ADVISER FUND UPDATE

Market Summary and Commentary for Individual Investors from Adviser Investments

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Markets Disembarking from QE2

The Federal Open Market Committee (FOMC) made a big splash this week when Chairman Ben Bernanke held the first live press conference in the central bank's 98-year history. Prior to the historic presser, the Fed announced it intended to wrap up its second "quantitative easing" program (QE2) by June 30.

If you are among those who normally associate the term "QE2" with a famous ocean liner, what follows is a quick primer on quantitative easing.

The FOMC has several tools at its disposal to manage interest rates, inflation, and the nation's financial system. Normally, adjustments to the Federal Funds Rate are sufficient to steer interest rates and the economy in the Fed's preferred direction. However, with the global economy on the brink of a depression in late 2008, the Fed took extraordinary steps to engineer what is known as "quantitative easing." These measures were taken to reduce interest rates, increase liquidity, stimulate the global economy and (some argue) artificially prop up the stock market.

From December 2008 to March 2010, the Fed bought $1.7 trillion of U.S. Treasury bonds and mortgage-backed securities (QE1). This helped breathe life into the economy by lowering yields on fixed income securities, reducing interest rates for consumer loans and mortgages and encouraging investors to seek higher returns in the equity markets.

When high unemployment rates and sluggish economic growth persisted, the Fed set sail on a second round of quantitative easing (QE2). Between August 2010 and June 2011, the Fed will have purchased an additional $600 billion of U.S. Treasury bonds.

While QE2 will end in June, the Fed will continue to reinvest about $17 billion a month in proceeds from its portfolio of mortgage-backed securities to buy Treasury debt. The Fed also announced it plans to keep short-term interest rates at ultra-low levels--where they've been since late 2008--for an "extended period."

Gauging QE2's Success

With QE2 coming to a close, some are questioning whether the program was successful. If the overall goal was to prop up market confidence and support economic growth, the results were mixed to positive. The stock market has clearly made a remarkable recovery, and QE1 and QE2 provided ample liquidity to the markets. Money flowed into riskier assets, drawing investors away from more conservative fare such as Treasury bonds. As a result, U.S. Treasury bonds and the U.S. dollar both declined.

Now that the Federal Reserve has announced it will not commit to an extension of its quantitative easing program, what happens next? Some believe the removal of the Fed's fiscal stimulus, combined with efforts to reduce government spending drastically, will weaken the U.S. economy and the stock market. Others contend the Fed's extra stimulus will trigger runaway inflation and a sharp rise in interest rates.

The table below suggests the end of QE2 could lead to a market rotation similar to what we experienced last summer, when stocks fell and bonds and the U.S. dollar rallied.

	QE1 Change (11/25/08 – 3/31/10)	Between Time (03/31/10 – 08/27/10)	QE2 Change (08/27/10 – 03/31/11)
S&P 500	36.4%	-9.0%	24.5%
Gasoline	30.1%	-8.4%	45.9%
GSCI	40.8%	-3.7%	42.1%
US Dollar	-4.6%	2.3%	-8.5%
10Y TSY Yield	+72 bps	-118 bps	+83 bps

Source: Adviser Investments Note: "GSCI" stands for "Goldman Sachs Commodity Index."

Investors who are tempted to dramatically increase their exposure to risk assets, especially commodities, may want to reconsider before moving too quickly. Although stocks and commodities benefitted greatly from increased liquidity during QE1 and QE2, both lost ground during the interim period last summer, while Treasury bonds and the U.S. dollar both gained.

What's the best course for investors? As always, we prefer a balanced approach for our clients. While liquidity is only one factor determining market direction, other key factors include earnings, valuations, interest rates and sentiment. Therefore, we think that maintaining a balanced and diversified portfolio managed by some of the best mutual fund managers in the business is the best approach over the long haul.

About Adviser Investments

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