



QE II

December 2010

There has been much discussion in the media about the effectiveness, rationale and wisdom of further quantitative easing by the Federal Reserve. In our view, not only is a second round of quantitative easing ("QEII") a good idea, it is critical to keep the economy from slipping back into recession and, potentially, into another financial crisis.

The U.S. has experienced a massive financial crisis driven by excessive debt levels relative to incomes and asset values. As homeowners stretched to purchase homes, including second homes and investment properties, they drove prices to unsustainable levels. Many financed those purchases with little or no equity. One "banana peel" and the whole system came crashing down. Over indebtedness drove this collapse and caused financial institutions to suffer immense losses, become scared to lend to anyone, including their peers, and the funding markets to dry up. With the failure of Lehman Brothers, a prominent money market fund "broke the buck" and investors stampeded to the door - only Treasuries would do. Unemployment quickly rose from 5% to 10%, wealth declined significantly, and the economy teetered on failure.

Earlier, a financial crisis driven by over indebtedness has happened before - in 1929. The Great Depression resulted, including many bank failures, vast wealth destruction and 25% unemployment. Why? Two reasons that have held up to historical scrutiny by economists follow: the government allowed financial institutions to fail and the money supply to contract. Irving Fisher, in his 1933 paper titled "The Debt Deflation Theory of Great Depressions"¹, explained that it was the domino effect of an over levered economy with an economic recession that created the tinder for a deflationary spiral where institutions lost significant amounts of capital on bad loans, tightened their credit standards, sold off repossessed assets at depressed prices, which created low "comps" for remaining borrower assets, which caused more loans to be called, financial institution failures, etc. Sounds familiar. He said that the only way out of this spiral, once underway, is to either let all with debt to go bankrupt (which we tried in the 1930's and it led to Hoovervilles and 25% unemployment), or to "reflate" by printing a significant amount of money and create inflation to help the asset values of borrowers. He said that we might as well reflate right away since we will have to do so anyhow to escape the economic depression that will ensue if we don't reflate.

¹ Fisher, Irving (1933), "The Debt Deflation Theory of Great Depressions", [Econometrica](#).

Many history books cite WWII as the catalyst to get the U.S. out of the Depression. In her 1992 paper “What Ended the Great Depression²”, Christina Romer argues that government spending on WWII was not the catalyst to end the Depression, rather an increasing monetary supply served that purpose. She notes “...the simple but often neglected fact that the money supply (measured as M1) grew at an average rate of nearly 10 percent per year between 1933 and 1937, and at an even higher rate in the early 1940’s. Such large and persistent rates of monetary growth were unprecedented in U.S. economic history.” We are inclined to agree with Ms. Romer and feel that monetary policy, of which QEII is a part, is necessary to get the US economy growing again.

One critique we hear in the debate on QEII is "we printed a lot of money in QEI, it didn't work, therefore why are we debasing the dollar to no avail via QEII?" This critique assumes that we have printed enough money in QEI for the policy to have worked. We see no evidence that we printed enough money, simply that we printed a lot of money. Consider the camper who wants to start a campfire but has pile of wet wood. The camper can douse the wet pile with lighter fluid, throw on a match and see if the wood starts to burn. The match will ignite the fluid, but if there is not enough fluid to get the wood burning, the flames will soon die out. Using a process of trial and error, the camper will eventually find the amount of lighter fluid which will cause the wet wood to burn. Likewise, we feel there is an amount of monetary expansion that will get the economy growing – we just don’t know prospectively what that amount is.

But what about the inflation risk that monetary expansion brings? Inflation is driven primarily by wages. If wages increase significantly faster than productivity, inflation will result. Based on past experience, wages are estimated to account for 70% of inflation. Clearly, wages are not a problem today. In fact, in many instances, wages are actually falling. Witness the deflationary wage saga at SubZero, a Wisconsin manufacturer of refrigerators or at Harley-Davidson, a Wisconsin manufacturer of motorcycles. In these cases, the labor disputes are over how far wages fall, not whether they will fall. Further, housing is the largest component of the CPI. No pressure on prices there. Until wages begin to rise faster than productivity and house prices rise again, our concerns about inflation take a back seat to our concerns about US economic growth.

But what about Japan? In our view, Japan has focused on Keynesian policies more than monetary policies to address their economic issues. Keynes argues that when an economy is weak, borrow and spend. When strong, run surpluses and pay off the debt incurred. We see two problems with using Keynesian policies in the US at this time. First, other than in a brief period in the late 1990’s, we have not seen the US government raise taxes and cut spending to pay off debt in good times. Secondly, and more importantly, once an economy becomes over indebted, further borrowing can actually make the situation worse. Keynesian policies can work well if starting from a frugal, under levered base. Once large debts are incurred, we question whether Keynesian policies are workable.

² Romer, Christina (1992), “What Ended the Great Depression”, The Journal of Economic History, Vol. 52, No. 4, pp 757-784.

This brings us back to the Irving Fisher, and later, Milton Friedman solution: money. In "A Monetary History of the United States 1867-1960³", Friedman wrote that "inflation (and, by corollary, deflation) is everywhere and always a monetary phenomena." It is the amount of money in the system that dictates whether we will experience deflation or inflation. Combined with Irving Fisher, who wrote in 1933 that a debt induced financial crisis leads to deflation, this argues that we should error on the side of excessive printing of money as an insurance policy against a deflationary spiral that could lead to a second Great Depression.

In the spring and summer of 2010, after QE1 was finished, the stock market fell dramatically, the economy slowed materially, and corporate spreads began to rise. Federal Reserve Chairman Bernanke sensed that we were headed back into the storm and gave a speech in Wyoming that, if needed, the Fed would restart the printing presses. This gave the markets great hope: stocks rose, spreads narrowed, and financing restarted. Since the markets rallied from August to November, the month the policy was enacted, some are now asking "why are we debasing the dollar?" In our view, if we did not keep printing money, we risked falling back into another recession that could have led to another calamity. A little insurance now, which can be reversed later, is well worth the cost.

About the Author

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Mr. Thompson founded Vilas Capital Management in 2010, and has been its Chief Executive Officer since inception. Prior to this, Mr. Thompson was the founder, President and Chief Investment Officer for Mortgage Assurance Corporation (now NMI Holdings, Inc.) in 2009. From 1993-2009, Mr. Thompson was Vice President and Chief Investment Officer for Thompson Investment Management, Inc. Mr. Thompson was an officer of the Thompson Plumb Funds, Inc. from 1995-2009 and was President and COO from 2004-2009. Further, Mr. Thompson was the lead portfolio manager of the Thompson Plumb Growth fund from 1996-2009 and the Thompson Plumb Bond Fund from 1999-2009. He received a B.S. degree in Mechanical Engineering from the University of Wisconsin - Madison and an MBA with concentrations in Finance and Economics from the University of Chicago. His investment career began in 1993 and he has been actively involved in the management of mutual funds since 1994. Mr. Thompson is also a CFA charter holder.

³ Friedman, Milton, and Anna J. Schwartz, A Monetary History of the United States, 1867-1960 (Princeton, 1963).