MV Capital Management Midweek Market Commentary

QE3: The Two Key Questions

September 14th, 2012

Note: Our Midweek Market Comment is actually an end of week comment this week, in order to focus on the Fed's latest quantitative easing announcement made Thursday September 13.

The odds seemed to be on something happening, and the chorus of conventional wisdom grew louder as the week went on that it might be something big. But when it arrived, the news presented itself with a Zen-like simplicity: $40 billion every month. No cumbersome time estimates or sunset clauses. $40 billion for as long as it takes to produce results. Zero percent short term interest rates as far as the eye can see.

There are two key questions we have been focusing on in the run-up to and immediate aftermath of what the financial chattering class inevitably refers to as QE3. Those two key questions are: (1) was the Fed right to make the decision it made, and (2) having made the decision, is it likely to actually work?

Unsurprisingly that first question has been sucked into the venal vortex of partisan politics. It's less than two months before a presidential election and the Fed – an organization independent of the three branches of Federal government – has opened the floodgates to rescue the economy (though technically the $40 billion mortgage backed buying program won't start until after the election). Partisan reaction from both GOP and Democratic party flaks was in full view yesterday and will no doubt be woven into campaign narratives as the days go on. But that is absolutely the wrong way to look at the question of whether Bernanke's call was the right call, which was very clearly **not** a political call.

The Fed has a dual organizational mandate: to undertake policies in support of **full employment** and **price stability**. That's it. When the Fed makes its Open Market Committee decisions about whether to raise or lower or hold steady the Fed funds rate, or whether to inflate its balance sheet with more QE, it is with those two objectives in mind. Bernanke was very clear about this in his statements. The recovery continues to be anemic, unemployment is persistently high and shows no signs of budging, and is far above what any reasonable person would consider to be "full employment". Meanwhile demand remains modest. Modest demand – reduced spending in other words – means that the threat of damaging inflation levels remains subdued. The Fed believes that a low inflation outlook gives it maneuvering room to try and stimulate the employment side of its mandate with QE. That's what yesterday's decision was about.

Which brings us to the second question: will it work? The task is daunting. Interest rates are already at historical lows. Credit has never been cheaper – but borrowing remains significantly below trend by both households and businesses. Is the purchase of $40 billion worth of bonds every month by the Fed going to be the act that moves the needle? It's hard to make a compelling case – but it's also hard to make a case for an alternative path to growth when there doesn't seem to be one. Central banks are, sadly, the sole policymakers anywhere in the world with the ability to take remedial action to stimulate the global economy. Governments are gridlocked and political leadership is weak. It's central bank action or nothing – and in a world where weak growth can fall back into recession in the blink of an eye, something is probably better than nothing. The markets seem to think so in the short term – but it's the growth, consumer confidence and – yes – unemployment numbers that will provide the ultimate judgment.

With warm regards,

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