House of Mirrors

October 17th, 2012

Dear Clients and Friends,

Did you ever try to navigate the "House of Mirrors" as a kid at your local carnival? You know the one I mean ---- where you walk through a labyrinth of mirrors designed to confuse your orientation while mocking you with various distortions of your body? If you were particularly skilled, you could use the mirror to your own advantage. By posing in just the right way ---- you could generate flat abs, large biceps, and a broad chest --- a pleasant distortion. (Ok, maybe this was only a guy thing…) Essentially, the humor in such a place is derived entirely from a disconnect between what is factual reality and what you think you are seeing. What a compelling metaphor for the current state of the financial markets. Please let me explain…

Did you know that the Federal Reserve is currently purchasing between $65 and $85 billion of residential mortgage-backed securities (RMBS) in the open market each month and intends to do so indefinitely? This purchasing program represents most of the volume of RMBS transactions on a monthly basis in the market and is significantly manipulating the pricing of these assets. The average price of these bonds is already 9% above face value/par, and we are just getting started. For the moment, this ~~manipulation~~ pose in front of the ~~market~~ mirror is a pleasant distortion. The problem is that the slightest flinch will alter the distortion ---- which may go from pleasant to horrifying. So, how long can we hold the pose? Such massive manipulation carries substantial risks, not the least of which is the Law of Unintended Consequences.

Perhaps the best recent example of this Law occurred when the Tech Bubble burst in 2000. Federal Reserve Chairman Allen Greenspan successfully utilized aggressive monetary stimulus to re-start the economy at the time. We experienced a pleasant distortion… Unfortunately, the unintended consequence was the creation of what we now know was a massive housing bubble. In fact, the Tech Bubble was not eradicated. It was simply transferred to real estate.

By manipulating the bond market, the Fed's current monetary stimulus is once again designed to ~~create a pleasant distortion~~ re-start the economy by lowering borrowing costs on real estate. These manipulated prices have spilled over into other asset classes as well. Real estate refinancing activity has strengthened bank profits. Buyers/investors are being drawn into the residential real estate market. The stronger real estate sector is feeding the construction/remodeling industry. Ultimately, a stronger construction industry will spill over into other sectors of the

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economy as these workers spend earnings. Such a "virtuous cycle" is exactly what the Fed is hoping to achieve.

However, it is wise to remember that this entire game is being played in front of mirrors that are distorting reality. Sadly, there is a pattern of decreasing effectiveness in these ~~monetary stimulus packages~~ planned distortions as evidenced in the chart below cited by Dr. Lacy Hunt of Hoisington Investment Management in his most recent commentary:

Quantitative Easing: Critical Market Values
Positive Responders to Inflation/Risk

		QE1 Change	No QE	QE2 Change	No QE	W.S.J. QE3
		1.	2.	3.	4.	5.
1.	S&P 500	36.4%	-9.0%	24.1%	-5.6%	6.8%
2.	Gasoline	30.3%	-8.6%	36.8%	-5.5%	19.1%
3.	GSCI-Food	7.1%	19.1%	21.7%	-5.5%	18.7%

Source: Federal Reserve, Bloomberg, Haver Analytics, NYMEX, Standard and Poors.
(Column 5 is from June 20 through Sept. 30, 2012.)

Notice that the real effect of these QE moves is to consistently increase the cost inputs (gas and food) while obtaining smaller asset value gains with each new QE initiative. This inflation cost actually hinders economic growth. Essentially, dollars that otherwise might be used to productively grow our economy are now required to pay our food and gas bills.

Eventually, the Fed will have to stop buying mortgage bonds. Eventually the market will have to mediate rational discourse between buyers and sellers without interference from the Federal Reserve. Does this mean that markets necessarily must implode? Not necessarily. It simply means that we do not know where the market will price assets ---- as the market is clearly not solely responsible for today's price action in most asset classes.

The U.S. is certainly not alone in the quantitative easing/monetary stimulus game either. Virtually the entire world is trying the same experiment: the Bank of England, the Bank of Japan, the European Central Bank, and even the Bank of China. Such global coordination of monetary stimulus is both breathtaking and unprecedented.

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Out of respect for the unintended and as of yet unknown consequences of this global stimulus, I continue to believe that alternative investments offer superior risk management and compelling value. Is it prudent to shun broader financial market participation in the face of such strong global political willpower? That is a very fair question --- one I would like to answer by asking another. What durable economic growth has actually been achieved by this global political willpower? Earlier this month and for the second time this year, the International Monetary Fund reduced its forecast for global growth to 3.3% in 2012 and 3.5% in 2013. The bottom line is that in the face of historic and unprecedented monetary stimulus, global growth is still questionable at best. Meanwhile deficits and sovereign debts continue to be largely unmitigated and risk assets continue to edge higher. In my view, it is entirely possible that we are all walking casually through a house of mirrors unaware of the vast difference between reality and what passes for a pleasant distortion in the mirror before us.

By Jeremy Boynton, CFP ®
Founder, Laureate Wealth Management