What investors need to know about quantitative easing

and where should you place your money

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The term 'quantitative easing' is a convenient euphemism which makes it sound as if central bankers around the world have the tools to achieve growth. Instead, it should be called what it truly is: deliberate currency debasement through printing money.

Having already lowered interest rates to zero, the US Federal Reserve (The Fed) announced details of the second round of quantitative easing or QE2. The plan was to purchase $600 billion of short-term bonds on the open market with newly-created funds, hence creating money through wires and cheques for the sellers of these bonds. The hope was that with all this extra new money sitting in bank deposits, the banks would be encouraged to lend some of this money out. In other words, the solution to an overly indebted society is to foster and create more debt. The Fed had hinted in August last year that it would continue currency debasement or quantitative easing, and the hint alone sent the US dollar lower, while stocks and commodities rose.

At the G-20 Summit in Korea, world leaders attempted to come up with a framework for currency stability. The US accused the Chinese of having a currency that was too low, while the rest of the world accused the US of achieving an advantage by deliberately lowering its currency. In the end, no agreement was reached and it seemed that every country's currency should be weakened against everyone else's.

Asian currencies have been embarking on a quantitative easing programme for over a decade. Since the Asian crisis of late 1998, the People's Bank of China, the Bank of Japan, the Central Bank of the Republic of China (Taiwan) and the Bank of Korea have created the equivalent of $5 trillion worth of their own currencies to support a low currency and thereby foster export-led development. Data from China in the late 2010 showed money-supply growth at a whopping 28.7 percent, as opposed to 4.7 percent in the US.

Quantitative easing is a huge global experiment which in all likelihood will not end well. The very people pulling the strings on this gamble are the same people who saw no problems with the technology bubble, nor any with the latter real estate bubble.

The goal of quantative easing is three-fold. One, lower the value of the currency to encourage exports. Two, provide more liquidity to banks to encourage more lending. Three, prop up stock values so people feel wealthier, and are thus encouraged to spend more. However, increasing debt does not create real growth. Growth accompanied by stable total debt levels from 1952 to 1980 exceeded growth levels between 1980 and 2007, when debt exploded upwards. This would seem to be the financial crisis that keeps on giving. In the short run, many European nations have seen rapidly rising interest rates, led by Ireland where 10-year bond yields touched 9 percent as investors fear default. Another risk is that the increased money-supply could continue to inflate food and energy prices, which could then cause consumers to retrench on discretionary spending decisions.

Money-printing and zero interest-rates could cause investors temporarily to flee cash for stocks and commodity investments as we see. However, stay tuned as one will need an exit strategy when the world's central bankers again begin raising interest rates.

The advice of Jim Grant of Grant Interest Rate Observer, is that it is perhaps wise to place one's money in a currency where the housing market has already gone bust, rather than in one where there is still a bubble in the housing market, as in Canada.

To summarise, the economic recovery will remain sub-par for many more quarters, or perhaps even years. Consumers in the western world have been consuming at rates above their income for years, stealing consumption for present purposes from some time in the future. I would argue that for the majority of people that future time is now upon them. That being said, cash globally continues to pay rates lower than the inflation rate. These negative real rates may cause investors to continue to flee cash in favour of stocks and commodities, for yet a while. ■