

Tech Spotlight

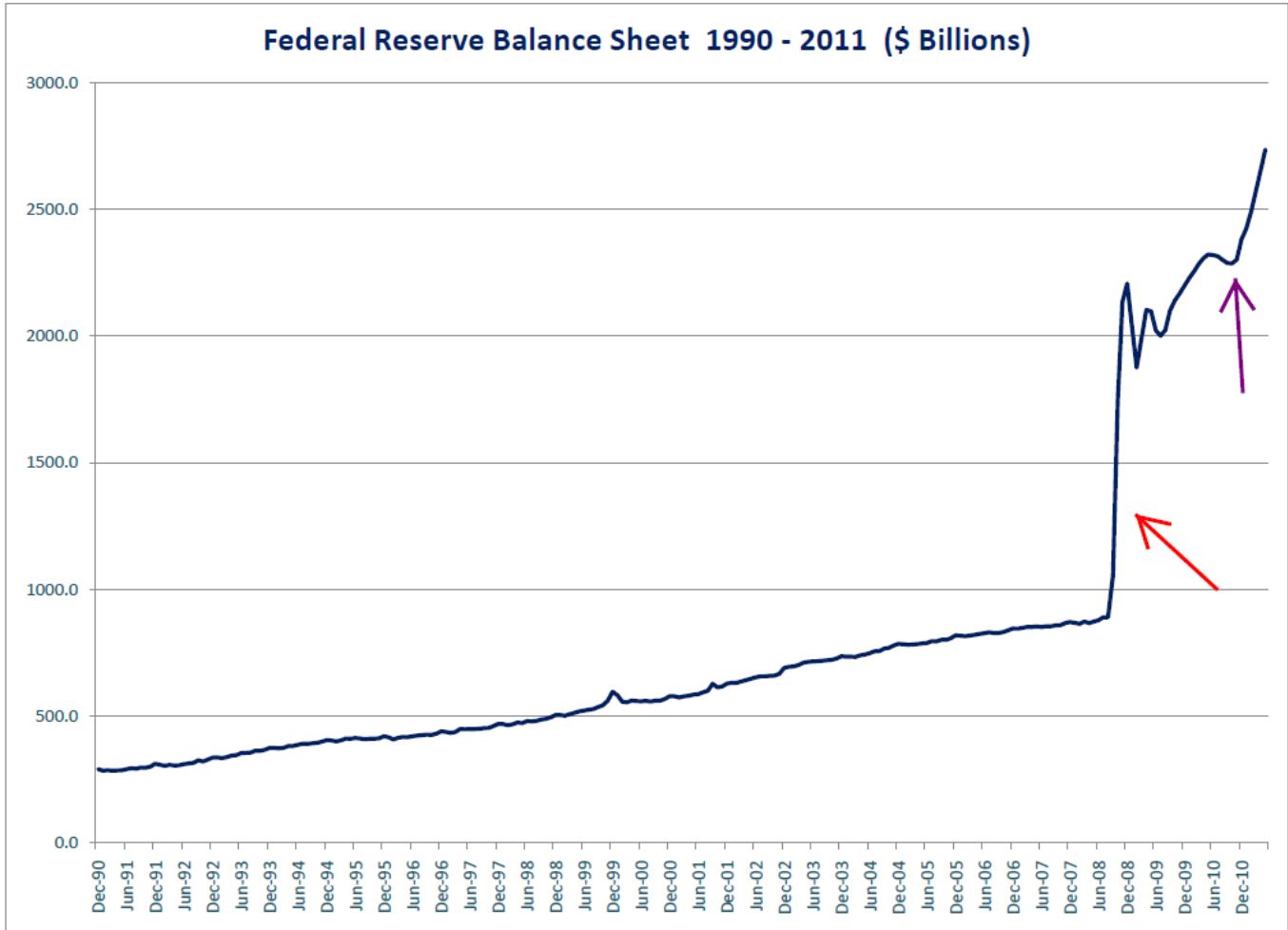
We have led off the last two Tech Spotlights with discussion on the Federal Reserve Board's foray into Quantitative Easing. QE1 (unofficially bailing out the banks) ended in April 2010. QE2 began in November 2010 (though talk of it by Bernanke began in late August 2010) and looks to end in just over three weeks. And talk of a QE3 has really heated up, with extremely diverse opinions coming from and between members of the Federal Open Market Committee (FOMC) and amongst and between very well-known names in the institutional investment world (Bill Gross - Pimco, Larry Fink - Blackrock, Jim O'Neil - Goldman Sachs, Rob Arnott - Research Affiliates and David Rosenberg - Gluskin Sheff & Associates, to name a few). And the same questions that were being asked last summer and fall, and which have yet to be definitively answered, are still in play today: Do "we" need more easing? Should there be more easing? Will there be a lot more easing? Is monetizing the debt a good thing? Is printing more money akin to "pushing on a string"? Have we done too much already? Are we going to have inflation or deflation? How will the different asset classes be affected? And a "new" one to add to the list, that should have been mentioned last summer - Is it possible that "politics" could have an effect on any of the decision making process with regards to Quantitative Easing in whatever form it may appear?

Last summer, the markets were about to finally enter into a severe correction when Fed Chairman Bernanke began to talk about the possibility of a QE2. And, boy, did the various stock and commodity markets rally in tandem as the U.S. Dollar began to fall relative to other foreign currencies. At the time Mr. Bernanke began to talk of QE2, he made these comments:

I believe that additional purchases of longer-term securities, should the FOMC choose to undertake them, would be effective in further easing financial conditions. However, the expected benefits of additional stimulus from further expanding the Fed's balance sheet would have to be weighed against potential risks and costs. One risk of further balance sheet expansion arises from the fact that, lacking much experience with this option, we do not have very precise knowledge of the quantitative effect of changes in our holdings on financial conditions. In particular, the impact of securities purchases may depend to some extent on the state of financial markets and the economy; for example, such purchases seem likely to have their largest effects during periods of economic and financial stress, when markets are less liquid and term premiums are unusually high. The possibility that securities purchases would be most effective at times when they are most needed can be viewed as a positive feature of this tool. However, uncertainty about the quantitative effect of securities purchases increases the difficulty of calibrating and communicating policy responses.



Following is a chart of the growth in the Federal Reserve Board's Balance Sheet since 1990:



Between the end of 1990 and the end of 2007, the Federal Reserve's Balance Sheet grew at a pretty steady rate of 6.7% per year – and this includes the Long Term Capital Management blow-up and Asian Financial Crisis in 1998 and the period surrounding the 9/11 terrorist attacks in 2001. But as you can see, beginning in 2008 (and, more specifically, in September of 2008) the Federal Reserve's Balance Sheet has grown at an annual rate of 40%! Imagine what Bernanke, Paulson, and Congressional leaders were confronted with that resulted in the Fed virtually tripling the size of their balance sheet in late 2008 (the almost vertical line in the above chart – red arrow) and Congress passing large fiscal stimulus packages (TARP, TALF, etc.). And, right when it looked like things were calming down in 2010 with the end of QE1, the Fed began their talk of QE2 within four short months and two months later (purple arrow in above chart) their balance sheet took off again.

It is interesting to see how the components of the Federal Reserve's Balance Sheet have changed since the end of 2002 after the stock markets finally began to rally after the tech bubble burst over a two-year fall. All of the following numbers are in the Billions of dollars:

<u>Security Holding</u>	<u>Dec - 2002</u>	<u>Dec - 2007</u>	<u>Apr - 2010</u>	<u>May - 2011</u>
U.S. Treasuries	\$ 626.5	\$ 754.6	\$ 776.7	\$ 1,529.7
Mortgage Backed Securities	\$ 0.0	\$ 0.0	\$1,098.8	\$ 917.9
Federal Agency Debt Securities	\$ 0.0	\$ 0.0	\$ 168.9	\$ 119.1
Maiden Lane (I, II & III)	\$ 0.0	\$ 0.0	\$ 65.3	\$ 63.9
Treasury Currency	\$ 34.5	\$ 38.7	\$ 43.1	\$ 43.9
Gold Stock	\$ 11.0	\$ 11.0	\$ 11.0	\$ 11.0
<u>Other**</u>	<u>\$ 68.5</u>	<u>\$ 121.0</u>	<u>\$ 210.8</u>	<u>\$ 145.4</u>
Total:	\$ 740.5	\$ 925.3	\$ 2,375.6	\$ 2,830.9

* Assets "received" from banks created from Long Term Capital Management crisis.

** Repurchase Agreements, Term Auction Facilities, Central Bank Liquidity Swaps, and other FRB assets (that I could not find an accounting for).

One can quickly see that the "subprime" problems in 2008 resulted in the Fed taking \$1.268 Trillion in Mortgage-Backed and Federal Agency Debt Securities off the hands of U.S. banks and giving them U.S. Treasury Securities in return. In this way, the U.S. Banks would be able to continue to meet their capital reserve requirements and not have to cease their banking operations and then closing down. [Banks are required to mark their assets to market. The Fed is the only institution that is not required to mark their balance sheet assets to market.]

At some point in time, assuming the Fed wishes to reduce the size of its balance sheet, these assets may have to go back on the balance sheets of the banks. Therefore, the banks are in the position of having to build up and “repair” their capital reserves, reserves which will most likely be needed to write off whatever losses may be occurring in these assets – and those losses could be substantial.

The main problem in 2010 involved the spiraling U.S. federal deficit. The Federal Government’s fiscal year is October through September. In looking at the potential of a \$1.5 Trillion deficit in the 2010-2011 fiscal year (that’s about \$125 Billion a month) the Fed felt it was necessary to step in and begin buying U.S. Treasuries in the monthly bond auctions to help pay for part of this debt. You can see this spending and increase in the Fed’s balance sheet in the numbers above as the Fed’s U.S. Treasury holdings increased by \$753 Billion over a one-year period between the end of QE1 in April 2010 and today as we enter the last month of QE2.

The Fed’s thinking appears to be that without their interventional buying of 2-Year, 3-Year, 5-Year and 7-Year Treasury notes, interest rates would rise and that could significantly increase the U.S. Government’s borrowing costs for a sustained period of time. Please remember that, in addition to the current fiscal year’s deficit that requires funding/borrowing, there is at least another \$1.9 Trillion of past debt that is rolling over and needs replacing. Put the two together, and the Treasury is looking at having to raise/borrow about \$3.4 Trillion this year – that’s about \$285 Billion per month. The Treasury Department, as well as the Fed, doesn’t want to see the borrowing costs on that money move up by any significant amount. The Fed has not had to buy on the short end of the yield curve (4-Week, 3-Month, 6-Month and 12-Month Treasury Bills) as there is plenty of interest in these shorter-term T-bills by the public at large (estimated to add up to about \$1.3 Trillion in 2011). The Fed felt it was important to help out on the middle part of the yield curve where the largest borrowing/bidding of Treasury auctions is taking place (estimated to be about \$1.6 Trillion in 2011). Not much is having to be raised, relatively speaking, on the long end – about \$500 Billion total out of the \$3.4 Trillion needed in 2011.

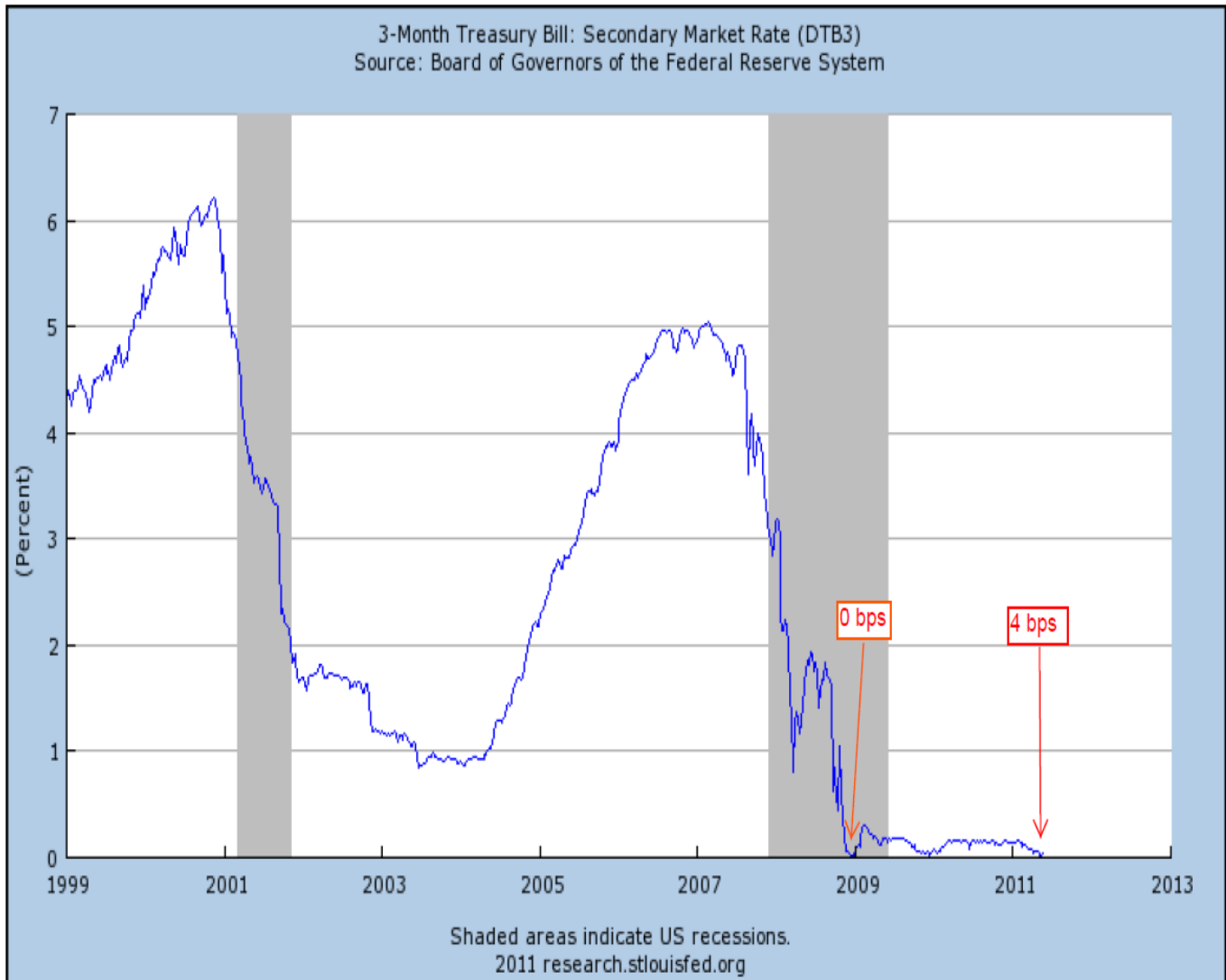
The public’s evolving interest in the various U.S. Treasury securities is somewhat demonstrated in the yield charts for these securities. Before reviewing the yield charts, consider the following current yields for the various treasury securities (1 basis point = 1/100 of 1 percent):



4-Week Treasury Bill:	one-half of 1 basis point (which = 0.005%)
3-Month Treasury Bill:	4 basis points (which = 0.04%)
6-Month Treasury Bill:	11 basis points (which = 0.11%)
12-Month Treasury Bill:	18 basis points (which = 0.18%)
2-Year Treasury Note:	45 basis points (which = 0.45%)
3-Year Treasury Note:	78 basis points (which = 0.78%)
5-Year Treasury Note:	165 basis points (which = 1.65%)
7-Year Treasury Note:	234 basis points (which = 2.34%)
10-Year Treasury Bond:	301 basis points (which = 3.01%)
30-Year Treasury Bond:	427 basis points (which = 4.27%)

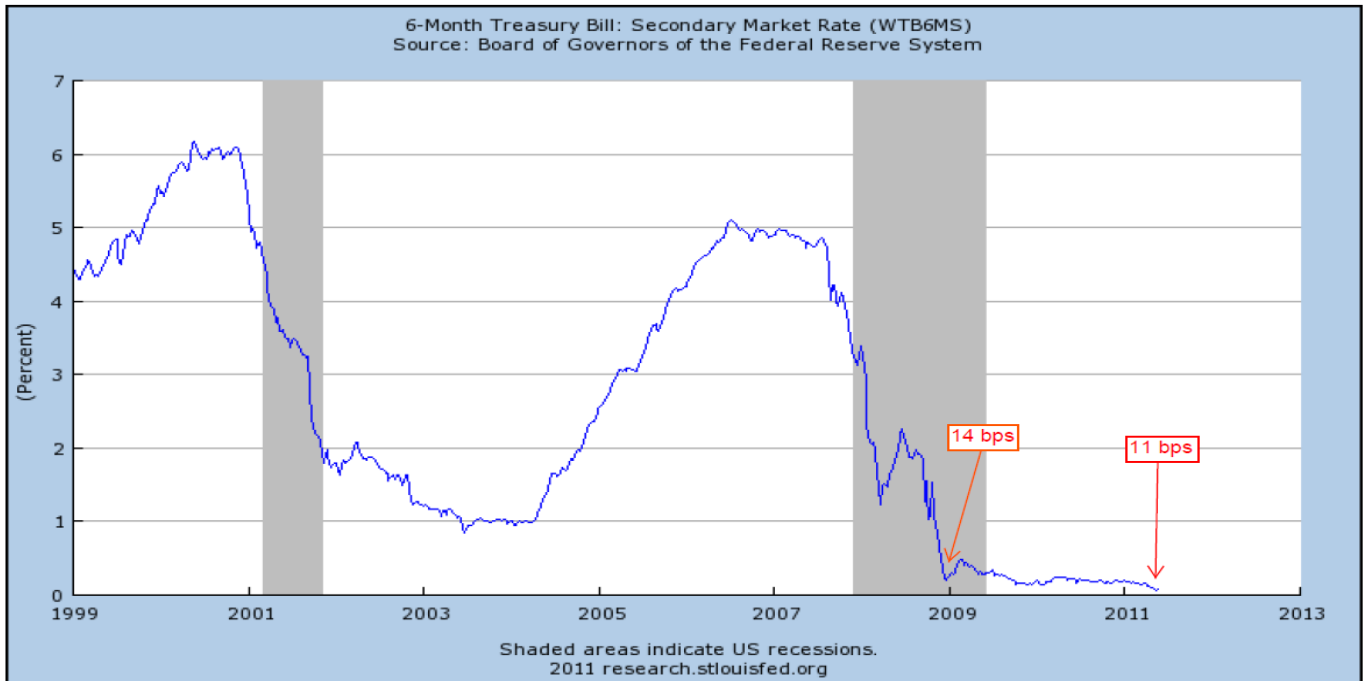
Remember, the Fed is doing its QE2 treasury buying in the 2-Year through 7-Year T-Note securities, with perhaps a little in the 10- and 30-Year treasury securities. They are not doing any buying in shorter term T-Bill securities. With fears of inflation and rising bond yields, many buyers appear mostly interested in these shorter term treasury securities until they see if inflation and rising bond yields break out at which time they may begin buying longer term bonds. Suffice it to say, investors feel “safer” in the shorter term treasuries. All the “natural” interest/demand in shorter term treasuries exerts downward pressure on yields (remember the old bond price vs. bond yield teeter- totter analogy?).

Consequently, with a lot of public interest in the short-term treasuries, their yield charts should reflect that “natural” (not accompanied by interventional Fed buying) collective demand:

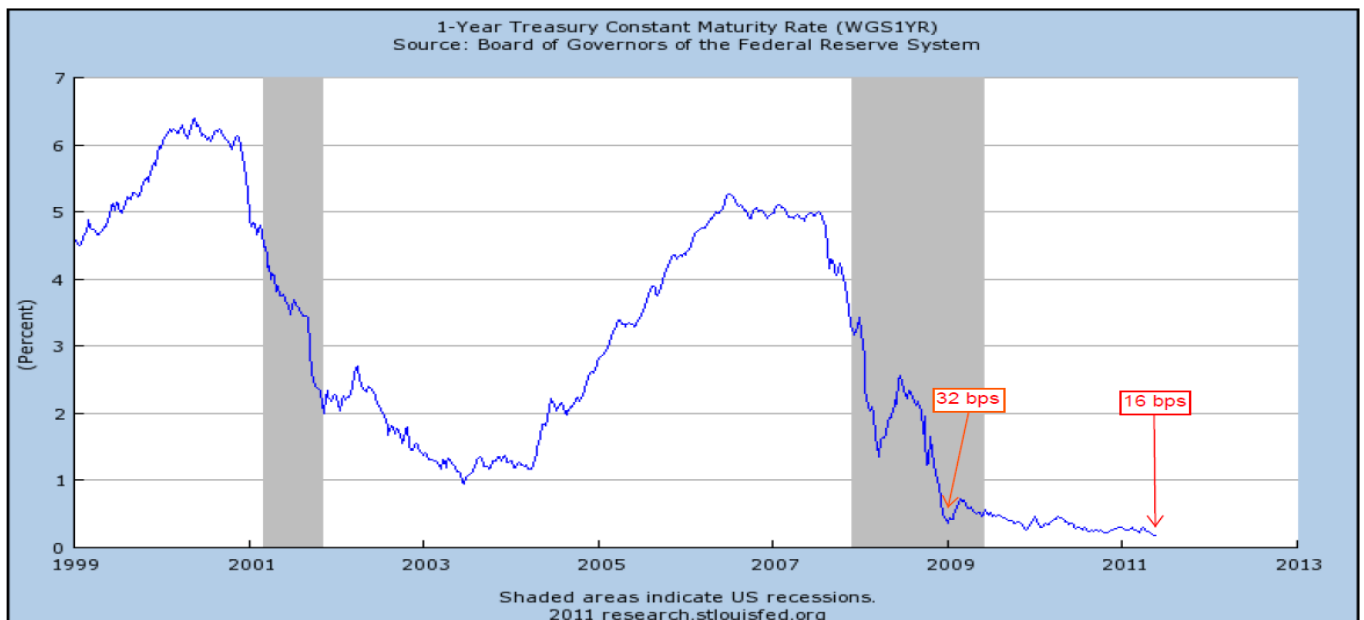


Above is the yield chart for the 3-Month Treasury Bill. Note that the current yield is at its lowest point since it reached zero during the market panic in December 2008. Let me repeat that last part, it was market panic in late 2008 that drove money into the short term T-bills in a flight to safety that drove the yield on 3-Month T-Bills from over 1% just a few months before (after the stock markets had already dropped 25% in ten months) to zero. Today, there is no panic, and yet, there is enough “natural demand” for safety to drive the yield in the 3-Month T-Bill down to almost zero, again.

Now, take a look at the chart of the yield for the 6-Month and 12-Month Treasury Bills:

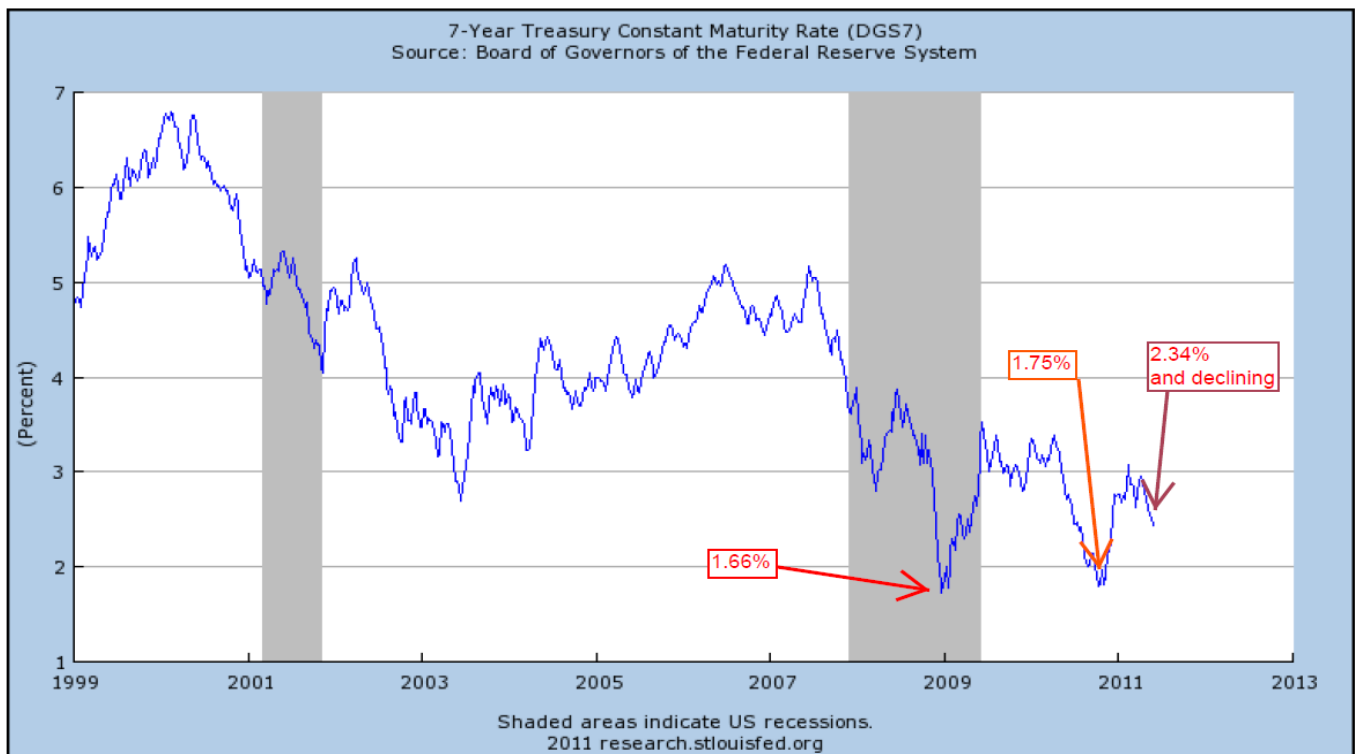
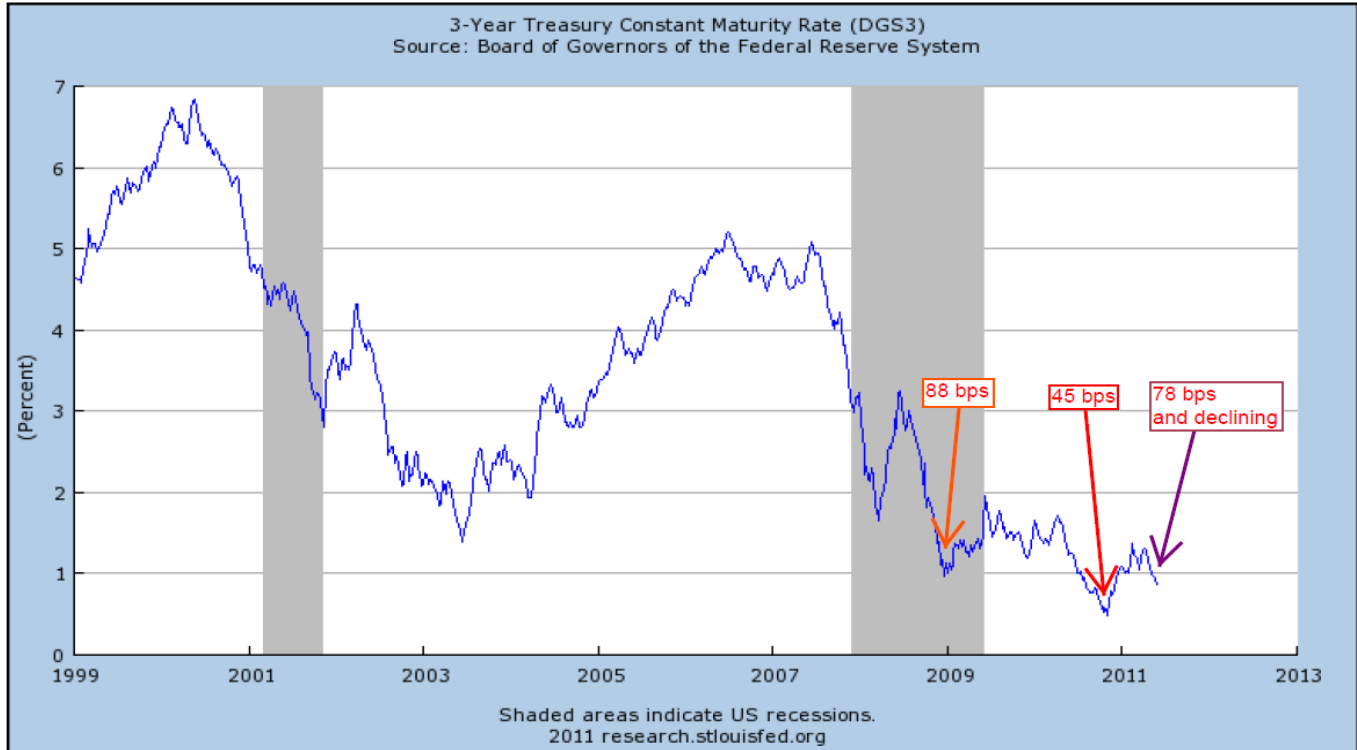


In the case of the yield for the 6-Month T-Bill we see that the yield today is now **lower** than it was during the market panic in 2008. The same can be said for the yield on the 12-Month T-Bill, its yield is lower today than in the panic of 2008. To repeat, there appears to be no outward panic today, at a time when the Fed is determined as ever to force money out of low interest rate investments into riskier assets (stocks, commodities and hopefully business investment) and, yet, the demand for these short term treasuries keeps their yield at generational lows.





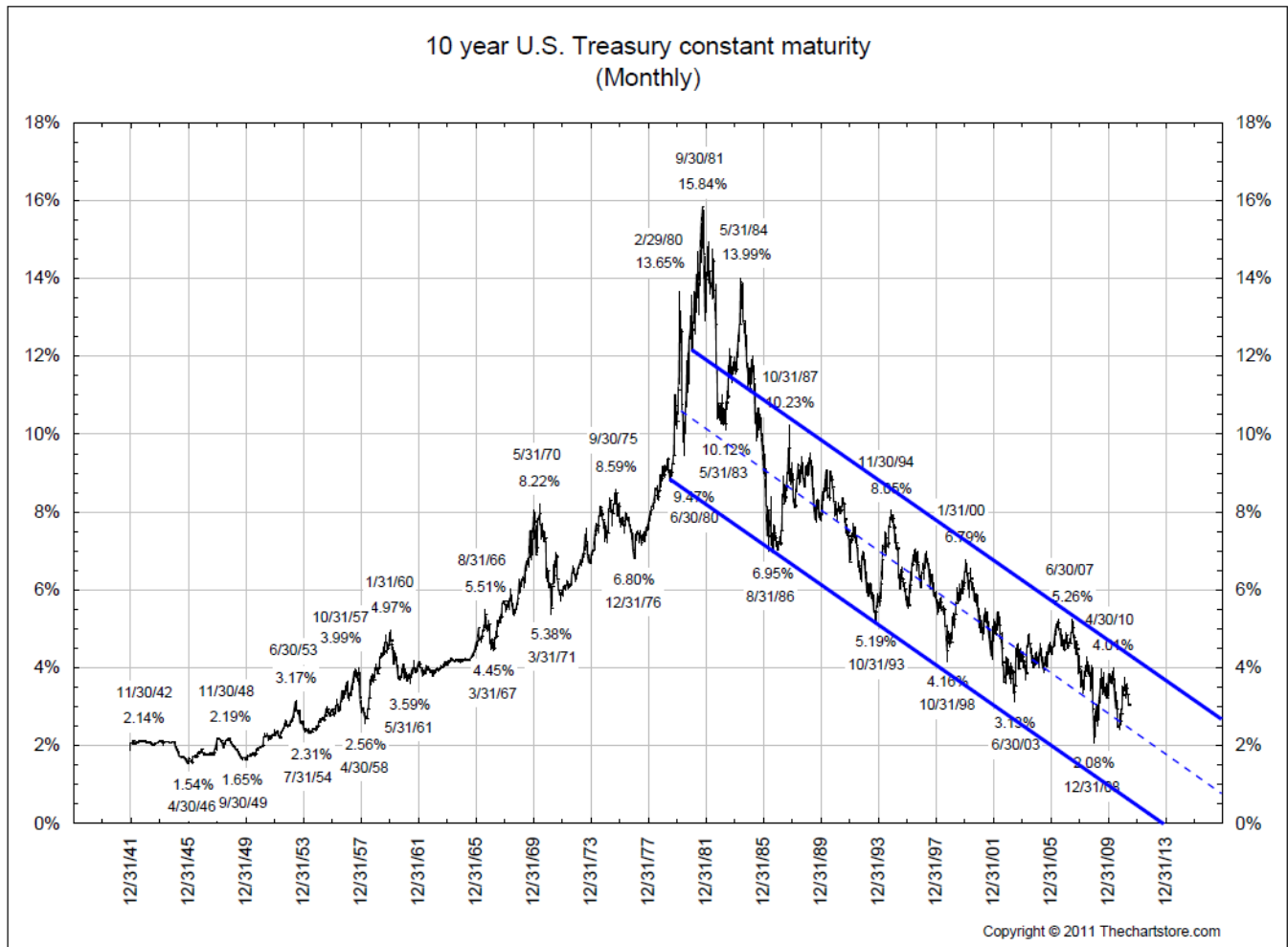
Now consider the following two yield charts for the 3-Year and 7-Year T-Notes:





The yield charts for the 2-Year and 5-Year T-Notes are extremely similar to the above charts for the 3-Year and 7-Year T-Notes. These are the four treasury securities where the Fed has focused their buying over the past seven months. The yields on all four of these securities are low, but not anywhere near their lows of 2008 or 2010. With these four treasury securities representing almost half of the treasury offerings being made this year, we can see why the Fed is so focused on trying to hold down their interest rate yields. There is not as much interest in purchasing these securities by the public as there is in the shorter term treasuries. Consequently, that additional buying by the Fed adds at least some downward pressure on the yields. The Fed has said that one of their goals is to hold interest rates down. They could be having that effect in this space, as we can see that the intermediate term trend for these yields is still downward. Of course, the longer term trend for all of the treasury securities has been downward since the early 1980's, as evidenced by the following long-term chart for the yield on the 10-Year T-Bond:

Data as of May 2011

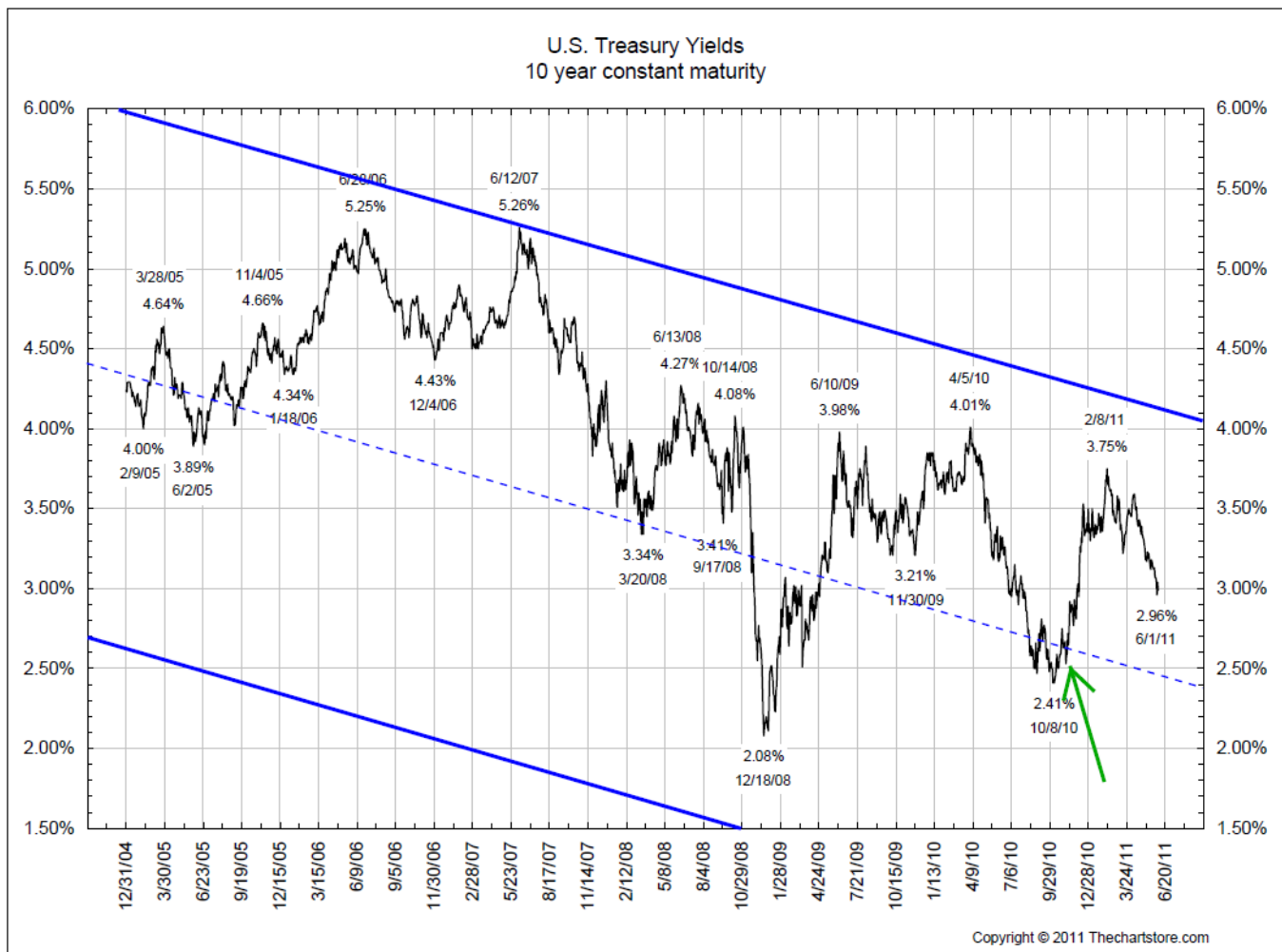




As we have repeated in past Tech Spotlights, until the yield breaks out above the downward sloping upper trend line (currently around 4.15%) we expect the yield on the 10-Year T-Bond to continue to work its way down to at least 2.5%, if not lower. And, if the sovereign debt issues in Europe and Japan are not successfully resolved, we could see a temporary worldwide flight to the “safety” of the U.S. Dollar and our Treasury securities, which could lead to the yield on the 10-Year T-Bond heading on down to at least the dotted middle downward sloping trend line.

It is interesting to note in the shorter term view of the yield on the 10-Year T-Bond (in the chart below) that when the Fed began to implement QE2 in early November 2010 (green arrow) that the yield began to almost rise vertically. It wasn't until the tsunami hit Japan in early March that money began to move back into the 10-Year T-Bond driving the yield down from 3.75% to its current yield of 2.96%. Part of the renewed interest in the 10-year US T-Bond is due to the concern over the perceived “safety” of their counterpart sovereign bonds in Europe.

Data as of June 3, 2011

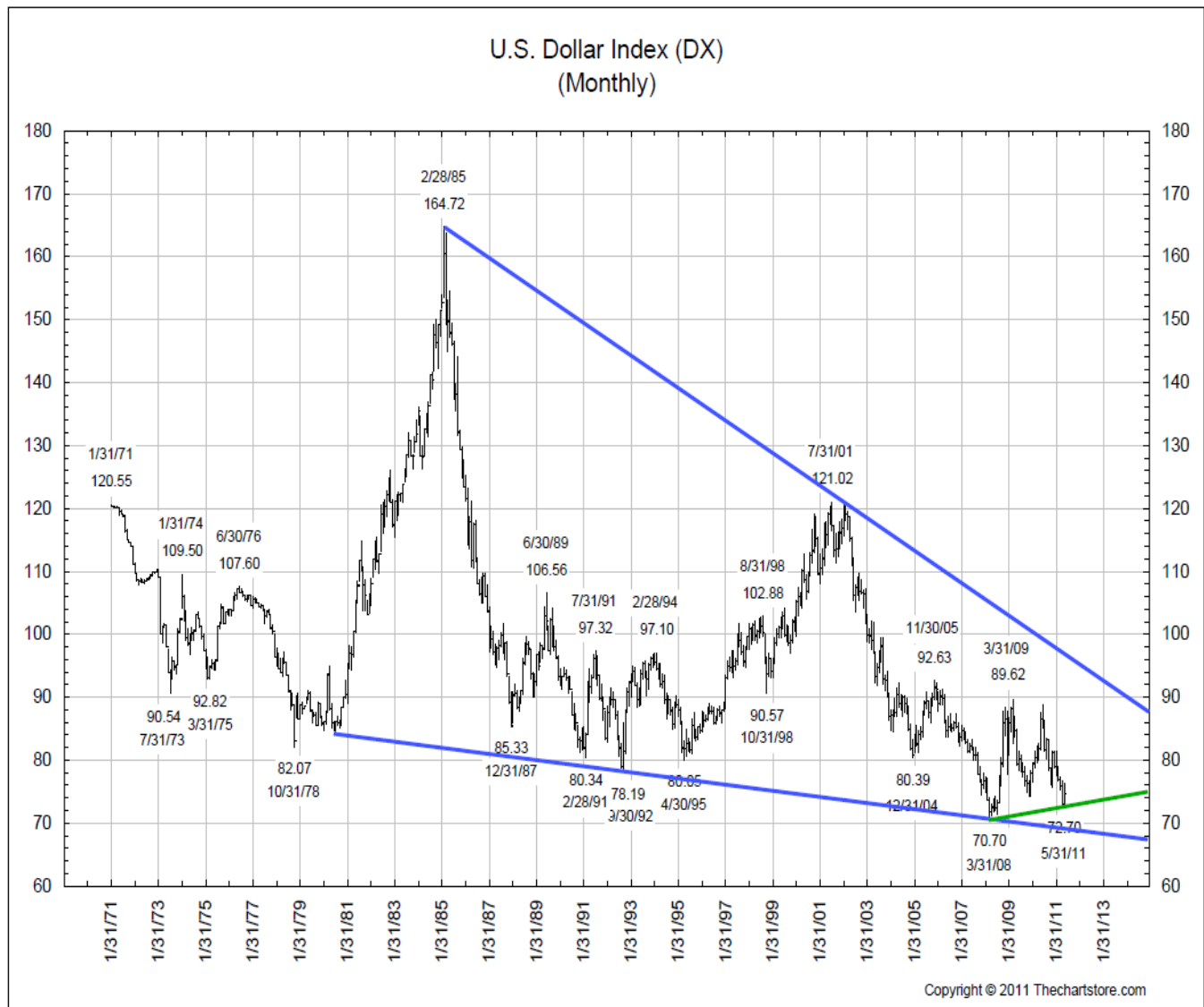




So, what is happening with the dollar? If there is to be any increase in international interest in the mid-term and/or longer term U.S. treasuries, we should see, at a minimum, a consolidation/stabilization in the U.S. Dollar Index (the DX/Y).

The US Dollar has been in a long-term downtrend since 1985, as you can see in the chart below. We have talked in earlier Spotlight issues about how the Dollar has room to rally up to 90 and still remain in that downtrend. A rally to 90 from where the US Dollar is today (73.5) represents a 22% move. Since the Dollar “bottomed” in 2008, it appears to be moving upward in a short-term uptrend (green trend line below). But that short-term uptrend is not yet firmly entrenched so that it may expand into an intermediate term trend with some “teeth” to it.

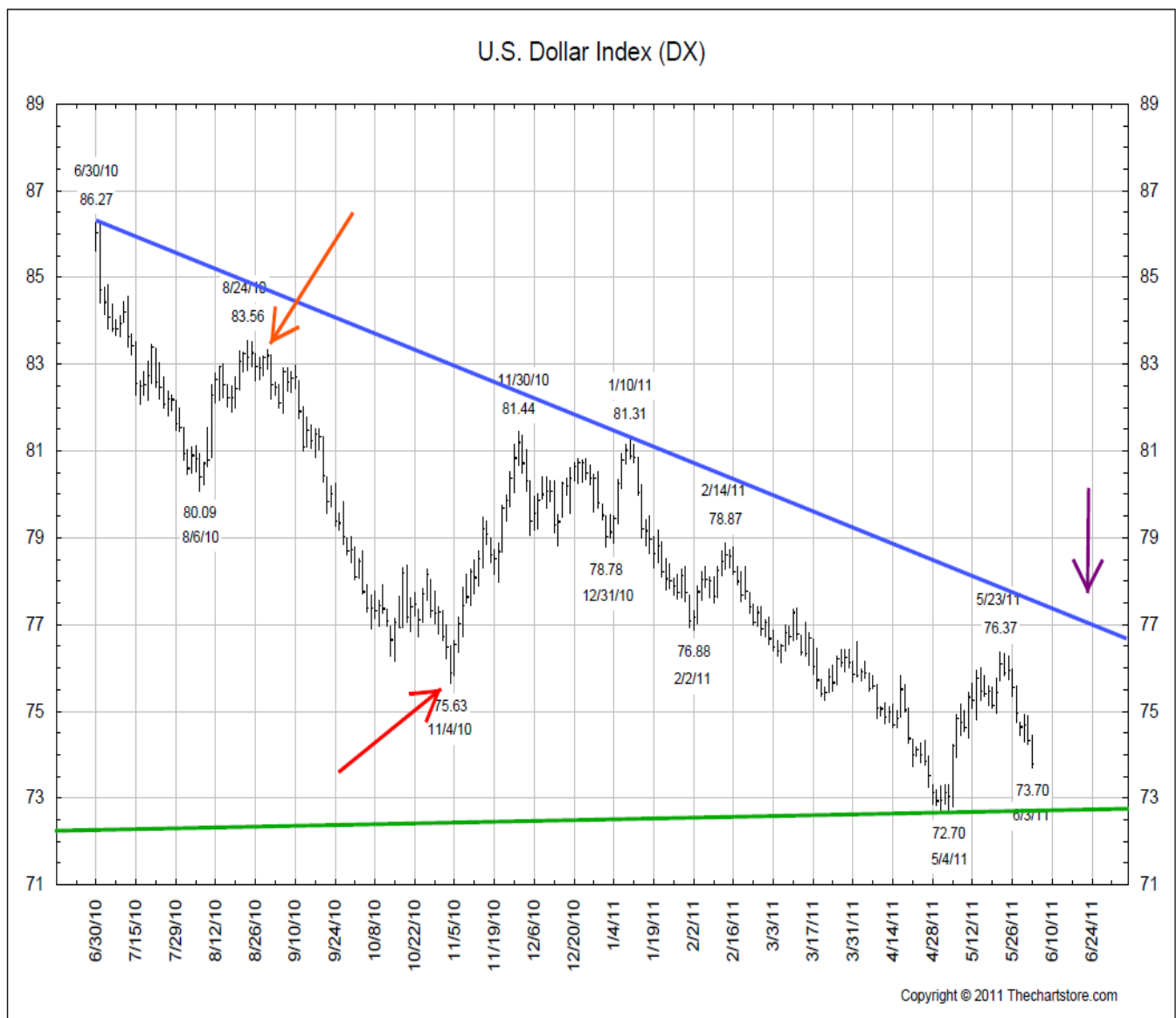
Data as of May 2011





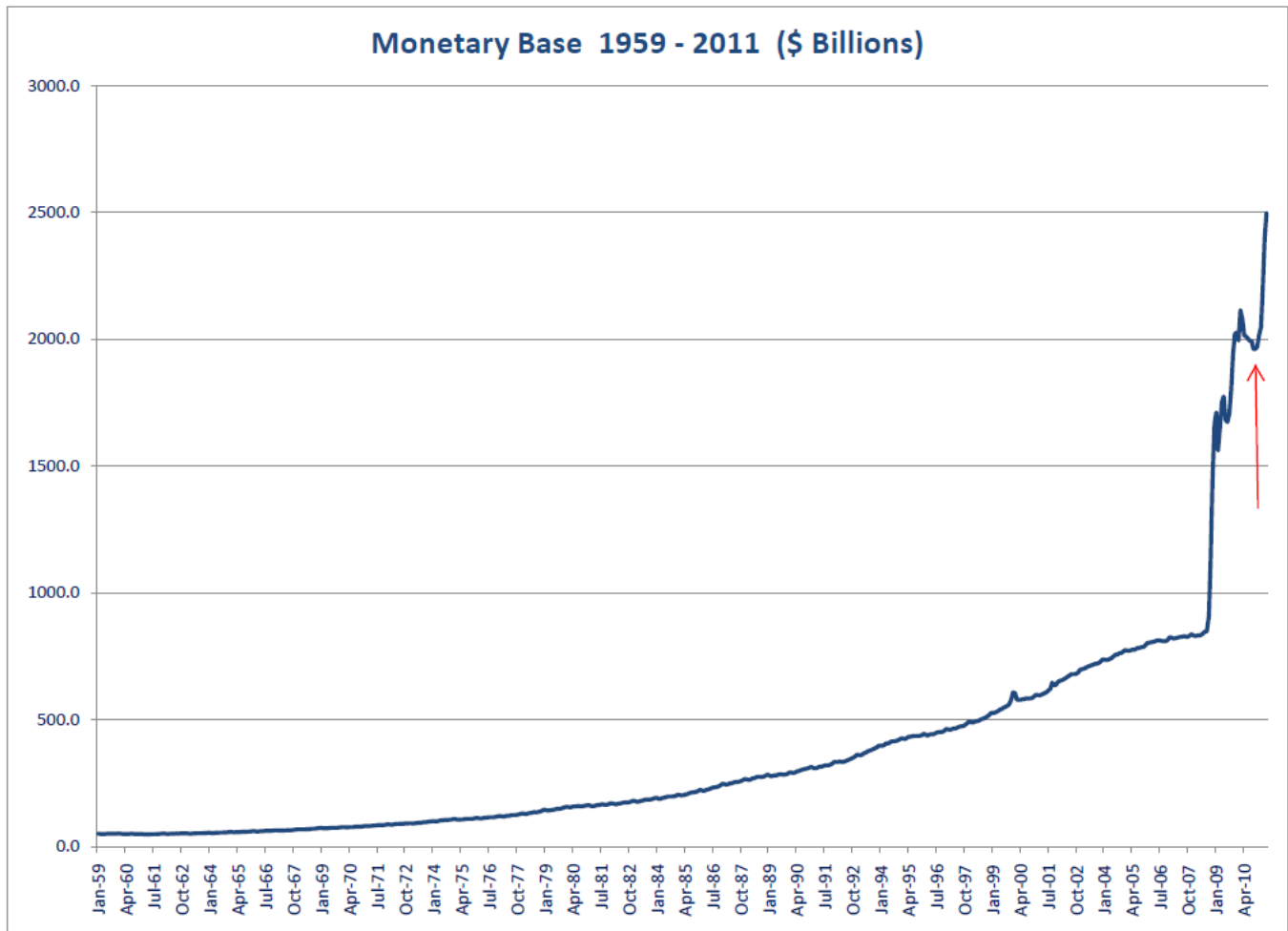
Below is a view of the US Dollar's movements in the short term. The orange arrow indicates when Chairman Bernanke began to talk about the possibility of a QE2. The Dollar almost immediately began to fall. Once the Fed began to implement QE2 in November 2010 (red arrow), the Dollar staged a 7% rally before rolling over and heading down again. We are at a point where the Dollar needs to at least consolidate and begin to rally in order to "hold" the short term green uptrend line from the longer term chart of the Dollar. And to see real buying interest from the international community, we should see the US Dollar break out above \$76 (purple arrow in this shorter-term chart).

Data as of June 3, 2011





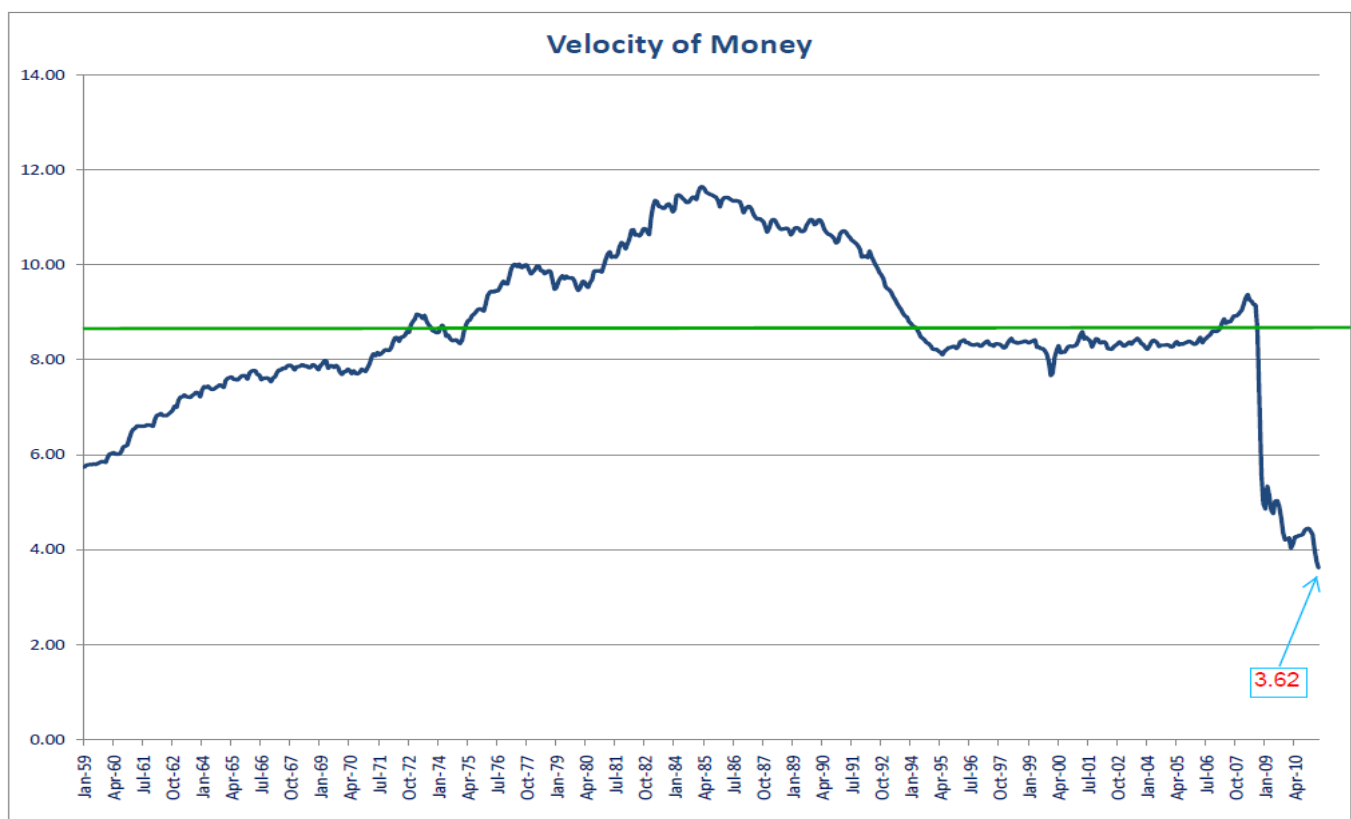
If the Federal Reserve's Balance Sheet has been rising so dramatically over the past few years, where is the money coming from to do all the buying? From the US Treasury, of course – does money just grow on trees? No, but it does multiply well with a simple keystroke on a treasury computer. Below is a chart of the growth in the size of the US Monetary Base:



Between 1959 and the middle of 2008, the US Monetary Base grew at an average annual rate of 5.9% (a little less than the Fed's Balance Sheet annualized growth rate of 6.7%). And, just to give an example of the consistency in that growth rate, from 1990 to 2008 the Monetary Base also grew at 5.9%. But, beginning in September 2008, the size of the Monetary Base exploded almost vertically, averaging a growth rate of almost 50% a year since! (The Fed's Balance Sheet grew at the rate of "only" 40% during that same time). The red arrow indicates when the Fed began to implement QE2 in November 2010. You can see the Monetary Base grew by almost \$600 Billion during this time (the past seven months) which is just about equal to the estimated size of direct QE2 intervention.



As we have discussed in the past, with all of the growth in the Monetary Base, why are we not seeing more dramatic signs of inflation? And why are some people still talking about the possibility of deflation? That is because the velocity of that money has reduced greatly over the same time period. Velocity is one measure of how fast a dollar is able to move through an economy and be reused. In a healthy economy, we would expect to see a Velocity of “9”, and at least rising in the case of a successfully recovering economy. The actual average for this Velocity of Money indicator going back to 1959 is 8.66 (green line).



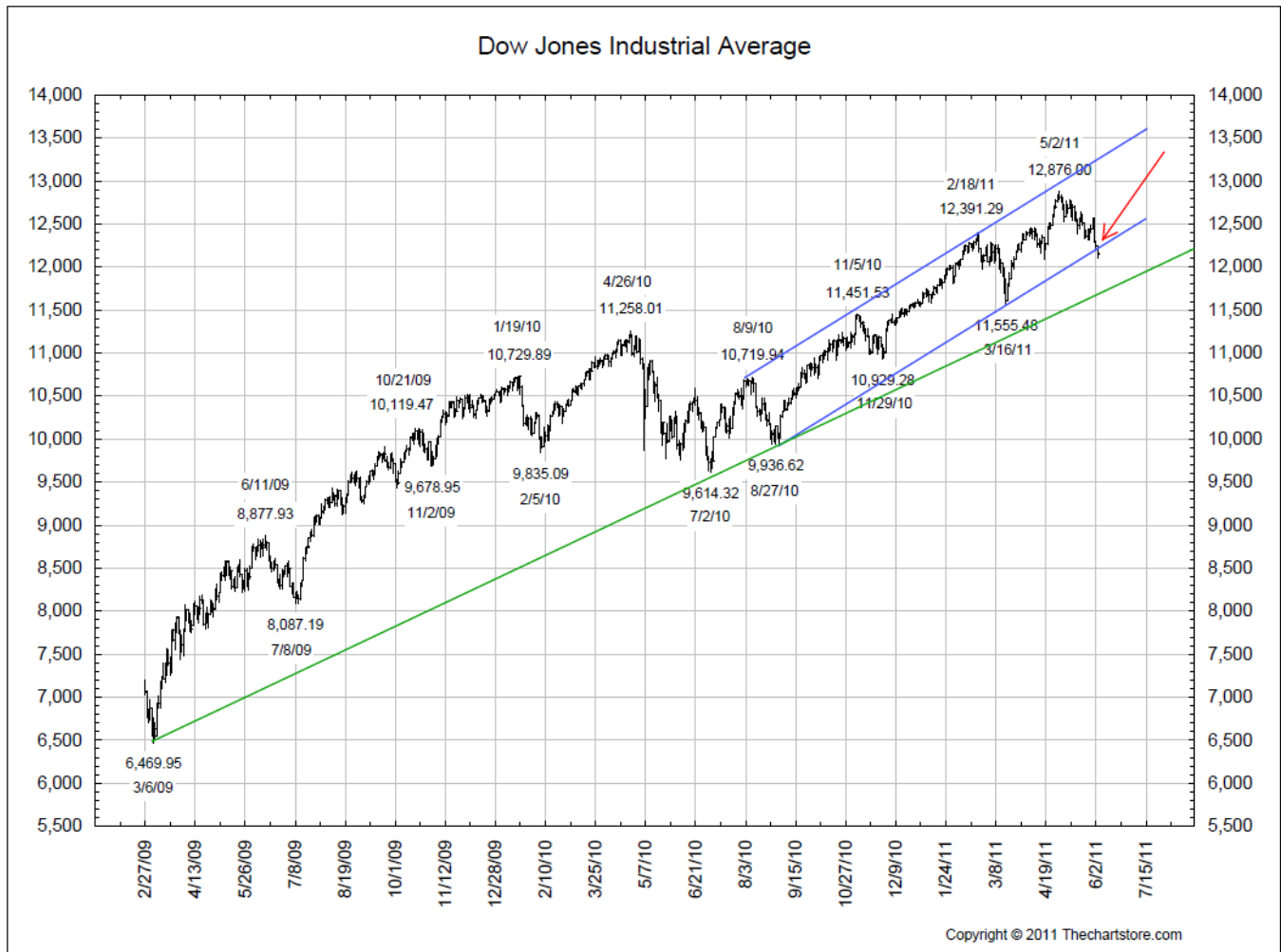
As you can see, after seeming to “bottom” and then beginning to rise in early 2010 amongst all the talk of a recovering US economy, the Velocity of Money has again turned down and gone to the lowest it has been in at least 50+ years. And it does not, yet, appear to be bottoming, or at least even consolidating. Until we see this indicator turn up, it is hard to imagine the economy gaining any sustainable strength.

It is interesting to note that when the Velocity indicator is above 9.5, the economy was experiencing periods of high inflation, which only makes sense. Anyone remember the high inflation days in the 1970’s and 80’s?



Now, to the stock markets ...

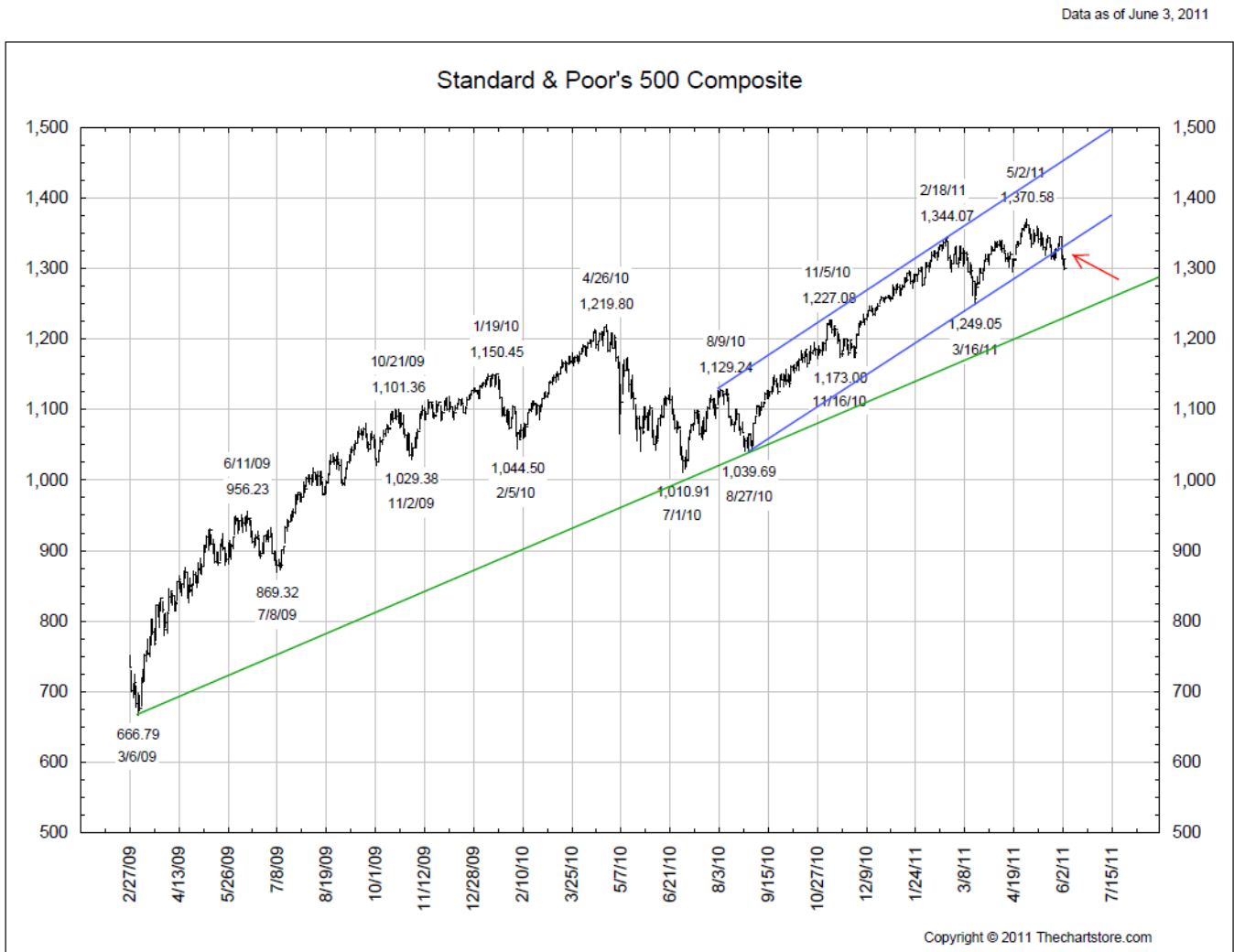
Data as of June 3, 2011



The Dow Jones Industrial Average has been trading in a narrow upward trending channel since Chairman Bernanke began his talk of the possibility of QE2 in late August 2008 (the two parallel blue lines in the above chart). [How many times have I repeated this statement about Bernanke in this Spotlight? And people wonder whether there is a correlation between QE2 and the markets?] The Dow 30 broke down below this trading channel last Friday. We would expect the index to struggle for at least a short while during which it may wander on down to the more important green support line running from the market lows that were established in March 2009. If the Dow breaks below 11,700 (along that green trend line) we would pay serious heed. Otherwise, the markets' movements will resemble those of a "normal" market adjustment/correction to the end of the stimulus provided by QE2.



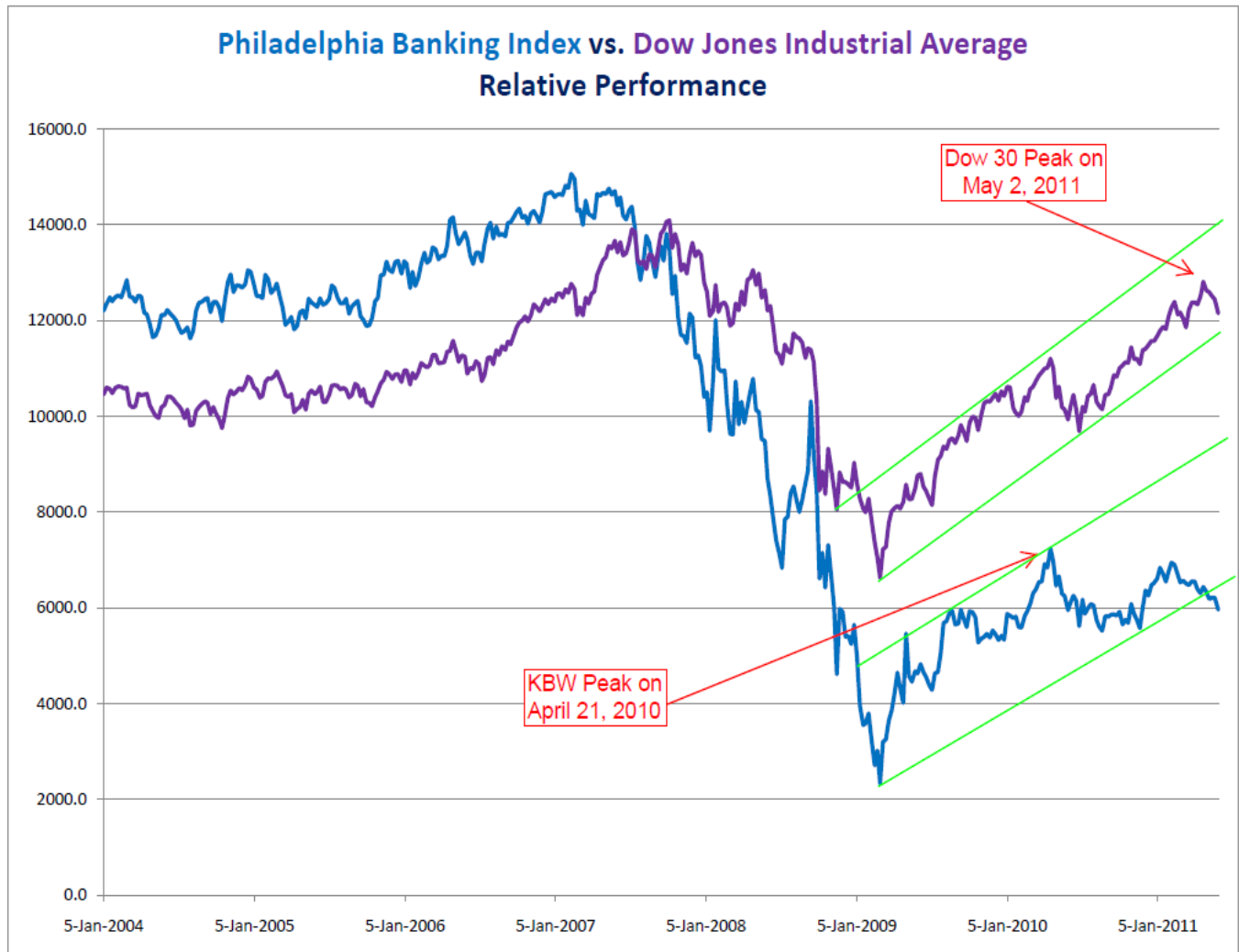
The chart for the S&P 500 is very similar to that of the Dow 30. It is also trading in a channel since August of last summer, and, it, too has broken down through that up trending channel and looks to test the more important green uptrend line from March 2009. Its area of concern along the green trend line is in the neighborhood of 1240 – 1250.



When trying to determine if there is a major trend change brewing in the markets, technical analysts look for indices that begin to diverge in their trends. For example, consider the case when two indices that generally trend together begin to diverge from each other. This could be a sign that the diverging index would eventually change back to the original trend or that the second index would eventually experience a change in trend to get back “in line” with the first. Whichever result occurs, the divergence, however temporary, says that it is a time to pay attention to the possibility of a trend change.



Below is a chart that compares the performance of the Philadelphia Exchange Bank Index (KBW - an index of 24 of the biggest publicly traded banks in the U.S.) versus the Dow Jones Industrial Average:



The Philadelphia KBW Bank Index includes such banks as Bank of America, Bank of New York, Citigroup, Commerce Bancshares, Comerica, Capital One, Fifth Third, JP Morgan Chase, Northern Trust, State Street, US Bancorp, Wells Fargo, Zions and others.

Generally speaking, the KBW Bank Index trends very well with the Dow 30 Index, the S&P 500 Index and a number of other broad market indices. Amongst all of the considered broad market indices, the KBW is the only one to break its uptrend line generated from the market "bottom" in March 2009 (again, the green uptrend line in the above chart).

The KBW Banking Index and the Dow 30 both bottomed in March 2009 and together began trending up at the same time and then they both experienced an intermediate-term top in April 2010 (pink arrows). But it is here where their paths began to diverge somewhat. After correcting in the summer of 2010 and with the onset of QE2, the Dow 30 rallied over the next six months to new intermediate term highs. The KBW Banking Index did not. The KBW index, late to the rally party that began with just the talk of a possible QE2, only began to rally two months later at the time of the actual implementation of QE2, and its rally petered out within two months after that and has been trending down ever since while the Dow 30 moved higher.

One more divergent sign – the Dow 30 and most other broad stock market indices fell about 55% between late 2007 and early 2009. The KBW Index lost 85%. In the subsequent market rally, the Dow 30 has since made up over 80% of that loss (and some of the other broad based market indices made up close to 100% of their loss). The KBW Index only made up about 40% of its loss and has subsequently given back about a quarter (25%) of that gain.

It is hard to imagine that, assuming the US economy is recovering and will continue to strengthen with the completion of QE2, the stock markets would continue to rise without the banking sector feeling some of the effects of an improving economy which would result in expanding profits. The KBW Banking Index is not currently acting like “good times” or even “positive muddling times” are taking place. Likewise, if the banking sector does not see any improvement, we would expect the KBW Index to continue trending down and, consequently, we would expect to see the markets’ broad based indices (like the Dow 30, the S&P 500 and the Nasdaq) all start moving lower for a more serious correction.

And we haven’t even discussed the details of the sovereign debt issues in Europe and Japan, nor the municipal debt issues in the U.S., nor the real estate bubbles in Australia and China, nor ...

In December we did a comparison of the charts for the S&P 500 and the yield on the 10-Year T-Bond. We determined that we should expect to see money flowing out of US Treasury bonds and into the stock market – and we have seen that happen. Now, without showing the charts here, we are seeing the reverse beginning to occur, at least on a short term basis. Is this another confirmation of a trend change?

What will the end of QE2 mean for fixed income and equities? Will it prove to be the same as the market volatility that appeared within weeks after the end of QE1 in April and May 2010? And, who will step in and do the buying of treasuries that the Fed has been performing in the middle of the yield curve for the past seven months?

At this point, all we can do is wait to see what the charts tell us. Which indices' trend will "win out" – the KBW Banking Index or the Dow 30?

Kenneth G. Hobbs III
Managing Partner

TECHNICAL ANALYSIS

Seeks to define the trend of various markets, be it short-term, intermediate-term or long-term.

Remember, markets never move straight up or straight down, they move more like the ocean tides, surging (trending) up or surging (trending) down until the tide changes direction. We use various chart time horizons to give us an idea of how far a wave will move within a tide. Our intent is to keep clients apprised of changes in the various markets' movements in the months and years ahead.

Technical Analysis operates under three Basic Premises:

1. Market Action discounts everything. Or ...

Supply Versus Demand governs market action.

2. Prices move in trends. And ...

Trends stay intact until broken.

3. History often (but not always) repeats itself. Or ...

At the very least, it sure seems to rhyme.

The study of charts is based on the evaluation of past events to determine future probability. We seek a stock, or other asset or financial instrument, forming a particular pattern. We note that this pattern resembles that which typically precedes an asset's upward or downward move. In this way we are able to use our knowledge of the way a particular asset has acted in the past to estimate this particular asset's most probable future move. There will be a rational, logical and fundamental explanation for a particular chart formation usually following a given move in price.