Weekly Market Flash

What's the Point of QE?

August 20, 2021

Earlier this week the Fed issued minutes from the most recent Federal Open Market Committee (FOMC) meeting, and the release caused a bit of a kerfuffle in equity markets. By "kerfuffle" of course we mean something that actually triggers a pullback of more than one percent (barely) in the S&P 500 without triggering a Pavlovian buy-the-dip reflex. The consternation, mild though it was, came from the revelation that a majority of Fed officials are of the view that tapering of the $120 billion per month bond-buying program could begin before the end of this year. Previously, the consensus expectation was that the Fed would not start trimming its quantitative easing (QE) operations until sometime next year.

The FOMC minutes were only one part of a generally negative attitude towards risk assets this week. Other factors including a deteriorating Covid environment, China's continuing crackdown on the tech sector and the Taliban's swift and complete takeover of Afghanistan took some value off of a variety of assets from small cap stocks to industrial and energy commodities to, unsurprisingly, Chinese and Hong Kong indexes. Some observers pointed out that there is still disagreement among the FOMC's voting members, with some of the more dovish participants holding to the view that there is still enough economic uncertainty to warrant waiting a bit longer. That raises the question, though, about whether the monthly purchase of bonds is really a remedy suited to the particular economic conditions of the moment. There is a case to make that it is not.

QE's Origin Story

Quantitative easing first entered the financial lexicon in the aftermath of the financial crisis and recession of 2008-09. The medicine was entirely appropriate for the circumstances of that time. The recession was deep and left households and businesses scarred for many months thereafter. The unemployment rate was still close to 10 percent in July 2010, a full year after the recession technically ended. Consumer demand plunged during this period. Flagging demand –by households and businesses alike – was precisely the problem QE set out to solve. In tandem with the Fed's other, more traditional policy mechanism of lowering interest rates, the massive scale of bond purchases by the central bank pumped liquidity into the financial system, creating easier conditions for the generation of credit and thus spending power.

Demand Isn't Today's Problem

A similar demand-side meltdown looked likely in the immediate wake of the economic shutdown in March 2020 as the pandemic spread across the country. Arguably the Fed's rapid response to the pandemic crisis, even more aggressive in many ways than after 2008, helped us avoid that outcome. Trillions of fiscal relief dollars and several quarters of economic growth later, though, weak demand is not the problem. Consumer confidence is higher than at any time since 2018 and far above its peak during the 2003-07 growth cycle. Personal consumption expenditures drove the robust Q2 GDP performance.

Today's big problem is on the other side of the economic equation: supply. Supply chain disruptions have resulted in chronic shortages of a wide variety of goods from semiconductor chips to raw materials. Distribution bottlenecks have produced some of the highest freight and transportation costs in memory. Meanwhile services companies are suffering from a shortage in the supply of labor to fully meet the demand for their services. The Fed's bond-buying program doesn't solve any of these problems. If anything, the easy money makes the problems worse by increasing the amount of money thrown at a decreased supply of goods – i.e. the textbook recipe for inflation. In light of this it's not surprising that a majority of Fed members are ready to get on with it and start tapering QE.

But the Markets!

The fact that there is still disagreement at the Fed for a tapering start date speaks to the problem of communication optics more than it does to economic analysis. Asset markets are tightly wired to everything the Fed says and does (hence the ruffling of feathers this week when the minutes came out). Bond markets went into a full-scale meltdown when former Fed chair Ben Bernanke first uttered the word "taper" in May of 2013. The Powell Fed would like to avoid another such tantrum, and thus has to frame its intentions carefully and with enough sugar-coating to make them digestible to excitable markets.

Next week all eyes will be turned to Jackson Hole, Wyoming, where global central bankers will get together for their annual confab. Expectations are fairly low for any kind of a definitive policy announcement from Powell at Jackson Hole. But he may gently set the stage for the next FOMC meeting in September. If the majority voice gets its way for commencement of tapering within 2021 then that would be the right forum for making the case. It will be a delicate and much-nuanced dance. Given what we know now, we think it would also be the right thing to do.

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