

# The Greatest Challenge

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**W**illie Sutton, arguably the most accomplished bank robber in American history, had his most productive years between the late 1920's and 1952, when he was arrested for the final time. Over that period he robbed about 100 banks. "Willie the Actor" or "Slick Willie", as the police nicknamed him, was an expert in disguise when he was working, and a charmer who eschewed violence. When asked why he continued to rob banks despite his many years in prison he replied, "Because that's where the money is".

It's a good thing Willie didn't work for Fed. The Fed has the authority to print money, a useful tool when liquidity is constrained by recession or during periods of unnatural financial stress. Such was the scene during the serious crises of 2008 and 2009. The crises actually began in 2007 with the decline in U.S. housing prices and subsequent delinquencies of subprime mortgages. As it turned out, the crisis of subprime mortgages was only the initial phase of a much wider problem brought about by the opacity of complex credit instruments. These were created by financial intermediaries with no understanding nor interest in the consequences of their actions. As subprime mortgage delinquencies increased, financial institutions responded by becoming more risk averse, and either ceased trading in these instruments or demanded substantially higher compensation to take on the risk. The crisis boiled over in September, 2008, with the failure of Lehman and near death experience of other major financial firms. Credit markets and liquidity dried up.

The Fed moved quickly to fill the liquidity gap. Its initial response was aimed at enhancing short term liquidity across financial intermediaries. That was accomplished by reducing the federal fund rate by a cumulative 325 basis points between September, 2007 and April, 2008, and other actions aimed at shoring up short term liquidity. The federal funds rate remains essentially at zero today. The actions were successful in bringing down lending rates. Credit markets and traditional financing sources among banks remained closed, however. In responding to the multidimensional nature of the crises the Fed created a broad array of new mechanisms targeting interbank markets and increasingly, specific non-bank markets. Thus, the Term Securities Lending Facility allowed dealers to swap illiquid mortgage backed securities for treasuries, which could then be used as collateral for borrowings. Other targeted programs provided liquidity backstops to money market mutual funds and to commercial paper borrowers. The common element among the increasingly aggressive Fed actions is the willingness to use its balance sheet to extend credit and purchase the securities of a wide variety of institutions and market sectors.

Similar to the U.S., European and England central banks took steps to improve liquidity by quantitative easing programs of their own. Through the process of expanding the kind of assets the central bank would accept as collateral, interbank interest rates were brought down to near zero. Since the liquidity crisis faded away monetary policy in the Eurozone has diverged from the



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US, as the European Central Bank backed off its accommodation. The Fed has moved ahead with additional aggressive steps, a policy which has become increasingly controversial.

As the Fed altered its focus from interest rates and liquidity to direct efforts to stimulate growth its purchase of debt securities grew exponentially. The Fed started purchasing mortgage backed securities in November, 2008. When it halted the program in June, 2010, it held \$2.1 trillion of bank debt, mortgage bank securities, and treasuries. The Fed's holdings of treasuries prior to the crisis were about \$800 billion. In response to a slower growth rate than it wished the Fed embarked on an additional \$600 billion program of treasury purchases, and instituted a program to reinvest mortgage principal and maturities in more purchases. Dubbed QE 2 this program is scheduled to end in June 2011, and is highly unlikely to be renewed.

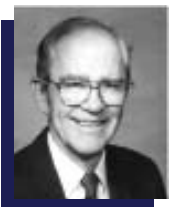
QE 2 has drawn sharp criticism from many sources and on many grounds. Liquidity is plentiful, and banks are flooded with excess reserves. The credit faucet is open again although demand for bank credit is still low. The Fed's primary goal in the \$600 billion purchase of treasuries is to inflate asset prices which had declined dramatically during the recession. In so doing the Fed hopes to recreate the "wealth effect", whereby consumers feel better off as their assets – primarily their houses – rise in value. As house prices increase the collateral such as mortgage backed securities also increases in value. The rationale is problematical. Explicitly

targeting an increase in inflation is a very dangerous game, with a potentially serious outcome especially for the millions of retirees living on fixed income.

There are other major concerns about the unprecedented direction of monetary policy. Many economists believe it has contributed to the rise of commodity prices over the past two years. The \$600 billion of new money creation explicitly monetizes about three quarters of all new debt created by the government's budget deficit, now running about \$1.5 trillion. This is in addition to the \$2 trillion of monetary stimulus since the onslaught of the financial crisis. The enormous supply of new dollars has certainly been instrumental in the decline of the dollar especially against the euro. Foreign nations, many of whom we rely on to purchase our debt, legitimately view it as an effort to devalue the dollar. Several of them have instituted currency controls as their currencies rise sharply in relation to the dollar.

No matter how well intentioned the Fed is, the distortions created by monetary policy will increasingly weigh on our economic outlook. The greatest challenge to the Fed is to engineer a reduction in its balance sheet and to back off the zero interest posture in time to avoid a totally new problem. Inflation is already visible in some areas, and once inflation takes hold it is hard to contain. Throughout history rarely has monetary extravagance ended happily. The extraordinary supply of newly created money would have made Willie very happy.

**Alfred A. Lagan, CFA, Chairman**  
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Mr. Lagan founded Congress Asset Management Company in 1985 and is Chairman of the firm. Mr. Lagan is a member of the Investment Oversight Committee and Large Cap Committee and Chair of the Fixed Income Committee. Mr. Lagan also is Vice Chairman of the Board of Directors of Congress Trust, N.A. Prior to starting Congress, Mr. Lagan held senior investment positions at several financial services firms. Most recently he was Senior Vice President, Senior Portfolio Manager, and director of several investment subsidiaries of the Putnam Companies. Mr. Lagan is a CFA charterholder and a member of the Boston Security Analysts Society and the Boston Economics Club. He has an MBA from New York University with distinction and a BA from Iona College.

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