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WORSE THAN PUSHING ON A STRING – THE DANGERS OF A LIQUIDITY TRAP

Eccles: *Under present circumstances, there is very little, if any, that can be done.*
Goldsborough: *You mean you cannot push on a string.*
Eccles: *That is a very good way to put it, one cannot push on a string. We are in the depths of a depression and... beyond creating an easy money situation through reduction of discount rates, there is very little, if anything, that the reserve organization can do to bring about recovery.*
Congressman T. Alan Goldsborough supporting Federal Reserve Chairman Marriner Eccles in Congressional hearings on the Banking Act of 1935

Given the political realities of this year's election, I believe the Fed is the only game in town. I would urge you, now more than ever, to take whatever actions are warranted. So get to work, Mr. Chairman. ***Camera-shy New York Congressman Chuck Schumer July 2012***

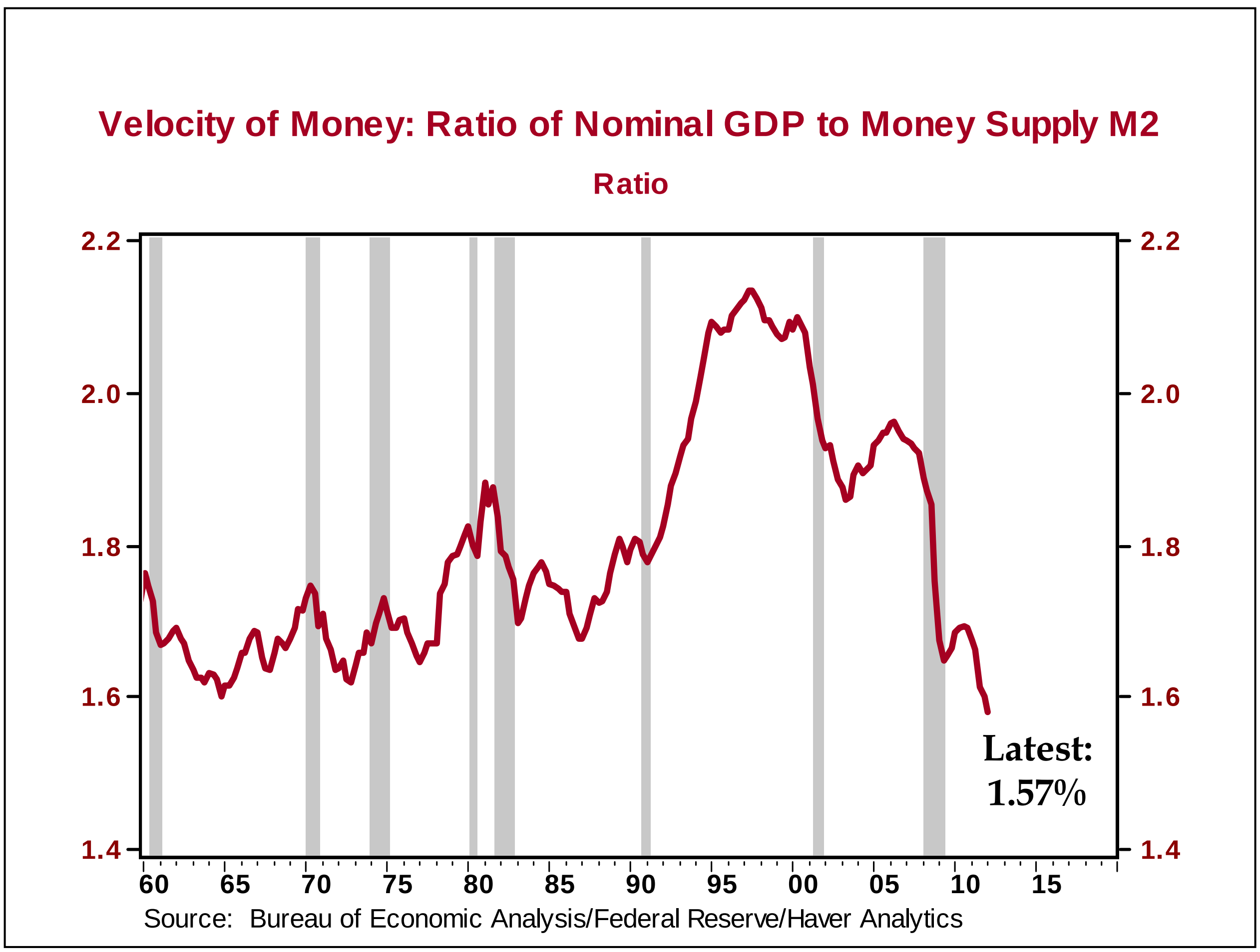
For those of you who might have been able to stand to watch it, Ben Bernanke's testimony and questioning from the House and Senate this week would have done little to shake your belief that the Chairman is a good and decent man trying to do his best or that Congress is largely made up of a bunch of narcissistic and odious yahoos whose primary concern is their own reelection rather than the welfare of the American people. Remarkably, Chuck Schumer's entreaty was among the most coherent statements during the hearing, offering absolutely no pretense about the fact that, in the absence of its own creativity or proclivity for hard work, Congress would much prefer to have the Fed continue to expand its balance sheet so that the political elite can spend money they don't have.[1]

Regretfully, the Chairman finds himself in his own Heller-esque *Catch 22*. To continue to use accommodative monetary policy with potentially dangerous long-term implications for the U.S. economy may be a little crazy, but it is perhaps only slightly less crazy than handing the keys to the economy to an Administration and a Congress that

[1] Pat Toomey of Pennsylvania was a notable exception. *"...and so to address this [slow growth] with ever-easier monetary policy, I worry very much about the unintended consequences, including the fact that it has the effect of masking the true cost of these deficits and making it easier for us to continue this very imprudent fiscal policy*."

believes that it is unable to pursue anything other than a continuation of politically unfeasible Keynesian fiscal policies. Still, it must have required the patience of Job for the Chairman to stomach his interrogation from Congress given the fact that the Fed has nearly quadrupled the size of its balance sheet since Bear Stearns failed and that 30-year fixed rate mortgages now rest at an absurdly low 3.7%.

In a world in which the Dollar remains the reserve currency, the Fed, practically and legally, has unlimited ammunition to fight the potential effects of deflation. In this regard, Chairman Bernanke may be the most unambiguous Fed Chairman in history -- he came into the job as "helicopter Ben" and "helicopter Ben" he remains. He has succeeded in convincing many of us, perhaps most importantly the current head of the ECB, that when faced with stark choices between the potential for inflation and the ravages of deflation, the sober central banker should always err on the side of accommodation, thereby preserving some ability to act if things should get out of control. The problem of course, as Keynes correctly pointed out himself, is that there are times in which no amount of additional liquidity can prompt an increase in economic output. The continued decline in the velocity of money suggests that the Fed has gone well beyond "pushing on a string" and now faces the potential for a full-blown liquidity trap.



While we have all been taught to never fight the Fed and to believe that financial crises have always and everywhere been good for financial assets over the past 20 years, this syllogism is likely to be increasingly disappointing as an investment strategy when financial institutions fail in their role as effective transmission mechanisms for monetary policy. Capital destruction makes it difficult for the system to create liquidity regardless of the degree to which the Fed provides accommodative monetary conditions. This can explain, at least in part, the diminishing marginal returns for risky assets with each successive round of quantitative easing or other creative monetary policies.

While the mind may be willing among banks, the flesh is weak. Legendary Wall Street law firm Davis Polk has calculated that only 30% of the rules that must be written as a result of Dodd-Frank have actually been completed. Add this to the "boring but important" LIBOR scandal and its attendant potential liabilities, and it can't be all that surprising that banks have been unwilling to take large risks in expanding their loan books. But even if banks turned the taps wide open, there is little evidence to suggest that individuals and businesses would be all that interested in taking on more debt. A friend and client from a large Midwestern bank described it to us thusly just this week, "we have plenty of money to lend. The problem is businesses are too afraid to borrow."

In this way, the continued decline in the velocity of money suggests that, at least in the U.S., another Keynesian concept from the 1930s – the *paradox of thrift* – has also made a comeback. The central paradox being that while it's rational for individuals and businesses to save more in times of recession, aggregate savings in the economy will fall due to a decline in consumption and economic growth. The great irony here is that while Keynes' observations regarding liquidity and thrift are accurate, his prescriptions for the best ways to counteract weaker economic growth appear hopelessly anachronistic. Using deficit spending to smooth over economic cycles is likely to be far more effective when government expenditures are 2% of total GDP, as they were in 1929, than they are today, when they are close to 25%. Putting it simply, it seems as if we are rapidly approaching a period in which the world's central banks are rendered powerless at the same time our political elite prove themselves to be callow and ineffectual. This is not, of course, a uniquely American experience. Such is the fear of taking risk among investors globally, that more than half a dozen sovereign debt issues now offer *negative* yields. ***At a time in which the range of potential outcomes to such large issues as the European debt crisis, the U.S. Presidential election, and the fiscal cliff is so wide, it seems safe to suggest that the individual saving rate is likely to climb in the coming months. Not only is this likely to put a dampening effect on an already-weak global economy it is also likely to usher in a period of extreme volatility and risk for the institutional investor.***

As then Federal Reserve Governor Kevin Warsh put it in a speech in 2008, the concept of liquidity has less to do with the availability of capital and much more to do with the concept of confidence. It seems clear that additional fiscal and monetary stimulus is unlikely to do the trick. An exceptionally large fiscal stimulus package has been attempted and proved to be ineffective. Massive injections of liquidity by the world's central banks have also been in evidence. The only thing that hasn't been tried is a combination of supply side solutions and long-term, adult approaches to structural reform that could finally revive the animal spirits necessary for capital formation and growth. In this way, it is Chuck Schumer, not Chairman Bernanke, who should really get to work.

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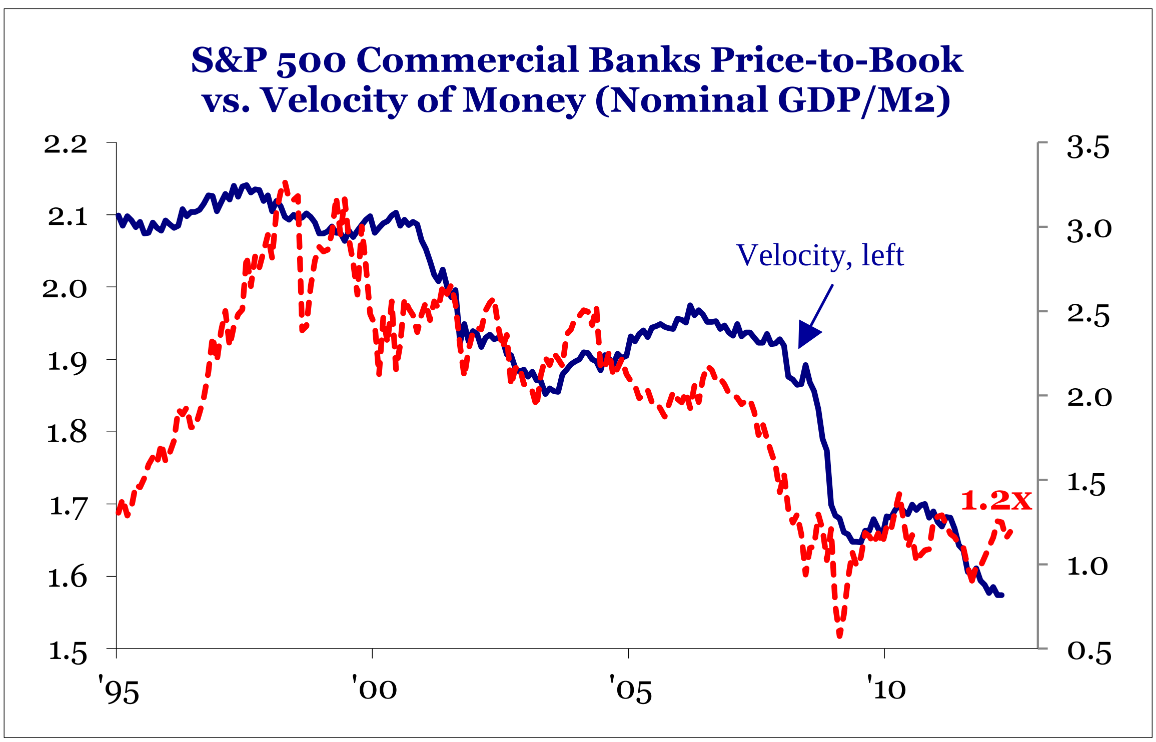
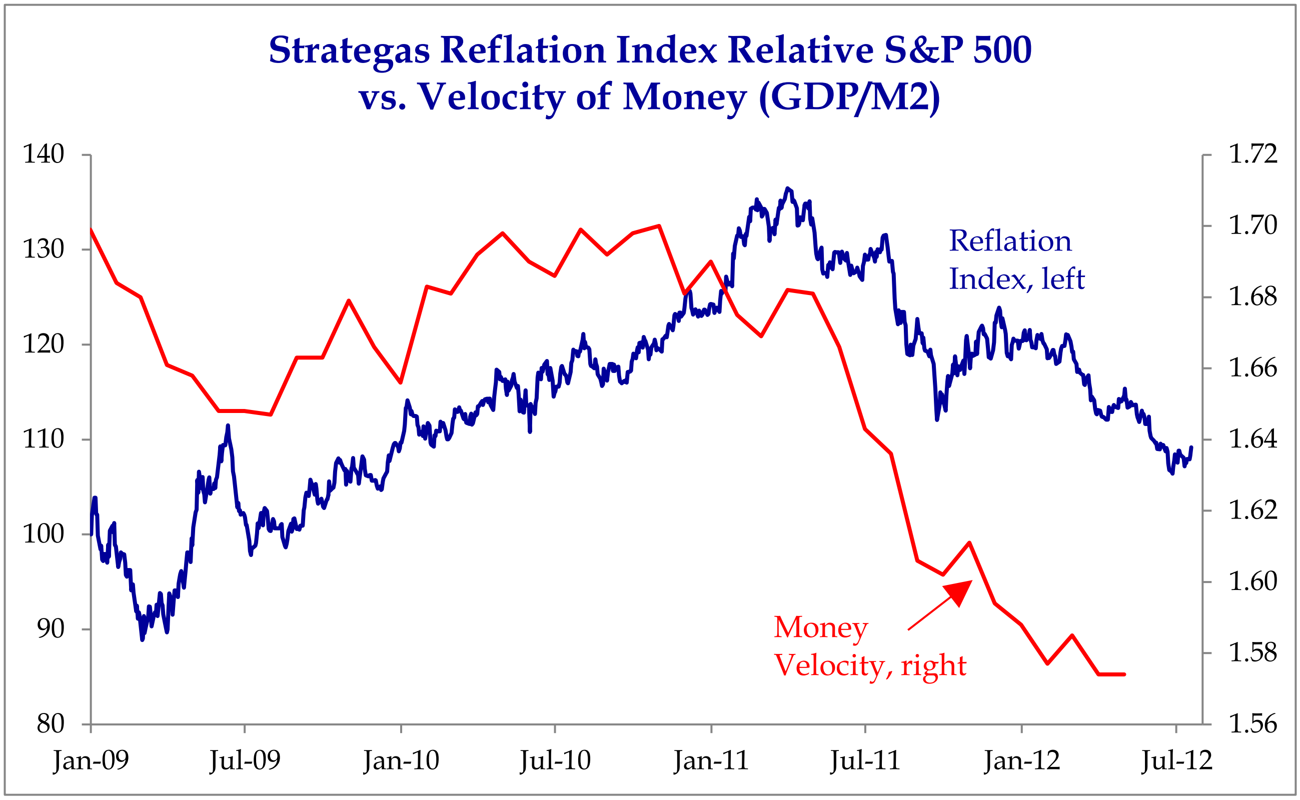
Velocity of Money Checklist (First Published 12/8/08)

	12/8/2008	6/12/2009	5/24/2010	Current	
China's Stock Market Sustainably Outperforms	Yellow	Green	Red	Red	The Chinese equity market remains under pressure.
U.S. Dollar Strength Ebbs & the Yen Stabilizes	Red	Green	Yellow	Red	The U.S. dollar continues to function as the best house in a bad neighborhood.
Baa Corporate & Jumbo Mortgage Spreads Recede	Red	Green	Green	Green	The U.S. corporate credit picture has improved and many companies have cash.
10-Year Yields Move Higher	Red	Green	Yellow	Red	This has not happened ... yet.
Unemployment Claims Trend Lower	Red	Green	Yellow	Yellow	Very noisy lately. Consistent with a deceleration to the pace of economic growth.
Fed's Loan Officer Survey Shows Improvement	Red	Red	Green	Yellow	For creditworthy borrowers, credit is cheap, but banks are not being aggressive.



STRATEGAS REFLATION INDEX UNDERPERFORMING AMID FALLING MONEY VELOCITY



Strategas Reflation Index Constituents

SLB	Schlumberger Ltd.
DIS	Walt Disney Co.
HAL	Halliburton Co.
BA	Boeing
DVN	Devon Energy
ROK	Rockwell Automation
TIE	Titanium Metals
COP	ConocoPhillips
TROW	T. Rowe Price
XOM	Exxon Mobil

Our Reflation Index identifies the 10 S&P 500 stocks with the highest price correlation to changes in money velocity over the 10-year period ending 12/31/08. The index has underperformed the S&P 500 materially since peaking in early 2011 as money velocity has continued to decline.