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October 26, 2012

$3 Trillion Reasons for Concern

During this month's commentary we will shift our discussion towards quantitative easing and the possible manifestations of risk that we believe need to be considered in the years to follow. To begin, we will take an unassuming position on the subject by first addressing the question of what is quantitative easing? Quantitative easing (QE) is simply put a monetary policy implemented by central banks where the central bank purchases securities in the market. Most often these purchases are meant to stimulate the broader economy by replacing securities with cash that is expected to filter into the economy and be put to productive use. Whether that transmission is successful is another matter. In any event, the money supply expands on the basis of QE, which creates the risk of higher future inflation as the supply of money rises faster than the corresponding growth of goods of services in the economy. This gives rise to the frequently cited definition of inflation as "too much money chasing too few goods."

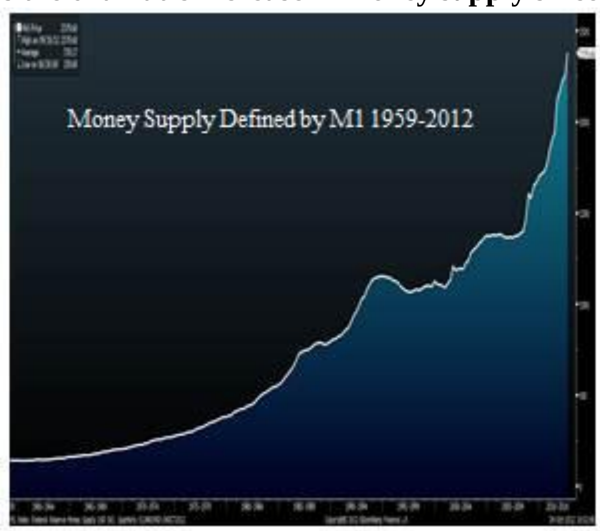
A simple analogy would be if we were playing the children's game "Monopoly" and one of our restless competitors decided to jump-start activity for those way behind in the game by producing another deck of money and adding it to the game. As we might expect, some prices for properties—maybe Boardwalk—would inevitably explode simply on the basis of doubling the amount of colorful money at work in the game. Likewise, the additional winnings would likely accrue to the same players who had shown superior skills since the outset of the game. Now, if we can imagine that an estimated $3 trillion (possibly more by some estimates) were added to our game, then this vignette basically represents Fed policy in a nutshell since 2008. Returning to the definition of QE; however, there are other tactics that have little or no effect on the overall supply of money. **One such example can be found in "Operation Twist" where the central bank implemented security purchases in order to simply affect the shape of the yield curve, without actually increasing the money supply (i.e., sell short term bonds and purchase long-term bonds of an equal amount).** Irrespective of the specific tactic, these QE policies are usually instituted in an environment of exceedingly low or zero-bound interest rates because the central bank has already exhausted its conventional methods of lowering interest rates. In the table below, we provide a brief summary of the Federal Reserve's QE activity since it began this policy in 2008.

QE1	QE1	QE2	Operation Twist	QE ∞
Announces Purchases of $600 bln	Announces New Purchases of $1.15 tln	Announces New Purchases Of $600 bln	Sell $400 bln Short-term & Buy $400 bln Long-term	New Purchases of $40 bln per month in Mortgage Backed Sec.
Nov-08	Mar-09	Nov-10	Sep-11	Sep-12

2008 → ?

Source: Lauren Templeton Capital Management, LLC

As we can see, the Federal Reserve has maintained a relatively steady regimen of unconventional monetary stimulus over the past several years. With the exception of Operation Twist in September of 2011, **the large majority of this activity has been inflating the money supply of the US dollar.** With that said, it is examining the cumulative results of these policies, and their effect on the money supply that stops most observers in their tracks. For instance, an illustration of growth in the money supply through M1 (cash and bank deposits) **demonstrates the dramatic increase in money supply since 2008.**

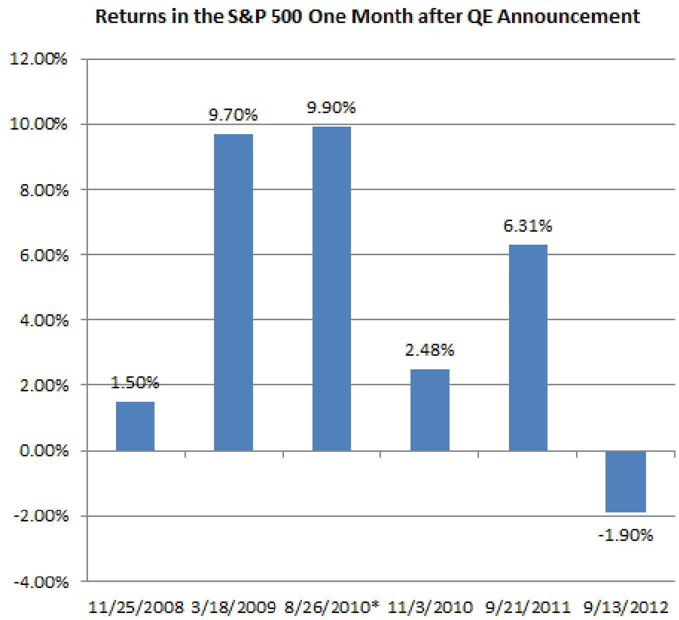


Source: Bloomberg, Federal Reserve

As dramatic as this increase has been, it belies the present day rate of inflation that one would anticipate following such exponential growth in the money supply, particularly in such a compressed time period. **Clearly, the rate of growth in the money supply has outpaced the production of most goods and services, and yet inflation (as it is presented by government data) remains <u>less than</u> one might expect.**

If we return to our common definition of inflation being a phenomenon where "too much money is chasing too few goods" we find the answer. The answer lies in the word "chasing." To put it bluntly, one would be hard-pressed to find money chasing much of anything at this moment in the broader economy…**staying put, maybe fleeing, hiding perhaps, but not chasing. The best evidence of money chasing an asset appears to be in the stock market**

itself surrounding the Fed's announcements of QE, as prices have habitually risen in the wake of this monetary policy. This is probably owed to two reasons, one is that QE is anticipated to create higher inflation in time, and the second is that many studies have now shown that stock prices rise after QE, which is enough to go on for many speculators in the market. However, this **relationship has begun to weaken** following the latest Fed announcement.



Source: Federal Reserve, Bloomberg, Lauren Templeton Capital Management, LLC
*Although official announcement was 11-3-2010, an August 2010 speech by Bernanke was widely seen as a signal of QE2

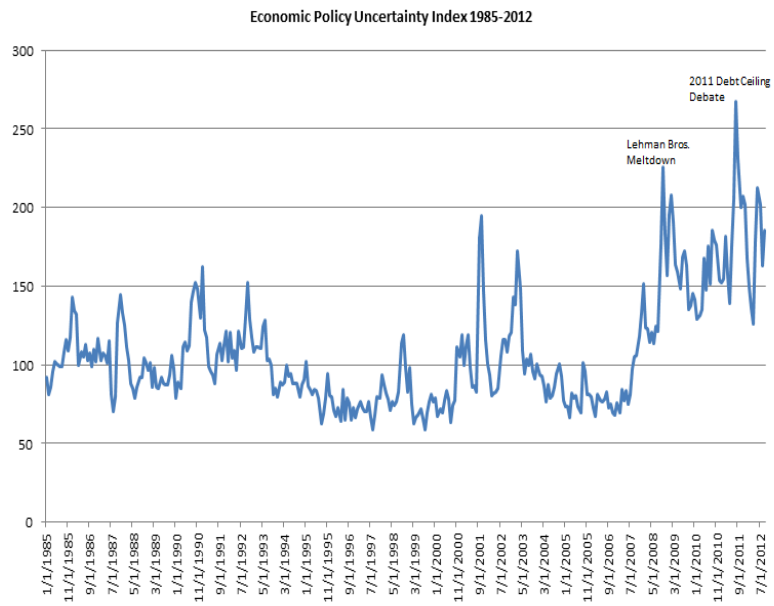
As we can see by judging from the one month returns in the S&P 500 following each announcement, this unconventional monetary policy seems to be losing its punch. We believe this is a natural progression of this policy regime and human behavior. **Basically, we attribute the waning effect to the law of diminishing returns which is exemplified by QEs 1-8 from Japan's experience during the past few decades. Given that little convincing evidence has come forth that QE has provided a great benefit to the broader economy, we believe that investors have turned to gaming it (or the opportunity cost of not) as the reason for these rallies, and their more recently ethereal nature.** We believe that the earlier rounds of QE in 2009 and 2010 were both novel policy moves as well as conducted in the backdrop of improving earnings. Conversely, we believe that the recent QE launched in September can claim neither of these qualities.

Returning to our discussion of the inflated money supply juxtaposed with a modest amount of dollars chasing a modest amount of goods, this reality is best revealed in a simple illustration of the velocity of money in the economy. The velocity of money illustrates how quickly money is changing hands in the economy and thereby affecting prices, **basically how much or little "chasing" is occurring.**

Source: Bloomberg

As evidenced in the preceding illustration, the velocity of money defined by the M1 money supply has experienced a relative descent over the past several years, whereas the apex on the right hand side of the figure above represents the second quarter of 2008, just prior to the Lehman Brothers meltdown. **What this illustration basically tells us is the "liquidity preference" of all of the various entities in the US economy. In a nutshell, the private sector currently desires to remain highly liquid, or put another way, sit on their cash.** This preference is reflected through a number of observations, but one good example comes from the often cited cash hoard sitting on the balance sheets of businesses across the economy, where the Federal Reserve reports that $1.7 trillion in cash is sitting idle among U.S. non-financial corporations.

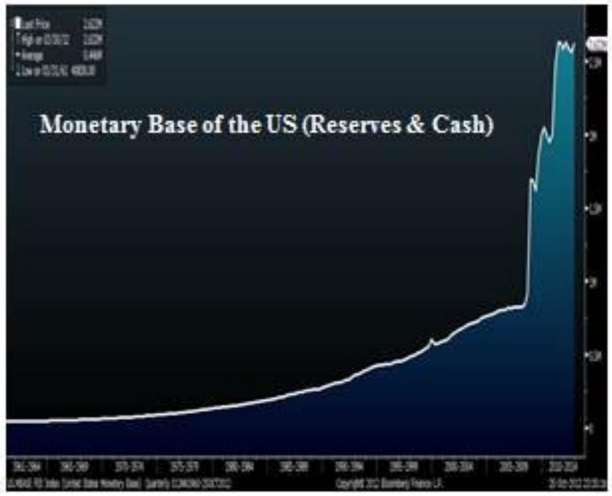
To be sure, companies are not alone in this behavior as many U.S. consumers are beholden to their own set of fears including unemployment, the safety of their savings following two asset bubbles in the past decade, looming tax increases, pending regulations for businesses from Obamacare, prospects for higher inflation due to Fed policy, already high gasoline prices, already high food prices, and while we are at it, we might as well throw in the destabilizing threats from a Nuclear Iran, European debt, and slowing growth in China. Clearly, for the engaged or just generally lucid individual, there are many reasons to be on the defensive or cautious with money. Although the preceding list illustrates the breadth of economic uncertainty in the market place—and in particular the role of policy makers in this phenomenon—a recent group of economists from Stamford University have taken this a step further. Indeed, this group has gone so far as to quantify the current level of economic policy uncertainty and place it in the context of a time series.



Source: Economic Policy Uncertainty (**www.policyuncertainty.com**)

Judging from the index, which reflects newspaper reports on policy related uncertainty, the expiry of federal tax provisions, and disagreement among economic forecasters, it is clear that since the Lehman Brothers debacle in 2008 the United States economy (and others) has been in an **elevated state of economic uncertainty**. Even so, we cannot pin the entirety of the coinciding decline in money velocity on this phenomenon, **as the role of deleveraging is also playing a critical role,** but these conditions certainly are not helping the circulation of money in the economy which is intuitively linked to higher levels of certainty or confidence on the part of economic actors. If we can return to our initial analogy to the game of Monopoly with the goosed deck of money, until the players start using the extra money, prices will not reflect their potential for dramatic increases, which could appear rather suddenly.

Now that we have captured a glimpse of what may be affecting the velocity of money circulating in the broader economy, it probably also makes sense to quickly examine another mitigating factor to near-term QE and inflationary conditions which comes from the "money multiplier." **The money multiplier addresses the third piece of the velocity puzzle, which is the creation of M1 through the extension of credit from the commercial banking system.** As we know, commercial banks are holding a relative mountain of reserves on deposit with the Federal Reserve, which represent a fraction of what could be potentially created through lending activity. Much like the earlier figure displaying growth in M1, the amount of reserves lying dormant (excess reserves) on deposit with the Fed that represent *potential* lending activity, that would further increase M1, is what keeps most Friedman sympathizing observers (we count ourselves here) up at night.



Source: Bloomberg, Federal Reserve

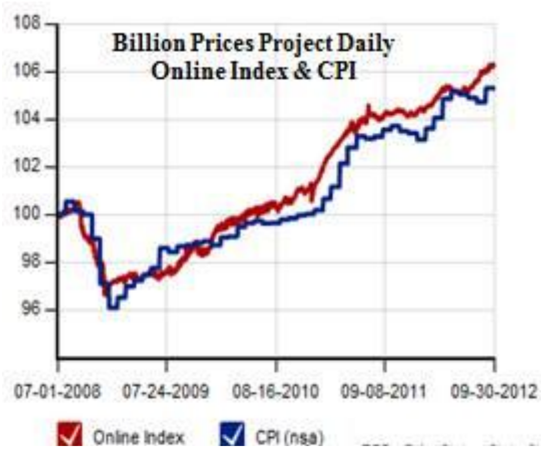
As you might have anticipated, these reserves supplied courtesy of Bernanke and Co., have not yet become inflationary given that once again the liquidity preference of commercial banks shows a heavier demand for holding these funds as reserves, versus creating loans. Reasons for this preference are varied, but the most obvious would be that many banks in the system still feel it is necessary to remain reserved against losses. These losses could be tied to deteriorating credits, or even the burgeoning litigation that is confronting Bank of America (and likely others) on the basis of lending practices surrounding mortgage backed securities sold to Fannie and Freddie from the long ago burst housing bubble. Similarly, credit transmission is likely also being affected by a customer base where much of the collateral in place for existing credit has fallen in price since the cri sis and remains depressed in price (negative equity, underwater mortgages, etc.). Lastly, corporations currently self-funding on the basis of strong profit margins and cash flows, complete with their repaired balance sheets, and cash hoards are not clamoring to borrow and expand in the face of a tepid economic backdrop. **Putting all of this together, despite the remarkable potential for inflation arising out of the reserves held by the banking sector, the banks are more content to hold cash and collect 25 basis points for doing so.** Perhaps the easiest way to visualize this lack of activity on the part of the banking system is to examine the money multiplier ratio, which is simply M1 divided by the monetary base, which basically gives a view of how much the reserve base has been lent to the private sector.

Source: Bloomberg, Federal Reserve

Finally, the last piece of the currently depressed velocity of money puzzle that deserves mention is a now shrinking, but one-time stalwart player from the great leveraging up of the global financial system during the past thirty years, **the shadow banking system.** The shadow banking system, as we discussed years ago in *Buying at the Point of Maximum Pessimism (FT Press, 2010)* was the greatest facilitator of the credit mania that fueled the housing bubble and related euphoria for securities tied to the leveraging up of the US, and other developed market consumers. Comprised of credit-trading hedge funds, money market funds, specialty finance companies, GSEs, asset-backed security investors, and various other players, these investors played an outsized role in the credit expansion that lasted from the early 1980s through 2008.

Since its last hurrah in the first quarter of 2008 however—when the shadow banking system reached $20.7 trillion in assets (28% larger than the commercial banking system at the time[1]—it has since been emaciated by risk aversion and losses and most recently has been estimated at $9.5 trillion in assets (over 50% lower than 2008 level). Realistically speaking, the Federal Reserve has also been trying to replenish the lost lending activity from this channel of credit (which is clearly substantial), albeit its efforts are funneled directly into the traditional banking system, thereby creating the potentially inflationary results of fractional reserves waiting to be loaned out at some point in time. To grasp the importance of the shadow banking system one need only return to the illustration above, which suggests that lending activity and credit creation has steadily fallen since the mid-1980s. Clearly, in all that we have experienced since 2008, we know that credit expanded in an unbridled fashion over that multi-decade time period, which suggests that it was happening through an alternative channel such as the shadow banking system.

Taking into consideration the declining velocity of money, it might be suggestive that prices across the economy are muted to falling, but based on observation through either the official CPI data, or an empirically based measure such as the "billion prices project" we find evidence of inflation.



Source: Billion Prices Project (http:mit.bpp.edu/usa)

This begs the clear question as to **why the Federal Reserve wants to pursue inflationary strategies of increasing the money supply, given that inflation erodes the real incomes of consumers in the US economy (as well as transfers wealth from savers to borrowers).** Basically, it seems that the Fed is honoring the simple reality based on the "quantity theory of money" which states that MV=PY. This time honored equation simply translated tells us that M (money supply) times V (money velocity) = P (price level) times Y (real GDP). This equation does hold, and **therefore implies that when velocity is falling a higher money supply is then needed to maintain a given level of *nominal* GDP.** Given that velocity has been falling, the Federal Reserve has continued to increase the money supply through its QE policy. Likewise, these efforts also suggest that within the scope of rising home prices, which have re-appeared during 2012, these efforts can rehabilitate the banking system as well as consumer confidence through the wealth effect of improved personal balance sheets. This helps explain the Fed's targeting of mortgage backed securities during its latest QE, which is to remain open-ended until it sees an improvement in employment data. In sum, **the Fed appears to be trying to reflate the housing market by spurring buying activity through subsidized mortgage rates (holding them artificially low).** Similarly, rising stock prices serve the same purpose based on the Fed's calculus, but with fewer households owning stocks than homes, it affects a smaller subset of people.

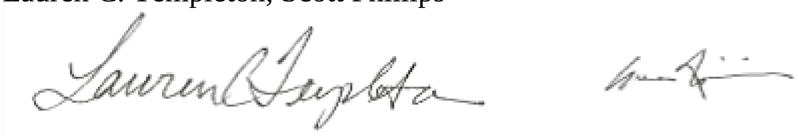
Judging by reports from the Case-Shiller Index for home prices, prices in the year-to-date 2012 (July last available) have risen 3.9% on a seasonally adjusted basis. The growing consensus among observers is that the housing market has finally entered a period of recovery after years of steady declines, but it is anyone's guess as to whether the market can sustain itself, particularly in the face of potential external shocks such as the ones we described earlier (relating to economic uncertainty). In any event, supposing that the housing market sustains its rejuvenation and the U.S. government does not throw the economy under the bus through the fiscal cliff, then it stands to reason that rising home prices could renew confidence among consumers, as well as the banking system. If so, then a sustained recovery in the housing market also provides a logical path towards renewed confidence among consumers, which could lead to more economic activity, more demand for loans, more willingness to extend loans (as existing loan portfolios look healthier too), and eventually an influx of dollars chasing the available goods and services, i.e., rising velocity and the potential for higher inflation. This sequence of events seems to carry a reasonable probability in our view, but the timing of its appearance obviously remains unknown. We could be in the beginning stages of such a scenario, or the near-term rebound in housing could prove to be another false dawn, postponing recovery for a few more years.

Irrespective of its timing we believe that some specific businesses, that we also believe to be bargains, are well positioned to profit from further increases in M1 and the velocity of money. More specifically, there are two global security firms, The Brinks Company and G4S PLC, in particular that appear to be well positioned to benefit from an eventual acceleration in the velocity of money across the global economy as they are two global leaders in providing cash handling, secure transport of cash and valuables, as well as ATM servicing and replenishment. As we described earlier, the falling velocity of money owed to the liquidity preference across most economic participants has naturally slowed down the circulation of money through the economic system. The basic translation for these firms has been relatively stagnant earnings on the basis of their business lines relate d to cash transport, valuables transport (gold, jewelry, etc.), and ATM servicing, but clearly an acceleration in the velocity of money either owed to M1 creation through increased commercial lending, or just a higher velocity in the existing M1 supply could generate a stronger earnings stream not currently discounted by the equity markets. In other words, we believe both companies trade at discounts to their respective intrinsic values based on an extrapolation of recent money velocity trends (lack thereof) into the future. Brinks in particular, trading at 11x depressed 2013 earnings estimates, and 3.6x EV/EBITDA appears discounted, while G4S at 10.2x earnings and 7.6x EV/EBITDA also represents an attractive discount in our opinion.

In our view, these valuation multiples represent meaningful discounts versus historical levels, thereby showing the potential for expanding multiples on rising earnings under more normalized velocity scenarios should sentiment and fundamentals change in regard to these companies. Basically, both firms appear leveraged to an increase in the velocity of money, or the continued rise in M1 over time that should result from several years of QE policies that have transpired (and should continue for the time being). We believe that both firms stand to benefit under this scenario given that their services and their earnings are based on the frequency, volume, and the value of what is being protected, or securely transported, meaning that the secure transport of gold, precious metals and other valuables such as jewelry would also positively impact earnings in the event of higher inflation. Likewise, we also believe that if and when the velocity of money begins to accelerate, either on the basis of renewed confidence among consumers, creditors, or both, that it will be very difficult for the Federal Reserve to reverse its course. In our view, it is possible that the Federal Reserve will be too cautious in its handling of the risk that its reversal of polices would lead to recession. Moreover, it would in our opinion be difficult to rein these policies in without causing recession. The bottom line is that from a policy making standpoint, it is much simpler to create these activities than it is to dismantle them and for evidence consider the trouble that governments have encountered trying to dismantle aggressive fiscal policies across the European economies. **At the end of day, unsustainable transfers of wealth can prove ruinous, irrespective of whether they occur through fiscal or monetary policy.**

Putting the entire discussion in perspective, we believe that the Quantitative Easing policies currently instituted worldwide in the developed market economies pose unique potential risks, and a wide set of possible unintended consequences. Although we have highlighted two possible beneficiaries of this policy regime, we spend the large majority of our time studying and hopefully anticipating the potential risks that are being created and posed to investors by short-sighted policymakers. With that said, many of these long-term investments include firms that we believe can pass along rising costs, as this is in our view perhaps the single most critical competitive advantage a firm can possess in this economic backdrop. In future commentaries, we will discuss other investments related to this unusual environment of economic policy experimentation conducted by the central banks.

Visit us at www.laurentempletoninvestments.com.
Lauren C. Templeton, Scott Phillips



Principal & Portfolio Manager Portfolio Manager

[1]Deloitte "Deloitte Shadow Banking Index Debuts: 'Only' 9.53 Trillion in Size at End of 2011. May 29, 2012. Oct. 25, 2012. http://www.deloitte.com/view/en_US/us/press/Press-Releases/