman believes he can cook up a fix for them, too), and they're what concern us most. For the capital markets and economy are not a controlled laboratory; they are huge, messy systems which history shows can confound any central authority's attempts to engineer them into behaving nicely for long.

As to fulfilling one half of the Fed's dual mandate ("promote maximum employment"), the prior efforts haven't found traction off Wall Street; jobs and Main Street incomes have emphatically not joined the stock and bond markets' party. As to fulfilling the other half of the mandate ("promote stable prices"), open-ended asset purchases have the potential to be profoundly destabilizing, pumping money up, up, up.

We have no doubt of Dr. Bernanke's will to act, but we question any man's presumption of Foreknowledge or capacity to bestow Providence; no matter how "elevate" his thoughts or how well capitalized, his efforts find no end, and have him wandering deeper in a maze of his own making.

Celebrating our New CFA Charterholder

Having completed a rigorous curriculum both wide-ranging and deep, our portfolio manager Monica Poveda is now Monica Poveda, CFA. The Chartered Financial Analyst designation is the most widely known and respected investment credential in the world, and it does not come easy. Kudos to you for your hard work and tenacity, Monica, and congratulations on your success!