MV Capital Management Midweek Market Commentary

Competitive Easing

September 20th, 2012

The aftermath since the Fed's announcement of QE3 last week has been settled and somewhat unremarkable. As one would expect, investors have trimmed some of their equity positions after the initial rally following the announcement, but overall there has been no real drawback in risk asset markets. However, warnings related to future inflation expectations have surfaced among some observers, notably Richmond Fed Governor Jeff Lacker as the potentially unlimited expansion of the Fed's balance sheet increases potential for future inflation.

Following the Fed's announcement of QE3 last week and the European Central Bank's (ECB) establishment of an open-ended sovereign debt buying program earlier this month, the Bank of Japan (BoJ) has thrown its hat into the ring with its own revamped monetary stimulus package.

Changes to the BoJ policy include an increase to the size of its asset-purchase program by purchasing about ¥10trillion ($126 Billion) in additional Short-Term Government Bills and Long-Term Government Notes (¥5trillion each), as well as extending its deadline by 6 months to the end of 2013. The hope of the BoJ is that the lower long-term interest rates resulting from these measures will weaken the appeal of the yen which tends to serve as a refuge in response to predicted economic turbulence around the world (though it should be noted that interest rates in Japan have been at extremely low levels for years as it is).

While a number of factors drive the persistently high value of the Yen – a perennial sore point for Japanese economic policy makers – the race for ever bigger quantitative easing measures exacerbates that tendency. The recent action by the BoJ, Fed and ECB have raised some concerns that central banks are engaging in "competitive easing" by pumping money into the home country's (or region's, in the case of the ECB) own economy despite whatever negative effects it could have elsewhere. These concerns are reinforced by this more aggressive policy by the BoJ, which comes as a surprise to many analysts who predicted that the more conservative BoJ Governor would delay any easing measures until late October.

The aftermath of QE3 also has an effect on the bond market but this is trickier to make sense of. Theoretically in a bond-buying exercise like QE one would expect to see bond yields fall as bond prices go up. Contrary to the theory, however, are the realities of present-day asset markets where QE induces interest rates to rise as investors sell out safe haven assets – this happened in both QE1 and QE2. However, QE3 has been something of a hybrid. Investors have – predictably – flowed into riskier assets, but there is no sustained upward trend in bond yields (as there was with QEs 1 &2). Yields on 10 Year Treasury Notes remain not far from historic lows and have not yet managed to surpass the already modest 1.97% yield seen at the beginning of 2012.

And so, the question remains that we posed last week: will QE3 work? And to follow that up with an even more ominous question: how bad will it be when interest rates really do start to rise, for real? We'll be talking a lot about that in the weeks and months to come.

Courtney Martin
Investment Analyst

Katrina Lamb, CFA
Senior Investment Analyst

MVCM 2012 0049
DOFU: September 2012

Investment Advisory Services offered through MV Capital Management, Inc., a Registered Investment Advisor. MV Financial Group, Inc. and MV Capital Management, Inc. are independently owned and operated.

Please remember that past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product (including the investments and/or investment strategies recommended or undertaken by MV Capital Management, Inc.), or any non-investment related content, made reference to directly or indirectly in this newsletter will be profitable, equal any corresponding indicated historical performance level(s), be suitable for your portfolio or individual situation, or prove successful. Due to various factors, including changing market conditions and/or applicable laws, the content may no longer be reflective of current opinions or positions. Moreover, you should not assume that any discussion or information contained in this newsletter serves as the receipt of, or as a substitute for, personalized investment advice from MV Capital Management, Inc. To the extent that a reader has any questions regarding the applicability of any specific issue discussed above to his/her individual situation, he/she is encouraged to consult with the professional advisor of his/her choosing. MV Capital Management, Inc. is neither a law firm nor a certified public accounting firm and no portion of the newsletter content should be construed as legal or accounting advice. A copy of the MV Capital Management, Inc.'s current written disclosure statement discussing our advisory services and fees is available for review upon request.