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Quantitative Easing: A Curse or Blessing?

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Synopsis:

Déjà vu! As we vigorously attempt to exit a period of excessive leverage are we errantly extending and establishing tomorrow's doorstep to economic Armageddon? Are we malevolently remiss of the ineffectiveness of earlier 'Quantitative Easing' measures taken to resurrect a recessive economy?

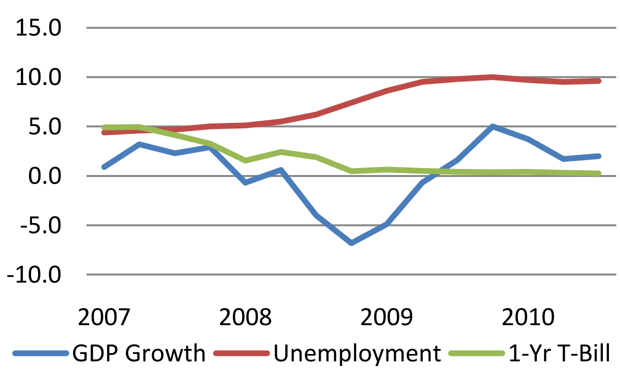
The authors through their research and writing of "Quantitative Easing: A Curse or Blessing?" examine the impact of the Federal Reserve Bank's 'Quantitative Easing' measures. Their discovery exposes concerns that need greater consideration for the well fare of the U.S. economy and beyond.

Quantitative Easing: A Curse or Blessing?

"Quantitative Easing" (QE), a lingering buzz-word, emanating from the hallowed halls of the Federal Reserve in Washington D.C. to all corners of our country and throughout the world, has profound ramifications for commerce. Through QE, the Federal Reserve intends to stimulate the U.S. economy by adding liquidity to our economy by purchasing Treasury securities. Through the purchase of Treasury bonds, especially those that are long term, the Fed is decreasing yields and, consequently, overall financial costs. Importantly, QE also impacts the economy by devaluing the US Dollar and, conversely, foreign currencies appreciate relative to the US Dollar. Subsequently, the US economy benefits from QE as export goods become more competitive.

The authors believe that the supply of additional liquidity through prior QE measures and the current implementation of QE II is a questionable solution towards resurrecting today's economy and, not a panacea in creating sustainable demand. QE II creates a new set of challenges and may not provide a macro-global remedy. Although, the earlier QE stimulus was needed to stem the possibility of a systemic collapse of the domestic economy, the authors today question the consequential benefit of such action and of further monetary stimulus relative to the potential detriment of significant inflation. As we attempt to leave a period of excessive leverage we do not need to create a path to re-leveraging consumer and corporate balance sheets. The earlier QE actions, as shown by the graph above, have not stimulated

Sources: Bureau of Economic Analysis, Federal Reserve, and Bureau of Labor Statistics.



sustainable economic growth. In retrospect, the earlier actions have created varied challenges for both consumers and corporate America.

Today, we are experiencing a period of unmatched economic uncertainty. In such periods, it is rational to seek safe harbor, especially investors from investment markets. Rather than seeking leverage, investors as well as corporations seek and take alternative routes to safeguard investments. With a lower propensity to assume risk, investors and corporate citizens often seek alternative means to generate return on investment and from a corporate perspective, Return on Capital (ROC).

Historically, the cycles of fear and hope have caused investment markets to be out of sync with the underlying fundamentals of respective economies. These peaks and troughs, caused by the dynamics of a free market economy, often provide great opportunities as well as challenges for even astute investors. Incremental liquidity, as afforded through QE measures, further distorts investment markets.

Today's economic crisis, the greatest since the Great Depression and irreverently referred to as the 'Great Recession', provides different challenges and opportunities. With a very low Treasury yield curve, the lowest interest rates in the decade[1], corporations benefit from a low cost of funding. The low interest rates are a consequence of the QE measures implemented earlier by a Federal Reserve focused on spurring economic growth.

The favorable Treasury markets, characterized by a low yield curve, entice corporations to access the bond market to secure extremely favorable financing costs and terms. Corporate issuers are enticed to consider issuing new debentures, yet it remains

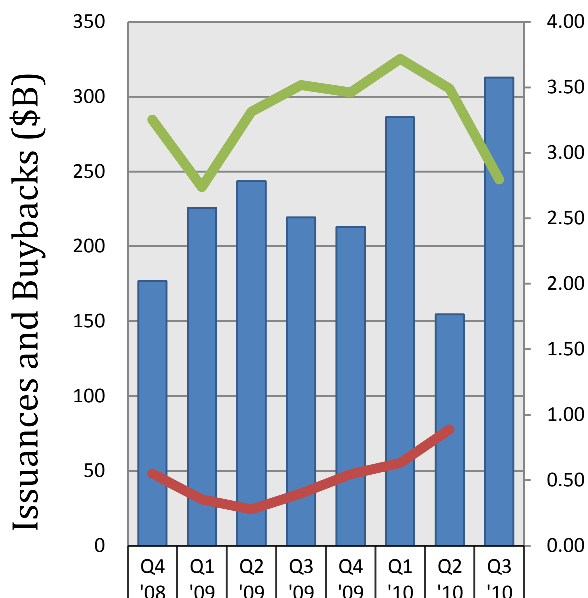
[1] Source: Federal Reserve

enigmatic as to what specific use they may apply such proceeds given the challenges of today's economy.

Nonetheless, the increase in new corporate issue debentures is striking. Along with the increase in new debentures it is apparent that there is a growing increase among corporate stock re-purchase programs. The authors have examined earlier QE measures to determine if there is a direct correlation between the new issuance of corporate debentures and the establishment of stock re-purchase programs.

We believe that a correlation between new debentures and stock re-purchase programs is evident and not coincidental[2]. The propensity for corporate chieftains to apply proceeds from their new debentures to re-purchasing company stock indicates the commitment to seek Return on Equity (ROE) in lieu of Return on Capital (ROC).

Source: S&P, SIFMA, and Federal Reserve



	Q4 '08	Q1 '09	Q2 '09	Q3 '09	Q4 '09	Q1 '10	Q2 '10	Q3 '10
Debt Issuances	177	226	244	219	213	286	155	313
Share Buybacks	48	31	24	35	48	55	78	
Treasury Yields	3.25	2.74	3.31	3.52	3.46	3.72	3.49	2.80

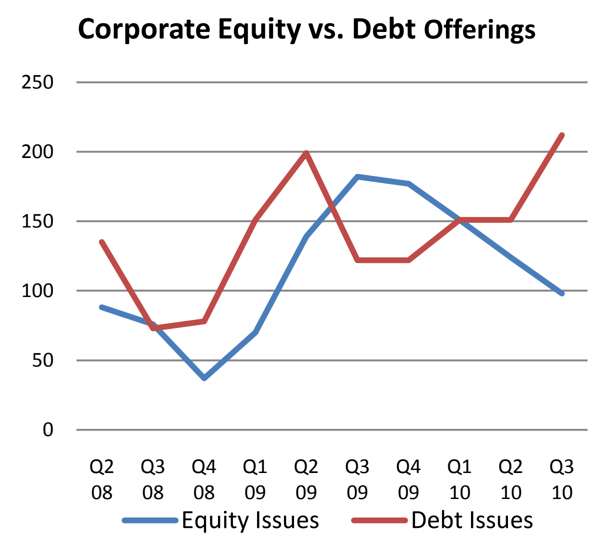
Debt Issuances · Share Buybacks · Treasury Yields

***Q3 2010 buyback data not yet released**

Alarmingly, greater investment returns are inaccessible due to the lack of current realizable investment opportunities. Importantly, the investment community should be aware of the inorganic derivation of reported earnings. Unquestionably, this will raise questions regarding the sustainability of such net earnings. Accordingly, earnings need to be closely examined to determine their source and sustainability.

[2] Q4 2008 debt issuance data is the average quarterly issuance in 2008. Calculation: (Total '08 issuance)/ 4

Today's distressed economy has caused many corporate executives to review alternative means to sustain revenue and earnings growth. With a challenging economy, which has limited and slowed top-line revenue growth and with cost-curtailment fulfilled, it is arduous to effectively manage earnings and shareholder equity. A lower Treasury yield curve causing attractive funding costs has influenced corporations to seek and take alternative corporate actions to increase ROC; including the establishment of stock re-purchase programs. The re-purchase of company stock decreases shares outstanding and effectively enhances earnings per share (EPS). Through issuing new corporate debentures and effectuating stock re-purchase programs, corporations have influenced and possibly impacted the potential to increase ROE, while leveraging their enterprises to new heights. The low financing costs have swayed corporations to generate Return on Capital through capturing increased ROE. The discourse of 'Quantitative Easing' has allowed corporations to issue new debentures at very favorable rates and terms, repurchase their corporate shares and, capture the potential to enhance ROE inorganically through financial engineering. With steady Price Earnings multiples, share price should appreciate with fewer shares outstanding and, allow shareholder equity and market capitalization to remain steady.



Sources: Bloomberg and ThinkEquity Partners

Spurring the growing interest among corporations to access funding through issuing new debentures is the continuing demand, and interest among investors to invest in fixed-income markets. Since early

2010, there has been an increasing propensity for investors to leave the equity markets and invest in fixed income securities. This transition to fixed income securities has been promulgated by heightened economic uncertainty and, consequent, decreasing investor confidence. Demand among investors for the comfort of a current return, as secured through investing in fixed income securities, spurs interest among corporations to continue issuing new debentures.

Broad macroeconomic indicators show that the US economy is not recovering as the Federal Reserve and the U.S. government intended. This has encouraged the Federal Reserve to continue decreasing interest rates to historic lows through QE in order to spur economic growth[3]. Through QE measures and the purchase of Treasury securities causing the decrease in Treasury yields there has been an increased propensity for corporate issuers to access the fixed income markets for lower cost financing. As interest rates decrease, the price of bonds increase and investors are furthermore attracted to invest. Our research, using data provided from the Securities Industry and Financial Markets Association (SIFMA), shows that the level of interest rates from 1996-2009 were inversely correlated with the level of bond issuances. We observed that, as interest rates decrease the nominal amount of bonds issued by US Corporations increase. This is consistent with economic principles stipulating that as interest rates go down the cost of issuing debt for a corporation decreases, and when price goes down, the quantity sold will increase to reach equilibrium. This explains the 11.57% YTD 2010 increase in the issuance of corporate debentures compared to 2009. New issuances of corporate

[3] "Bernanke Says Fed Will Act To Spur Economy : NPR." *NPR : National Public Radio : News & Analysis, World, US, Music & Arts : NPR*. 15 Oct. 2010. Web. http://www.npr.org/templates/story/story.php?storyId=130587303

debentures are increasing weekly, as reflected by the $33B+ issued during the week of September 10, 2010, a new record.

Our data reflect that the impact of QE I promulgated since 2007 has been ineffective. Growth in revenues among corporate America is questionable, unemployment remains high and private investors remain in ambiguity regarding the health or lack thereof of tomorrow's domestic economy. As a result, pessimism prevails among the investment community. The prevailing pessimism has driven many investors to re-consider their risk profile, withdraw from equity markets and, conversely invest in fixed income securities. Until investor pessimism declines, and, optimism and confidence in our economy are regained, there will be a low propensity for risk and a strong interest for fixed-income markets. Consequently, investor interest for fixed-income securities will further assist, among other factors, to decrease yields in Treasury securities.

Fear and hope are significant investment determinants influencing investor behavior. With an optimistic investment climate during 2006 and 2007, there was significant activity among new corporate bond issuances, with $1,058.9B and $1,127.5B in new debentures, respectively. This was despite an inverted Treasury yield-curve in January 2007, with the one year Treasury bill rate yielding 5.06 percent to maturity, and the 30 year Treasury bond yielding 4.85 percent to maturity. Subsequent to the economic collapse in late 2008, pessimism and fear were more than evident among the investment markets. In 2009, we had some of the lowest interest rates in the last decade but new corporate bond issues declined, as corporations remained perplexed about their economic future. Concern and pessimism were evident as exhibited by the limited number of new corporate debentures. Since 2009, with a favorable fixed-income market, corporations have become secure and confident in accessing the bond market. With greater confidence corporations have become comfortable in using new bond proceeds for stock re-purchase to inorganically derive higher ROE. Corporate management's focus on maintaining shareholder equity has become a primal factor encouraging the issuance of new corporate bonds.

Pessimism remains among today's investor markets. Along with the 'Quantitative Easing' measures exercised by the Federal Reserve the proclivity of investors to remain risk-adverse and invest in fixed income securities has kept the Treasury yield curve and interest rates low. With a low Treasury yield curve, various industrial and financial sectors have regained a penchant to issue new debentures at favorable financing rates and terms. The financial sector, notably large commercial banks, has prolifically accessed funding from the current bond market. Financial firms have represented approximately 64.66% of total new bond issues in calendar year 2010. While interest rates remain at a historical low the yields are higher than the current Federal Reserve discount rate. Thus, it is an enigma as to why financial firms are prolifically issuing new debentures, since a prudent borrower would aim to minimize costs at which money is borrowed and, the borrowing costs from the Federal Reserve is cheaper. Perhaps, this enigma may be answered by the new guidelines regarding Tier I capital reserves of 7.6% set forth by the Basel III Accords and 10.5% in Tier II capital, which can include corporate debt[4]. We believe the hesitancy to access Fed funds may be possibly due to the current erosion of asset portfolios and the inability of financial firms and banks to use them as full-value collateral with the Federal Reserve. Nonetheless, risk remains for those financial institutions that have increased their leverage thru accessing the fixed-income markets.

[4] Onaran, Yalman. "Basel Regulators to Bolster Bank Capital Requirements - Bloomberg." *Bloomberg*. 12 Sept. 2010. Web. <http://www.bloomberg.com/news/2010-09-12/basel-boosts-bank-capital-ratios-firms-get-till-2018-to-comply.html>.

Aside from the interest among the financial sector to access the bond market corporations are increasingly issuing debentures at record levels.

Company (Ticker)	Debt issued	Buyback amount
United Technologies (UTX)	$2.25 B	$4.3 B
Gilead Sciences (GILD)	$2.2 B	$5 B
Lowe's (LOW)	$2 B	$5 B
IBM (IBM)	$1.5 B	$8 B
Hewlett Packard (HPQ)	$3 B	$10 B
Philip Morris (PM)	$1 B	$12 B
Pepsi (PEP)	$2.25 B	$15 B
Wal-Mart (WMT)	$5 B	$15 B

The table on the left shows the interesting corollary between those corporations that are issuing new debentures and, establishing stock-repurchase programs. 8 out of the 10 biggest repurchase programs in the S&P 500 universe have been implemented by corporations issuing debentures[5]. Often, while waiting for an optimal time to implement their stock repurchases corporations are holding greater amounts of cash today, there is approximately $1.6T in cash on corporate balance sheets, accounting for greater than 6% of total corporate assets; most since 1964[6]. The cash has been applied to repurchasing stock as well as to increasing dividends as in the instance of Microsoft[7].

The consequence and impact of exercising stock re-purchase programs are profound. With the re-purchasing of stock the amount of outstanding stock decreases and, if total earnings remain unchanged, earnings per share will increase. Although market capitalization remains unaffected, the application of historic Price to Earnings (P/E) multiples for valuation may cause an investor to perceive that the company's stock is

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[5] Roesbaum, Eric. "Top 10 S&P 500 Buybacks of 2010 - The Street." *TheStreet.com*. 26 Oct. 2010. Web. <http://www.thestreet.com/story/10875488/top-10-sp-500-buybacks-of-2010.html>.

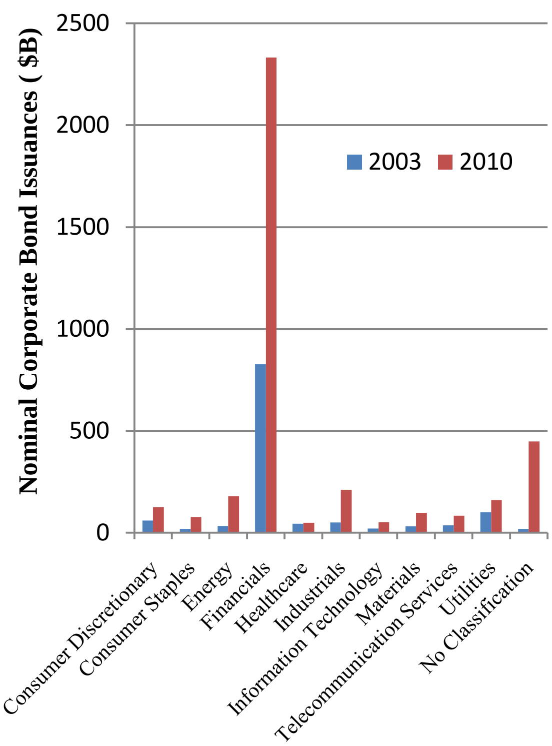
[6] Bowley, Graham. "Cheap Debt for Corporations Fails to Spur Economy." *New York Times*. 3 Oct. 2010. Web. http://www.nytimes.com/2010/10/04/business/04borrow.html?_r=2&scp=4&sq=graham%20bowley&st=cse>.

[7] Fierman, Greg. "Microsoft's Strategy: Borrow Cheap Money, Raise Dividend -- Seeking Alpha."*Seeking Alpha*. 5 Oct. 2010. Web. <http://seekingalpha.com/article/228428-microsoft-s-strategy-borrow-cheap-money-raise-dividend>.

undervalued and, consequently could spur them to purchase stock. The proclivity to purchase more stock will distort share price relative to the underlying economic fundamentals of the company. Certainly, stock re-purchase is not solely triggered by the new issuance of corporate debentures, but currently there are increasing instances where corporations are masking the lack of topline growth in revenues and, consequently driving ROE thru issuing debt and re-purchasing shares.

Another distortion attributable to the issuance of new corporate debentures is the payment of increased dividends. The application of debenture proceeds to pay dividends skews the underlying value of a given security. An increase in dividends, although beneficial to stock price in the near term, raises questions as to whether it may be sustainable. The issuance of new debentures will increase the leverage ratio of a company and, consequently, may increase their long-term cost of capital and weaken overall financial soundness.

Source: Bloomberg



In assessing the potential and possible impact attributable to 'Quantitative Easing' the authors have noted above the significant amount of new debentures issued today and the establishment of stock re-purchase programs. Aside from the application of bond proceeds to re-purchase stock to potentially increase ROE there has been a growing acceptance to increase leverage. This is alarming, especially as we migrate from an excessive period of borrowing. Today, the value of corporate bond issuance is three times the level of 2003.

The application of proceeds generated from the new issuance of debentures, as noted above, differs from the intent of the Federal Reserve to incite economic growth through earlier ‘Quantitative Easing’ measures. Rather than achieving top-line revenue growth among corporations, decreasing the untenably high unemployment rate and regaining economic sustainability, the impact from earlier QE actions have achieved results that may be counter to these objectives.

Earlier QE actions have generated adverse consequences. Attributable to the prodigious issuance of debentures and subsequent application of proceeds to re-purchase stock is the causative fracture between investment market fundamentals from the current economy. This gives further rise to considerations that may be detrimental to overall financial and economic health. Will the corporate stock re-purchase programs cause stock prices to divert from their underlying value? If so, will this distortion influence greater apprehension among the investment community, which may adversely impact the current economy? These considerations may not be readily apparent, but they will eventually be answered, hopefully not to our detriment.

Certainly, the issuance of corporate debentures has reached new heights and, possibly attained a saturation point. The Federal Reserve has lowered rates to historically low points and the availability of applying other monetary tools to resuscitate our economy are dwindling. Today, pessimism prevails among the equity investment markets and the possibility of a double dip economic recession is not remote. Nobel Economist Joseph Stiglitz recently stated that the fear for a double dip recession might be in the near future. If these concerns manifest and a double dip economic recession arise, Treasury yields will likely remain low due to existing and future QE measures. Fear and investor apprehension will further increase corporate yields. Should a double dip economic recession not occur, then inflation will emanate from these QE measures and the Federal Reserve will likely increase interest rates. With a stagnant economy, this may lead to another nightmare, namely that of 'Stagflation'. It would be an economic period highlighted by a stagnant economy with increasing inflation, an economic challenge greater than today's hurdles. The increase in interest rates will decrease bond prices since the price of a bond is inversely correlated with interest rates. This will not only be to the detriment of fixed income investors but also corporate issuers since the refinancing of debt will be done at a higher cost of capital. Thus, it would be more expensive for corporations to retire their debt.

We have discussed the impact of earlier 'Quantitative Easing' measures on the current economy and, specifically its adversarial influence on the financial markets. With the implementation of QE II, additional concerns regarding the propensity for the issuance of new debentures, from a diverse audience of the corporate sector, are profound. Whether the proceeds from the new debentures are applied to the establishment and execution of new corporate stock re-purchase programs or in enhancing dividend yield they have potential adversarial consequences. Foremost, the illusion that top-line revenue growth in earnings is real. Commensurately, the increase leverage in today's uncertain economic times impairs the financial stability of a corporation, diluting their credit worthiness and potentially increasing their future cost of capital. Although, it may be justifiable and beneficial to access bond proceeds in these times from a Return on Capital perspective, it may over time be injurious to the credibility of corporations' ROE and fracture shareholder confidence.

YAM Media

YAM Media, www.YAMMedia.biz, based in Menlo Park, California, is a leading publisher of insightful and poignant publications regarding Macro-Economics, 'Company Development' and, Investments. Aside from its publications, Mr. Yam is a global orator and, often addresses the above subject matters.

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