

## More QE on the Way

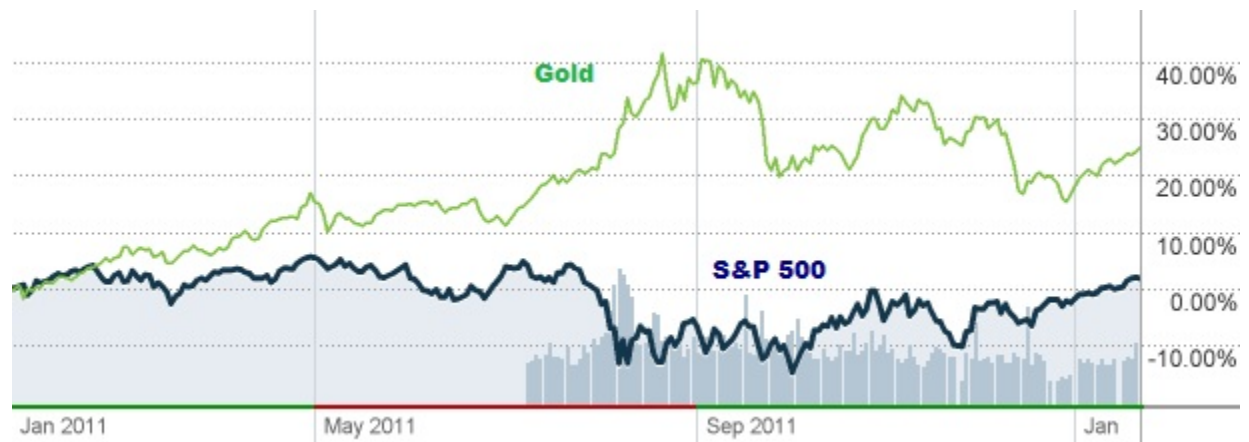
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There is an old saying around Wall Street: “So goes January, so goes the year.” Many traders believe that if the stock market is up in January, then the stock market will finish for the year in the black. Actually, there is some truth to the old saying. Data collected on the S&P 500 over the 65 year period of 1940-2004 show that the broad market closed higher for the year 69% of the time when stocks were up in January. Well, that’s better than flipping a coin, but it is hardly a basis for a successful trading strategy.

Fortunes are made by selecting the best investment compared to others. We have seen, for example, in 2011, stocks fared poorly compared to precious metals, investors in Treasurys lost capital and real estate values continued to decline. Many investors simply gave up and retreated to cash, which turned out to be a losing proposition as inflation cut into purchasing power of every dollar stashed away.



But there seems to be a change in sentiment in the air now. Despite massive debt, political gridlock, numbing high unemployment and turmoil abroad, there are some faint signs of optimism. The manufacturing indices have ticked up a bit, productivity has improved and even wages have inched up a bit. Consumer confidence is improving, and corporate profits may bring good news as the earnings season unfolds.

Even the Fed appears to be more optimistic. Last week, the Fed signaled it would hold off on new bond buying (QE3) for now, even though it trimmed its estimates for GDP growth for the New Year.

But not everyone is so sanguine about Fed restraint. Most traders and some economists believe the Fed will step in with another round of Quantitative Easing (QE3) in the first half of 2012. This round would be huge, as much as \$1 Trillion and targeted to support the ailing housing market. Under QE3, the Fed would purchase Mortgage Backed Securities (MBS), the derivative instruments that bundle thousands of home mortgages into a single, collateralized package. Many MBS's were considered “toxic” assets because they contained subprime mortgages that

defaulted, making them very difficult to price in secondary markets. When enough MBS's failed to fetch a bid, mark-to-market rules rendered them worthless, which destroyed many bank balance sheets and created the financial meltdown of 2008.

The next FOMC meeting is scheduled for this week, but there is little chance that the Chairman will announce the new round of bond-buying. But listen for Bernanke to list the continuing woes of the housing market, and its drain on the economy and growth. Housing will be the new demon. And Ben will excise it with a Trillion dollar dose of his favorite restorative quantitative elixir.

But the Fed has already injected \$2.9 Trillion into the banking system through expanded credit. The unprecedented credit expansion has failed to turn the ailing economy around. GDP is limping along at 2% or less. Unemployment remains at record highs. Capital is on strike, or out of the country. Adding another \$1 Trillion to the Fed balance sheet is not likely to make a positive difference. The technical reason is we have been stuck in a liquidity trap, where no amount of additional easing is effective.

Austrian economics gives the answer why. Fed intervention created a bubble in the housing market by artificially depressing interest rates. This encouraged malinvestment in housing assets by homeowners and speculators. Federal social engineering embodied in the Community Reinvestment Act, permitted unqualified applicants to receive taxpayer guaranteed mortgages, many of which ultimately defaulted. Government intervention in the markets is the cause, not the cure for our economic problems.

More QE would be welcomed by the Keynesians in Washington. More QE would pump up the stock market, particularly bank stocks. Higher stock prices give the impression that the US economy can't be that bad, after all. But more QE means higher prices in general. More QE debases the Dollar and reduces purchasing power. More QE means more inflation.

More QE means there is more reason to guard against inflation and artificially inflated assets. To the prudent investor, more QE means buy more gold.



One indicator cuts through the conflicting themes that affect the markets and the economy: the price of gold. The gold price is telling us that we are not out of the woods yet, and that there are many risks facing the US economic recovery. Gold continues to move up in price. The gain in gold is telling us to expect more volatility in the equity markets and to expect more pain from the European debt crisis, and maybe a military showdown with Iran.

The bull market for gold has a long way to go yet.

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