



About Bob Andres

Bob is a third party strategist. He regularly communicates economic viewpoints and investment strategies to the marketplace. Bob serves as a source of insight and perspective to advisors and their clients. He regularly engages with advisors in support of their client meetings, presentations and conference calls.

His business pedigree includes:

- President of Merrill Lynch Mortgage Capital Corporation
- Vice President and Manager of Merrill's secondary corporate bond trading division
- President and Co-Founder of Martindale Andres & Company, a firm that managed in excess of \$2 billion in assets

Bob has been featured in Barron's, Institutional Investor and a broad array of financial publications throughout his career.

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In Their Own Words!

Authored by Bob Andres



Janet Yellen, vice-chairwomen of the Fed said recently, "I'm having a hard time seeing where really robust growth can come from and I see inflation lingering around current levels for a long time. The economy also has real downside risk. It's conceivable that growth could fall short of what we're expecting and unemployment could start heading up further. And if we really get a weak scenario with unwinding confidence or, who knows, larger losses for financial institutions, we could find ourselves with a downward

dynamic occurring that really takes us into very difficult terrain. Even if we do not experience deflation, continued disinflation [a slowdown of inflation] could weaken the recovery further."



Fed Governor Kevin Warsh in a speech delivered on November 8th, stated, "Monetary policy can't fix the economy and we're already seeing signs of QE backfiring. The Fed's increased presence in the market for long-term Treasury securities also poses nontrivial risks. The Treasury market is special. It plays a unique role in the global financial system. It is a corollary to the dollar's role as the world's reserve currency. The

prices assigned to Treasury securities--the risk-free rate--are the foundation from which the price of virtually every asset in the world is calculated. As the Fed's

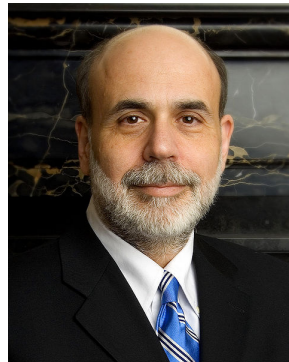
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[I]nflation that is too low can pose risks to the economy - especially when the economy is struggling.

balance sheet expands, it becomes more of a price maker than a price taker in the Treasury market. And if market participants come to doubt these prices--or their reliance on these prices proves fleeting--risk premiums across asset classes and geographies could move unexpectedly. The shock that hit the financial markets in 2008 upon the imminent failures of Fannie Mae and Freddie Mac gives some indication of the harm that can be done when assets perceived to be relatively riskless turn out not to be.”



Chairman Bernanke, in an op-ed column in the Washington Post on November 4th made the following observations: “Unfortunately, the job market remains quite weak; the national unemployment rate is nearly 10 percent, a large number of people can find only part-time work, and a substantial fraction of the unemployed have been out of work six months or longer. The heavy costs of unemployment include intense strains on family finances, more foreclosures

and the loss of job skills. Today, most measures of underlying inflation are running somewhat below 2 percent, or a bit lower than the rate most Fed policymakers see as being most consistent with healthy economic growth in the long run. Although low inflation is generally good, inflation that is too low can pose risks to the economy - especially when the economy is struggling. In the most extreme case, very low inflation can morph into deflation (falling prices and wages), which can contribute to long periods of economic stagnation.

Even absent such risks, low and falling inflation indicate that the economy has considerable spare capacity, implying that there is scope for monetary policy to support further gains in employment without risking economic overheating. The FOMC decided this week that, with unemployment high and inflation very low, further support to the economy is needed.”



Kansas City Fed President Thomas Hoenig voted against QE2 believing the “risks of additional securities purchases outweighed the benefits.” Mr. Hoenig also was concerned that this continued high level of monetary accommodation increased the risks of future financial imbalances and, over time, would cause an increase in long-term inflation expectations



[Bullard] recommended that current interest rate policy be supplemented with additional quantitative easing.

that could destabilize the economy. “We can’t control everything. There are a lot of other things affecting this economy and those have to be recognized. For example, the uncertainty that is in the market place. The uncertainty around taxes. The uncertainty around health care. The uncertainty around regulatory reform. Those are all impacting the economy and monetary policy is not an instrument that can offset everything else that affects the economy. And when you try to and use it in that way, and try to overuse it, you get bad outcomes too often.”

St Louis Fed President James Bullard this past week outlined his view of the QE2 decision in five pieces:

1. Economic Slowdown and Disinflationary Trend

Bullard said that the pace of recovery had slowed, creating a disinflationary trend. Labor markets continue to be weak and he expects they will lag the recovery, as has been the case in the past two recessions.

2. Lessons from Japan

“U.S. policy should strive to avoid the possibility of a Japanese-style deflation,” Bullard said. “The Japanese experience indicates that a near-zero nominal interest rate, mildly deflationary equilibrium exists and is difficult to escape.” In his paper (<http://research.stlouisfed.org/publications/review/10/09/Bullard.pdf>) published earlier this year, Bullard argued it may not be prudent to rely on low policy rates alone to keep the U.S. out of the deflationary outcome; he recommended that current interest rate policy be supplemented with additional quantitative easing.

3. Monetary Policy Should be Directed at Avoiding Further Disinflation

Bullard said the FOMC must defend its implicit inflation target from the low side as it would from the high side. Since U.S. short-term interest rates are already approximately zero, further disinflation would mean rising real interest rates in the face of a slowing pace of recovery.

4. Asset Purchases Can Substitute for Ordinary Monetary Policy

While asset purchases are sometimes viewed as unconventional, the financial market effects have been entirely conventional: real interest rates declined, inflation expectations rose, the dollar depreciated, and equity prices rose.



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Bullard said that because asset purchases put downward pressure on nominal interest rates further out the yield curve along with upward pressure on expected inflation, this policy puts downward pressure on real interest rates.

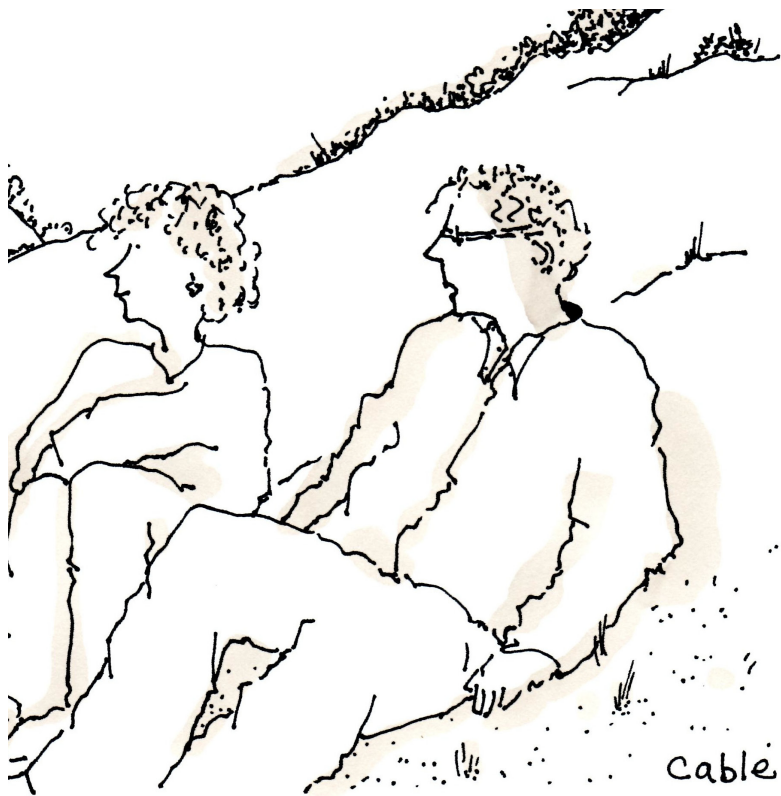
5. Maximum Effects on the Real Economy, While Difficult to Disentangle, Should be Conventional

"Easing of monetary policy produces its maximum impact on real variables in the economy, including output, consumption, and investment, with a lag of six to 12 months and can be difficult to disentangle, as economic performance is influenced by other developments during this period. However, the real

effects on the economy from this policy action should be conventional as well."

Commentary –

Having read all five passages above do you feel more confident that the "adults" at the Fed have a coordinated plan or are they just "punching at shadows" and hoping for the best? The Fed is buying bonds (QE2) in an effort to lower rates, further reducing the cost of borrowing while hoping the discounting process will bid up the value of risky assets to a point that consumers will spend and jump start the economy. Unfortunately, rates have increased, which in turn has reduced the "risk premium" expected by investors who purchase equities and other risk assets. Why is this happening? Many analysts point to profit taking and others have argued the old standby "don't fight the Fed." This last point suggests that contrary to existing empirical data (and many Fed Governors), the Fed will be successful in reflation the economy through its current monetary policy. These investors, by their actions, are raising



"Printing more money instead of using what's out there - is that environmentally friendly?"

short-term inflationary expectations. Ironically, this view coexists with last week's very weak Producer Price Index and Consumer Price Index data. Producer prices came in at +0.4% month-over-month, 50% less than economists expected. Core

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PPI (excluding food and energy) declined 0.6% compared to economist forecasts of +0.1%. Core CPI came in at 0.0% month-over-month and on a year-over-year basis, core registered 0.6% the lowest level since 1957. This is the third month in a row that core CPI came in flat.

Does the inflation crowd not realize that the real danger as I have said for months is deflation? Does the inflation crowd rationally expect a \$600 billion purchase of intermediate Treasuries over 8 months to generate a move from a deflation environment to a hyper-inflationary environment? Does anyone believe that short-term commodity price volatility leads to sustainable hyperinflation? Do investors see wage pressures developing with approximately 16 million unemployed workers and excess industrial capacity? We hear chatter that the Fed wants to drive inflation higher – in reality they are acutely aware of the increasing deflation risks and want to minimize the chances that inflation will actually move lower from current levels. They are aware that there is downward pressure on both core goods inflation and little upward pressure on core service inflation which could cause core inflation to decline significantly further over the coming months.

I believe the pullback in bond prices is the result of “bubble mania” and an inflation scare that has little merit in reality.

Good Fortune!

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