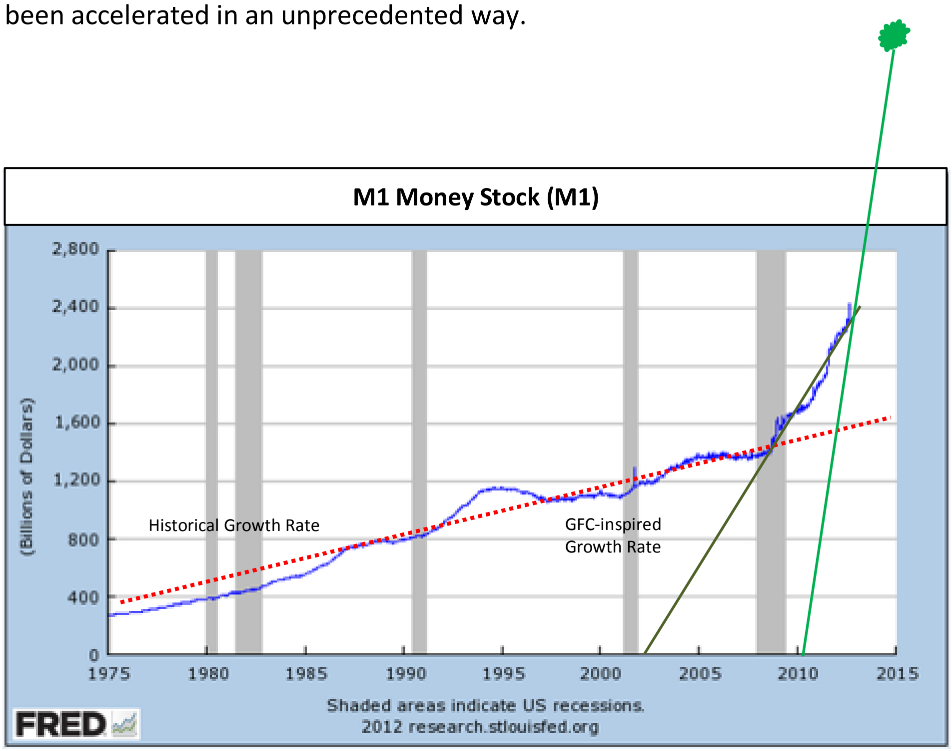
Impact of QE3?

October 4, 2012

The Federal Reserve ("FED") has just announced its third round of quantitative easing, commonly referred to as "QE3". Many in the capital markets are extolling the move for providing additional liquidity, and it seems that many more seem to be questioning the efficacy of the move. We at Bridge Investment Group Partners ("Bridge-IGP") are similarly trying to determine the practicality of this action, the potential impact on asset prices, and the effect it has on our investments. **In summary we believe QE3 and its predecessors to be an unprecedented injection of money that should certainly stabilize asset prices in the near term, while at the same time leading to an increased risk of inflation**.

Money Supply

In 1988, M1 was $800 billion. In 2008, M1 doubled to $1,600 billion. The recently announced QE3 suggests that the FED's balance sheet (to which M1 is closely related) could swell to $5 trillion in two years. As the simple graphic overlay to the FED's chart (shown here below) indicates, the growth path of money has been accelerated in an unprecedented way.



What $5 Trillion looks like

QE3 may well get us to $5 Trillion in two years

Unfortunately, Bridge-IGP believes that the QUANTITY of money is not the problem…

Source: Board of Governor's of the Federal Reserve

The Effectiveness of More Money

The looming question is, "Will more money spur economic growth?" We believe that it will do so only marginally, and in quite an inefficient way. Our problem in the USA is not the ***quantity of money.*** Our challenges are 1) the ***velocity of money,*** or the number of times per year that money actually turns over, 2) the inability or unwillingness of regulators to inspire inflation expectations, 3) the continuing weakness of financial institutions and bank lending, and 4) the need for financial institutions and governmental entities to continue making progress on a process to *rationalize real assets* acquired during the crisis. This process has "only just begun"…and is necessary to effectively unlock money which is frozen in these assets.

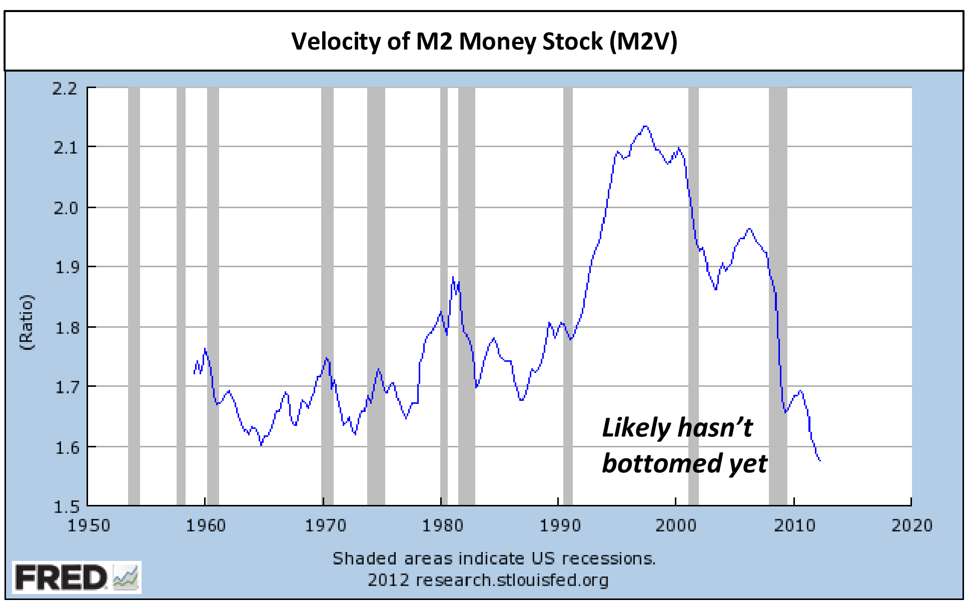
We at Bridge-IGP are not alone in this belief that QE3 may be either inefficient or even counter-productive to FED goals at this stage. Indeed, two of the FED's own members have argued against QE3. In opposition, Charles Plosser, President of the Philadelphia FED said, "The frictions and structural adjustments that are holding back improvements in labor markets cannot be cured by monetary policy."[1] Additionally, Jeffrey Lacker, President of the Richmond Fed, stated:

> "Further monetary stimulus now is unlikely to result in a discernible improvement in growth, but if it does, it's also likely to cause an unwanted increase in inflation. …Unemployment does remain high by historical standards, but improvement in labor market conditions appears to have been held back by real impediments that are beyond the capacity of monetary policy to offset."[2]

Statements such as these indicate that the **USA is in a classic liquidity trap** – a situation described in Keynesian economics in which injections of cash into the private banking system by a central bank fail to stimulate economic growth. A liquidity trap is caused when people hoard cash because they expect adversity such as deflation, insufficient aggregate demand, political instability, or war.

Signature characteristics of a liquidity trap are short-term interest rates that are near zero and fluctuations in the monetary base that again ***fail to translate into either: price level increases, economic growth, or employment level improvements***. These words should strike a resonant chord with Americans who have not only seen the quantity of money rise to new levels, but also now have a government debt exceeding $16 trillion and unemployment levels still exceeding 8%.

Fixing Velocity Now More Important Than Fixing Quantity



Source: Federal Reserve Bank of St. Louis

How to fix velocity?

- Sell frozen bank assets and other crisis-acquired assets

- Inspire inflation expectations

- Get the multiplier effect of financial-institution lending restarted

Opposing further monetary stimulus through additional MBS purchases, Mr. Lacker continued, "These purchases are intended to reduce borrowing rates for conforming home mortgages. Such purchases, as compared to purchases of an equivalent amount of U.S. Treasury securities, distort investment allocations and raise interest rates for other borrowers."[1]

Other Problems Outside the FED's Purview

The FED cannot spur individuals who are still significantly leveraged (versus historical levels) to rapidly absorb a large overhang of single-family detached housing. The FED cannot save money for individuals to rebuild those balance sheets and restore credit worthiness. The FED cannot deal with fiscal imbalances that may impact real wages and the consumer demand to buy goods and services.

John Mauldin adds, "The FED wants to grow employment faster, but jobs don't grow out of thin air. Corporations create jobs when they have the means, they see a need, and there is visibility to commit. Needless to say, the last two conditions are far from being met these days. The FED can't offset negative US politics, the European mess, nor the Chinese slowdown."[3]

Heading Toward Counterproductively

> John Mauldin explains, "If there were a direct link between QEs and corporate profits, it should be apparent in S&P 500 company revenues. Yet, Index sales have only grown 16.5% during the last 3.5 years, nothing close to the 60% jump in FED assets. Given that the FED is now totally focused on growing employment, I doubt that it would take credit for the spectacular jump in profit margins since 2009, since most of it emanated from cost cutting (mostly labor) and rising productivity."
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> "It is therefore dangerous to assume that margins will expand any further. From now on, corporations need to increase sales in order to grow their earnings. Unfortunately, demand is waning...Wages are not about to accelerate, but inflation and taxation are problematic."
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> "Bringing mortgage rates down further might help the slowly recovering housing sector and restart construction employment, but low wages and rising inflation remain a problem that might be perversely aggravated by the very actions the FED is taking."[3]

Bottom Line to Real Assets and Bridge-IGP Investments

For investors trying to navigate a potential inflationary environment such as this, we believe that an investment in multifamily ("MF") assets is a well-timed investment and a good portfolio hedge against inflation. Although our model does not depend on inflation, Bridge-IGP investments should certainly benefit from QE3's short to medium term effects on asset prices. MF investors must be ever vigilant of rising interest rates and must be careful to avoid financing with variable rate debt. Managers must also be vigilant of the potential increases in supply of multifamily housing not only related to large changes in systemic liquidity, but also related to existing fundamental drivers, such as the ongoing *nationwide* migration from Single Family Residences ("SFR") to MF housing. To date, some markets have seen a pick-up in permits and construction in MF, but it is the view of this Manager that these are still very moderate compared to the long dearth of new supply related to a lack of capital and viable financing since 2004. Combined with the positive trends in pricing implied by QE3, this continuing subdued supply should bode well for MF investments through the three years of ROC II's investment period.

END (*see disclosures below…)*

End notes:

[1] Robb, Greg. "Fed's Plosser Slams QE3." www.marketwatch.com.N.p.,25 Sept. 2012. Web. 26 Sept. 2012.

[2] Spain, William. "Fed Dissenter Cites Inflation, Interest Rates." www.marketwatch.com. N.p., 15 Sept. 2012. Web. 24 Sept. 2012.

[3] Mauldin, John, M.A., President Millennium Wave Investments, and Denis Ouellet. "What If the Fed Has It All Wrong?" MauldinEconomics.com. Mauldin Economics, LLC, 24 Sept. 2012. Web. 25 Sept. 2012.