PERSPECTIVE

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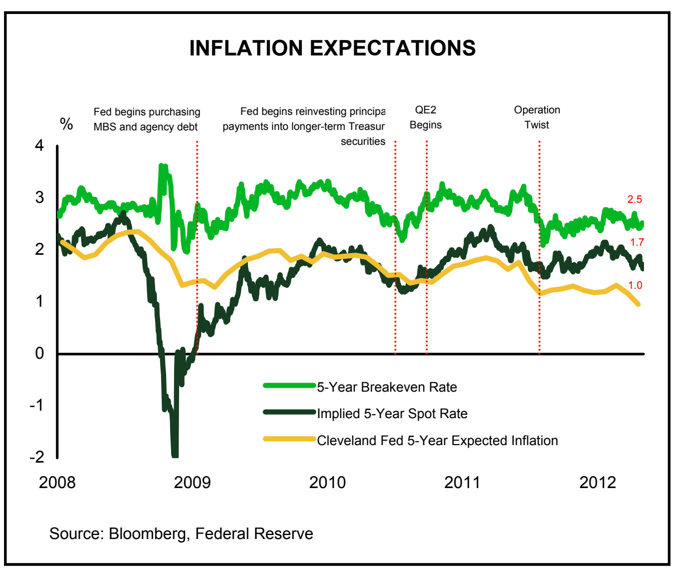
TO QE OR NOT QE?

Financial markets continue to speculate that the Federal Reserve could come to their aid with additional quantitative easing (QE). We agree that the possibility cannot be ruled out. If pushed to come up with odds, we would guess that there is roughly a 40% chance of it occurring. So, it is not our base case, but it is a high possibility.

If the additional monetary stimulus was undertaken, we would look for \$400 to \$600 billion of debt purchases, with the emphasis on mortgage backed securities (MBS) for two reasons. First, purchasing MBSs would help lower financing costs for the beleaguered real estate sector. Second, it would allow the Fed to avoid adding to its excessive balance sheet holdings of U.S. Treasuries.

However, one needs to ask what a third QE program would accomplish? Regrettably, the answer is very little. The purchases could lower yields a bit, but the level of interest rates is not the problem as they are already at rock bottom levels. The debt purchases would increase the money supply, but liquidity is not an issue. The problem is in the demand for credit, which is weak, and in the circulation of credit, which is poor. The inescapable conclusion is that additional QE would not boost economic growth or create significant numbers of new jobs. Sure, financial markets would rally on sentiment that the Fed was providing more stimulus. Equities and commodities would post gains. Yet, the advance would likely prove fleeting when the QE program ends – which is what happened with QE2.

If QE provides little boost to the economy, why would the Fed consider it? In our opinion, the main reason would be to anchor inflation expectations. A key risk to the economic recovery is that sustained slow economic growth could fuel disinflationary forces, and our current tracking for economic growth is below 2% in the second quarter. If markets start to expect lower inflation, it can lead businesses and households to plan for lower prices that could, in the extreme, lead to deflation. The Fed knows this and saw the deeply harmful effects of deflation from the experience of Japan since 1989. After all, deflation is falling prices, and why buy today what will be cheaper tomorrow.



Source: Bloomberg, Federal Reserve

The Fed employed QE1 in November of 2008, at a time when the economy was contracting at a fast pace and inflation expectations were plunging. Implicit inflation expectations as measured by the difference between nominal 5-year government bond yields and 5-year TIPS (real return bonds) fell into negative territory; while the breakeven on U.S. 5-year bonds fell to slightly below 2%. With markets bracing for the possibility of a depression, the Fed took the unprecedented step of purchasing government bonds to directly inject liquidity into the economy. The action helped lift inflation expectations, which remained low, but steadily climbed over 2009.

In the Spring of 2010, the Fed signaled to markets that they were prepared to launch QE2. The economy was struggling, but more importantly, inflation expectations were falling once again. Conditions were nothing like 2008, but the spread between nominal 5-year bonds and 5-year TIPs dropped towards 1.20%, while the breakeven on 5-year bonds fell to below 2.20%. Financial markets priced-in QE2, such that inflation expectations had already started to rise before the Fed made good on its promise in November 2010.

In mid-2011, a stalling of economic growth and worries about the risks to the U.S. economy from the fiscal crisis in Europe once again caused inflation expectations to fall. The spread between nominal 5-year bonds and 5-year TIPs dropped towards 1.50%, while the breakeven on 5-year bonds fell to below 2.20%. The Fed response was to introduce Operation Twist. This represented a softer approach, as the purchases of long-term bonds from the funds of maturing shorter-dated bonds meant that the Fed did not inject additional money into the financial system. But, the ultimate objective was the same as with the QE measures – boost market confidence in U.S. growth prospects by lowering borrowing costs.

In June 2012, the Fed extended Operation Twist, but left markets craving more QE. Inflation expectations today are weak, but they are not yet at levels that make additional easing likely. The key word in that sentence is 'yet'. The spread on nominal bond yields to TIPs is at 1.7% and the breakeven on 5-year bonds is 2.5%. Based on history, all it could take is another 30 basis point drop in inflation expectations to pull the Fed off the sidelines. This is quite possible if we get further negative economic news in the coming days. A truly bad payrolls report could do it, particularly if reinforced by bad news out of Europe and/or more economic weakness out of China.

Of course, the decline in inflation expectations would have to be sustained until the next Federal Reserve two-day meeting on July 31/August 1. Beyond that, the approach of the November Presidential election makes things difficult for the Fed. The central bank will not want monetary policy to feature as part of the political debate. There could still be scope to act at the September 12-13 meeting if necessary. This meeting has the added bonus of having a summary of economic projections and a press conference by the Chairman to help explain any action. The October 23-24 meeting is likely too close to the election for the Fed to act.

So, QE3 is a distinct possibility, but not our base case. The recent weakness in the economic indicators raises the possibility of more action from the Fed. However, the soft economic data are a necessary, but not a sufficient condition for the Fed to embark on QE3. The indicators to watch after poor economic news are metrics of inflation expectations, including: the breakeven of 5-year Treasuries, the implied inflation expectations on nominal versus TIPs, and other metrics like the University of Michigan Inflation Expectations and the Cleveland Fed 5-year expected inflation rate. The Fed doesn't have that many arrows in its quiver. It has to shoot when it counts. And it counts when disinflationary forces are building, because deflation must be avoided at all costs.

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