



Ted Scott on the wire

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“The financial gains from quantitative easing are fool’s gold” Why QE may not be successful in helping the US economy

Summary

- What the Fed has announced
- The aims of QE2
- Its likely impact
- Is it the right strategy
- Conclusions

Introduction

Following the Federal Reserve Open Market Committee (FOMC) meeting this week it was announced that another round of quantitative easing (QE) would be implemented. This was fully expected and has mostly been discounted over the last 2 months as Ben Bernanke, the Fed Governor, as well as some of his colleagues, have alluded to its likelihood in various public pronouncements.

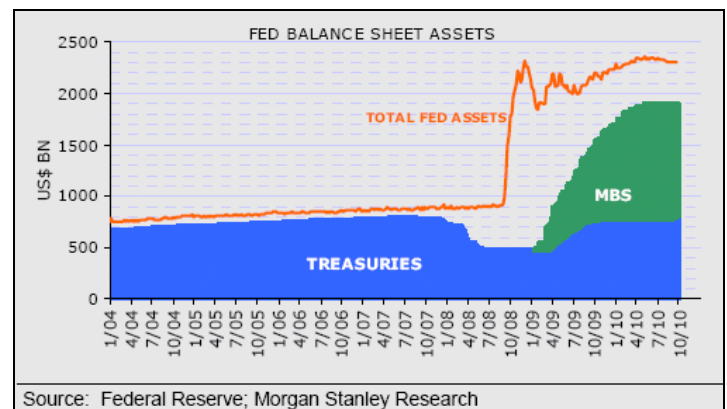
The aim of this note is to consider if the Fed is pursuing the right strategy given where we are in the economic cycle. The first round of QE in early 2009 has been credited with preventing a more severe recession, or even a second Great Depression, although it has failed in creating a sustainable recovery or in materially reducing the level of unemployment that is just under 10%. There is still a lot of scepticism regarding the efficacy of QE, even within the Fed itself, and the quote in the title comes from one of its critics, the well regarded financial commentator Edward Chancellor, who believes the short-term gains will be more than offset by the long-term damage to the economy, a view I concur with.

The read-across to the UK is highly relevant; the Bank of England also implemented QE in an effort to regenerate the economy and there has been much recent speculation that there will be a second tranche before the year end. I think this is unlikely because, unlike the US, the unemployment rate is much lower (at around 6%) and there are tentative signs that the economy is still in recovery mode whereas the US economy has clearly stalled in recent months. The UK has also recently announced the details of the austerity measures, mainly focused on cuts in public spending, and will want to assess its economic effects before announcing another round of monetary stimulus.

Therefore, this note will focus on the US experience but the analysis on the efficacy of QE is obviously relevant to the UK and other countries.

What the Fed has announced with QE2

The Federal Reserve, as widely predicted, announced on 3 November that it would start a second round of QE. The vote was not unanimous with one member, Federal President Koenig of Kansas City, voting against to give an overall majority of 9-1. The amount of stimulus was slightly more than expected at \$600bn but it is to be spread over a period of several months to the end of June next year so the average purchase of assets will be about \$75bn per month. The Fed also stated that its purchases would be concentrated in the 2 ½ to 10 year duration range of Treasury bonds with an average maturity of 5 to 6 years. This came as a surprise to a market that had been expecting it to be more evenly spread over the duration curve. The purchases will be of Treasury bonds in contrast to the last round of QE when mortgage-backed securities were bought; the breakdown of the Fed’s balance sheet is shown below as we are about to embark on QE2:



Importantly, the statement left the total amount of QE open-ended and to quote “the programme will be adjusted to best foster maximum employment and price stability”. Such an objective could have accompanied any policy measure by the Fed since the recession but the implication for QE is that, if necessary, further tranches of asset purchases will be announced if the objectives are not achieved by the time \$600bn has been vested.





Ted Scott on the wire

Some analysts think that the Fed may sanction as much as \$2 trn and further rounds of QE may yet be needed.

The analysis below looks at what the Fed is seeking to achieve and whether it is likely to do so and if it is the right strategy to adopt.

The aims of QE2

The common perception of QE is that is a monetary tool that is used to pump liquidity into the economy to stimulate growth when more conventional monetary (and fiscal) strategies have proved insufficient or failed. While this is true today it does not tell the whole story and the aims of QE2 are more far reaching than simply to promote economic growth.

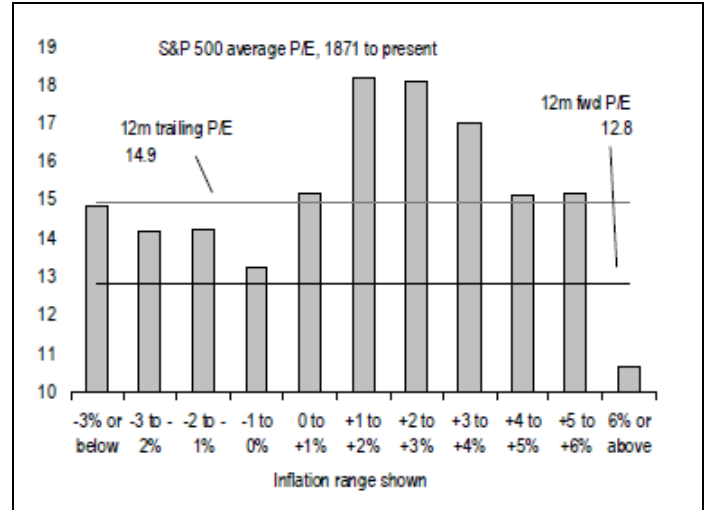
The Federal Reserve has a dual mandate: to achieve price stability and to maximise sustainable employment. At present, it is failing in both objectives. The level of unemployment has risen to a politically unacceptably high rate of 9.6% and has not fallen to despite some tentative signs of recovery in the economy. When the Central Bank is concerned about the level of prices it is usually because it is too high but, following the recession, inflation has consistently fallen and has now reached a level that the Fed considers too low. The core rate of inflation is just 0.8% whereas the Fed targets a level at or around 2%. At such a low rate there is a risk that inflation expectations will decline further contributing to the onset of deflation, a scenario the Fed is desperate to avoid. The chart below shows how high unemployment is and how low the core inflation rate is compared to the last 30 years.



Source: ASR Ltd / Thomson Reuters Datastream

The rate of inflation is important for the equity market as well. Historically, the level of inflation has always had a correlation to the valuation of the equity market as the bar chart for the S&P since 1871 shows.

The ideal rate of inflation for a high valuation is around 2-3% and anything significantly below or above will lead to a de-rating.



Therefore, QE2 is designed to help the Fed achieve both the above objectives. Firstly, with regard to full employment, it is hoped that jobs will be created as companies are encouraged to borrow through lower longer-term interest rates. One of the significant challenges the Fed faces is that the Fed funds rate is already at record low levels (0 to 0.25%) and bond yields are also the lowest for a generation. This means that the ability to stimulate more lending and capital investment through a declining cost of money is limited.

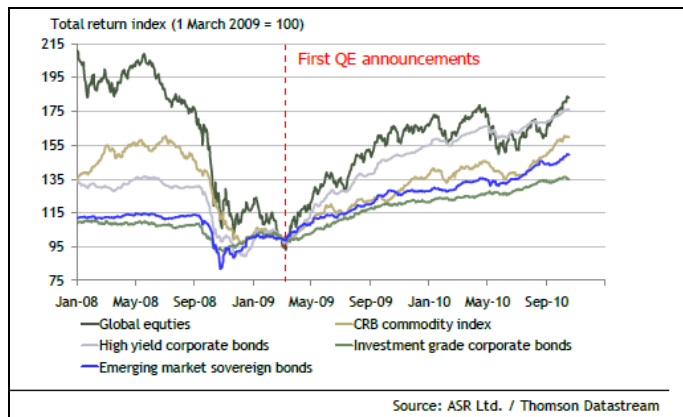
In the first round of QE it is estimated that the purchase of \$1,750bn of assets (mainly mortgage-backed securities) helped reduce the 10 year Treasury bond yield by between 30 and 100 basis points. As yields are now much lower it will not be able to replicate this. Since QE2 was first mooted a couple of months ago 30 year yields have, in fact, increased reflecting rising inflation expectations. So if it is going to be difficult for the Fed to meaningfully lower the cost of borrowing it will hope that the extra liquidity created will find its way into the real economy and thus boost consumer and investment spending. This did not happen in the first round of QE because the banks tended to hoard the cash raised from the sale of assets. This partly reflected the bank sector's aim to improve its capital ratios that had been decimated because of the credit crunch. However, it was also because there was a lack of demand for credit as the private sector continued to deleverage, a process that is still ongoing.





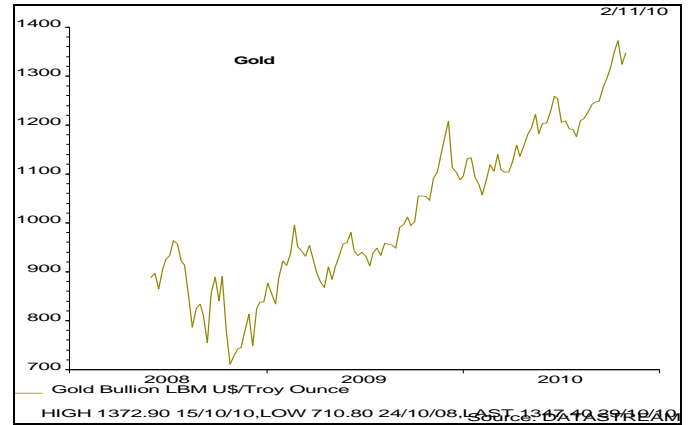
Ted Scott on the wire

With the Fed buying such a large quantity of Treasury bonds it is also hoped that the proceeds of the sales will boost other assets (e.g. equities and real estate). To some extent this has already happened with the equity market having risen over 10% in the period since the Jackson Hole speech by Governor Bernanke towards the end of August when QE2 was openly discussed for the first time. In turn, this will increase the wealth of the private sector leading, it is hoped, to higher consumption, employment and growth. The chart below shows the effect that QE had on various asset classes. The first QE announcements almost coincided with the nadir in the prices of most asset classes and all have enjoyed significant gains subsequently.



Another likely consequence that could help employment and growth is further weakness in the dollar. Like the equity market this has partly been discounted as the greenback has weakened by over 5% on a trade weighted basis in the last few weeks. The US is a relatively closed economy (less than 20% of GDP is represented by exports) but a weaker dollar will help the export sector. Also, it should deter consumers from buying cheap foreign imports, as their prices rise, and increase purchases of domestic goods to the benefit of the domestic economy. The dollar has already been weak and with commodities having strengthened in relation to the dollar's weakness this class of asset has done especially well.

The chart shows how much gold has risen in dollar terms with the acceleration of the rise taking place after the first round of QE in early 2009.



The second main aim of QE2 to reduce or even better eliminate the risk of deflation is equally important as reducing unemployment. If deflation did take hold it would be very difficult to reverse, as has been witnessed during the last two decades in Japan. The US still has memories of the Great Depression in the 1930s when the economy was ravaged by deflation and unemployment was even higher than it is now. The Fed Governor, Ben Bernanke, is a leading academic on the subject and he has staked his reputation on not allowing the mistakes of Japan to be repeated in the US. Indeed, in a famous speech in 2002 he stated categorically that deflation "was always reversible" but that different tactics had to be deployed than were used in the Depression or more recently in Japan.

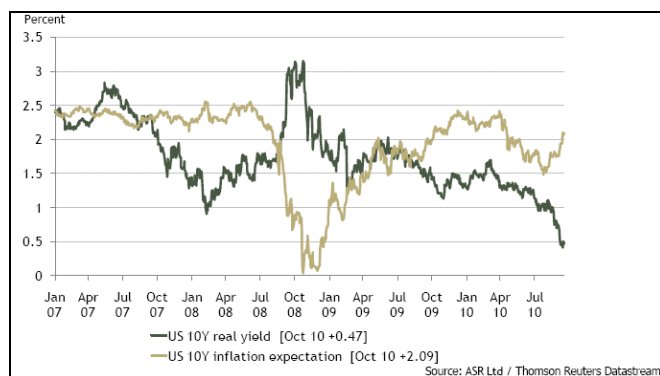
QE is not the only weapon in the Fed's armoury but is the most potent and the central bank is optimistic it will prove sufficient. The idea behind it is that by increasing the supply of liquidity (or de facto money) in the economy, the additional money will be reflected in higher prices assuming the velocity of circulation remains fairly constant. This is the monetarist doctrine that there is a casual link between the money supply and level of inflation and the high levels of inflation in the 1970s were blamed on excessive money creation. It is well known that Japan unsuccessfully tried QE to escape from the clutches of deflation but critics argue it did too little, too late.





Ted Scott on the wire

The Fed will hope that inflationary expectations, which are a major determinant of inflation itself, will be raised by its actions. Although it has not specifically announced an inflation target (which is an additional policy measure that is available if QE appears not be working), by saying that it is seeking price stability in line with its mandate of around 2%, the Fed is implicitly communicating its intention to do what is necessary to achieve that rate of inflation. By leaving the amount of QE open-ended the Fed will be expected to authorise more QE if it still feels the rate of inflation is too low after it has used up the \$600bn. The Fed's strategy is, therefore, designed to raise inflationary expectations because it will not give up until its target is achieved. Prior to the announcement the bond market had, to some extent, factored this into the relationship between nominal and inflation-proof bonds with the breakeven inflation rate rising to over 2% again during the last two months as the chart below shows.



The likely effects of QE2 and whether it's the right strategy to pursue

To gauge the efficacy of QE, certainly in the shorter term, will be very difficult. After the Fed implemented its first round of QE in early 2009 it was credited with preventing an even worse recession than in fact materialised but this can never be proven. Certainly risk assets responded positively to the extra liquidity created and the dollar weakened so helping the US economy. However, as the Fed made clear in its statement on 3 November the overall response of the US economy has been disappointing and unemployment remains stubbornly high, despite the extra stimulus. Furthermore, contrary to expectations inflation has fallen and it is only recently with the prospect of QE2 that inflation expectations have started to rise again. Back in the summer there were genuine fears that deflation in the US was a real prospect, something that the Fed could not countenance. Therefore, it has to be concluded that QE1 was on balance a failure that raises the question will QE2 do any better?

One point that even supporters of QE would agree on is that the policy poses great risk to the economy. It is an emergency measure that has never been deployed before on this scale and with no precedent it is impossible to know what the ultimate effect could be on the economy. The bullish case for QE is presented in the previous section about the aims of the policy which, if accomplished will fully vindicate the Fed. However, I am a sceptic and believe the risks to the economy outweigh the rewards as detailed in the points below:

The reason why QE1 did not have as much benefit on growth and employment as expected was not because of insufficient stimulus. The problem has been, and remains, a lack of demand for credit. The US has undergone the biggest recession since the War caused by excessive debt, particularly in the housing market. The private sector is still embroiled in the process of reducing its borrowing (called deleveraging) with debt levels remaining historically high and the housing market still in the doldrums. Lower borrowing and mortgage rates engineered by QE are not going to reverse that process so credit demand will remain low and act as a continuing constraint on growth.

As well as a lack of demand for credit, the lending institutions are still reluctant to increase loans. Following the credit crunch, the banks are under greater scrutiny with tighter regulation and want to be prudent about whom they lend to and ensure their capital ratios are robust. Most jobs are created by smaller businesses and they are particularly disadvantaged in obtaining access to credit. This is why following QE1 there is still an estimated \$1,000bn of excess reserves in the banking system. It is not as if there is not enough potential liquidity in the economy it is just that those that lend it are not prepared to do so and, even if they were, there would still be limited demand due to the ongoing deleveraging process. QE2 is unlikely to change these key dynamics.

One of the stated advantages of QE is that it helps increase the value of risk assets creating a beneficial wealth effect. This is fine so long as bubbles do not emerge as a consequence that ultimately destroy more wealth than they create. This is what Edward Chancellor was referring to as 'fools' gold' in the title of the note. Even before QE2 was announced equities, bonds and commodities had risen sharply, the latter especially as the dollar has also weakened in anticipation of the extra liquidity. Clearly asset prices are not just responding to improved fundamentals but are being distorted by the liquidity available through billions of extra dollars creating potential bubbles.





Ted Scott on the wire

If the economy does respond positively with unemployment falling there is no doubt that bond yields would rise sharply creating huge capital losses for recent investors. Alternatively, if the economy does not respond as hoped it is likely that equities and commodities would suffer a major correction.

Because QE is being implemented in the US and not elsewhere it is going to heighten what are already elevated levels of tension between international trading partners. As has been observed above, one of the effects of QE is to weaken the dollar as yields fall in the US and confidence in its monetary policy also recedes. As so much liquidity is being created much of the new money will seek higher yields overseas, especially in emerging markets where interest rates are generally rising and economic prospects look much brighter. In this respect, the benefits of QE are being transferred from the US to other countries. However, the recipients of the dollars will not welcome the inflow as it will put upward pressure on their currency – so making exports more difficult to sell - as well as raising the domestic money supply and so increasing inflation. China has already heavily criticised the US for this and QE2 will only heighten international tensions further so raising the prospects of a trade war in 2011. Some countries, in addition to China, have actively intervened to prevent their currencies rising and others have imposed capital controls to limit the amount of such 'hot money' coming into their country.

The larger QE becomes, the more difficult it will be to reverse or exit the strategy at a later date. This is important because we are ignorant of the long-term consequences. Just as it is taking a long time for inflation to respond positively to the increase in the money supply, when it does it could rise quickly beyond a level the Fed is comfortable with. In this scenario, it could prove equally difficult to reverse the level of inflation and would necessitate higher levels of interest rates that would jeopardise economic growth once more.

Conclusions

Bill Gross of Pico has recently called the policy of QE a 'Penza' scheme. Arguably that epithet should not only be applied to the more recent introduction of QE but the Fed's monetary policy since Alan Greenspan, Bernanke's predecessor, became the governor of the central bank back in 1987. Every time the economy got into trouble monetary policy would be eased to stimulate activity creating successive asset bubbles.

In Greenspan's time this took the form of lower interest rates but as the Fed Fund rate cannot fall any further Bernanke has had to resort to the less attractive and more risky option of QE. Gross' point is that like the infamous Penza scheme of Bernard Mad off, the Fed will have to face the inevitable one day as it runs out of bullets and is called to account.

The essence of why I believe QE will fail to achieve its objectives is because it is the victim of a classic liquidity trap. With a lack of demand and supply of credit it is impossible for the Fed to channel the extra liquidity into the economy. Keynes called it 'pushing on a string', i.e. a futile exercise. In the meantime, dangerous asset bubbles are being created and if the Fed persists in the policy post QE2 it is in danger of debasing the currency and generating a level of inflation that is too high.

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