MV Capital Management Thought Content Series: Markets in Transition

Quantitative Easing and the Expectations Game

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As this long summer of torpid heat, freakish storms and persistent economic jitters enters the home stretch, the term "quantitative easing" is back in the news alongside the pre-Labor Day back-to-school sales, college football predictions and the rest of the usual seasonal habits and rituals. Quantitative easing, or QE, is one of those phrases many people discuss without actually understanding what it is. It's an important thing to know and likely to be around for awhile - so let's take a brief moment and recap what it means, how it has been used as a crisis management tool thus far, what may happen in the coming weeks and months, and – most importantly – how a new round of QE may or may not influence investment market performance.

Quantitative easing is an unconventional tool the Fed initially applied in its attempt to stabilize financial markets in the wake of the 2008 meltdown. It is "unconventional" in the sense that it goes well beyond the traditional levers of Fed monetary policy operations; primarily the Fed funds target by which the Fed promotes easy credit in times of downturn and applies the brakes when growth begins to overheat. Its traditional turf is in markets for short-term interest rates, but quantitative easing moves the Fed out to more distant neighborhoods on the yield curve where it buys long-dated securities like mortgage-backed and other agency bonds. In 2009 the Fed injected about $2 trillion of stimulus into credit markets this way, and it arguably had the effect of stabilizing the prevailing volatile market conditions and helping to bring rates down – putatively making mortgages, auto loans and the like more affordable.

To enact that $2 trillion stimulus the Fed essentially printed money – as it has the authority to do – and created a balance sheet with the securities it purchased listed as assets. The intention, or at least the hope, was that as the economy began to recover the Fed could gradually reduce this balance sheet by letting the securities expire as their maturity dates arrived. This intention was put to the test earlier this month, when the Fed met to discuss whether to allow about $200 billion of mortgage bonds to retire when they came due in late August. This discussion took place in the context of a growing number of renewed economic danger signs: sagging consumer confidence; continued housing market weakness; and even the specter of protracted price deflation. The Fed was divided – at times bitterly so – on what course of action to take. Deficit hawks among the Board of Governors wanted to stick to the original plan – shrink the QE balance sheet as bonds came due. On the other side was the argument that without new stimulus the economy threatened to fall back into recession, which would make today's income, unemployment and spending problems much worse and threaten long-term economic health.

In the end the Fed's answer was to buy time. The balance sheet would not shrink, but it would not grow either. The plan as it currently stands is for the Fed to reinvest the proceeds from bonds coming due into US Treasury securities. In other words: agency securities the Fed bought last year come due and pay back the principal amount owed at maturity. Rather than "retiring" that money the Fed reinvests it, but limits its purchases now to Treasuries rather than a wider scope of fixed income securities. The balance sheet stays fixed at approximately $2 trillion.

This policy, which some media wags have (somewhat erroneously) dubbed "QE2", may or may not last. Fed Chairman Bernanke hinted in a speech last Friday that he still has a few weapons in his arsenal to deploy if economic data points turn demonstrably worse over the coming weeks. Presumably he was referring to the fact that the Fed can turn on a dime and substantially grow its balance sheet in very short order if it feels that is the right course of action. Technically there is nothing to stop the Fed from going back as an investor to the broader fixed income markets, or even the equities markets, if it believes that is the only viable course of action.

Quantitative easing is no free lunch. History tells us that the wholesale printing of money creates major risks for a national economy in the long term even if it solves short-term crises. But there is even a question as to how effective a new bout of QE will actually be in the short term. One of the key uncertainties revolves around investor expectations. For a measure like QE to be effective, investors have to believe it will be effective in dealing with the problems it targets for solving. The problem is this: the Fed has already exhausted its traditional policy options – the Fed funds rate has been at zero for more than a year and will likely stay there for a long time to come. The $2 trillion 2009 "QE1" package, while arguably successful in helping to prevent credit markets from falling off the cliff last year, did not really open the credit market floodgates – banks have kept far more cash on their books as excess reserves earning 0.25% than they have increased lending to businesses and households. Investors look at the fundamental problems bedeviling the economy and wonder if any amount of money thrown at the problem will do anything to solve it.

Paradoxically, businesses seem to be doing rather well. The 2Q earnings season was by and large a big success measured by the number of companies that beat expectations versus those that fell short. Based on 12-month forward earnings estimates the P/E ratio for the S&P 500 is now around 12x, which in normal times would be seen by many as a fairly strong buy signal. Yet money has been leaving the equities markets in droves and pouring into bonds. Perhaps that is a sign that the stock market is ready for a rebound as the "smart" money capitalizes on retail investor follies. After all, given the choice between 10-year Treasury yields at 2.6% and the average S&P 500 dividend yield at 2.75%, which investment would you prefer? But these are decidedly not normal times, and predicting future outcomes based on past performance is even less advisable than usual.

With warm regards,

Masood Vojdani
President

Katrina Lamb, CFA
Senior Investment Analyst

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MV Capital Management, Inc.
4520 East West Highway, Suite 400
Bethesda, MD 20814
www.mvfgroup.com
(301) 656-6545 tel
(301) 656-2722 fax