MARKET INSIGHTS

September 2010

QE II — Setting sail again on rough economic seas

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Further hints that the US Federal Reserve may embark on another round of quantitative easing (QE) have provoked sharp movements in some asset prices. We discuss what has been proposed so far, evaluate the impact of the first round of QE, and suggest what the results might be of QE II.

Words and deeds

'The Committee … is prepared to provide additional accommodation if needed to support the economic recovery….'

FOMC Statement, 21 September 2010

Modest words that may herald another offensive by the US Federal Reserve in its drive to restore the US economy to good health and prevent deflation from becoming a serious problem. The prospect of another round of QE raises several issues: what does the willingness of the Fed to contemplate an intervention — which they would surely rather avoid — suggest about the strength of the US economy, what are the risks, and what will the likely effect be on asset prices.

Comparing rates of GDP growth for the second quarter does not present the US in the most flattering light. Germany's economy grew by 9% (all numbers seasonally adjusted annual rates), China by 7.2%, and the UK, which shares many of the problems of the US, managed a robust 4.9%. The US, by contrast, expanded by only 1.6%. In fact, this figure is deceptive because the change in net exports subtracted 3.4 percentage points in growth when the remaining components rose by 5%. But most leading indicators suggest that growth has slowed since June. Many mainstream economists have concluded the same, with the average forecast for the change in GDP in 2011 falling over the last three months from 3.1% to just 2.5% now. The unorthodox monetary methods and quasi-fiscal intervention embodied by QE have been controversial. If the Fed is considering expanding them, the worry seems justified that it believes the economy's foundations are even shakier than they appear. The quick deflating of auto sales and housing starts following the end of government stimulus programmes is evidence that the recovery is not yet self sustaining.

J.P.Morgan Asset Management

Round one

Might an infusion of cash prompt rallies in the price of risk assets, as it did in early 2009?

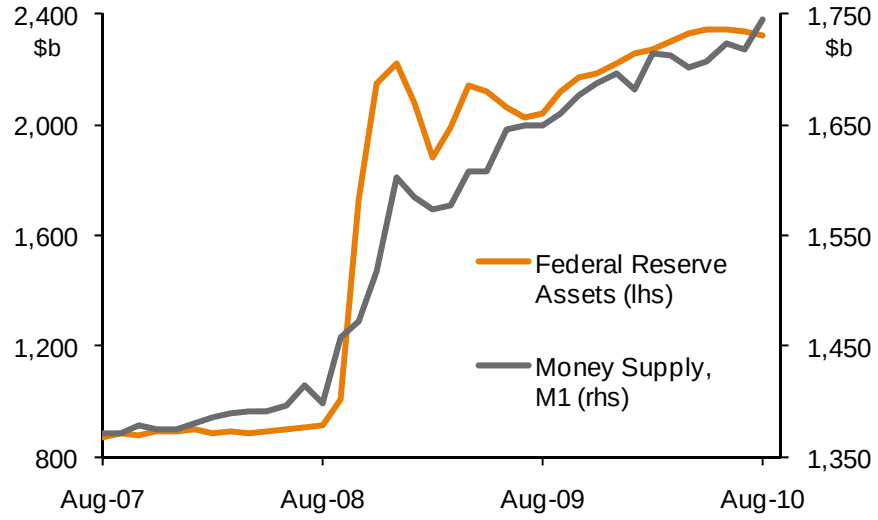
But this is the pessimistic view. An alternative interpretation would be that another infusion of cash will prompt rallies in the price of risk assets, as it did in early 2009. The first round of QE beginning in September 2008, focused on short-term interest rates and interbank lending and involved the provision of liquidity to the monetary system through credit facilities and central bank liquidity swaps. These efforts reduced the TED spread from almost 500 bps in October 2008 to less than 100 bps a few months later. [The TED spread is the difference between the yield on three month Treasury bills and three month Libor and is an indicator of stress in the lending market.]

Attention turned to interest rates faced by consumers and companies at the beginning of 2009. Liquidity programmes were wound down, replaced by direct purchases of mortgage-backed and Treasury securities. This had the desired effect: the coupon on 30-year mortgages has fallen from over 6% before QE began to about 3.5% now, while 10-year Treasury yields stayed well below 4% throughout 2009 and have declined to near 2.5% of late, though much of this has been driven by market demand rather than Fed purchases.

These various programmes resulted in the balance sheet of the Fed ballooning from under USD 900 billion to near USD 2,400 billion today, while the money supply has grown by USD 400 billion (the purchase of securities by the Federal Reserve is matched by an increase in the central bank's liabilities, namely deposits with commercial banks. At least some of this feeds into the broader money supply — see **Exhibit 1**). The increase in money supply, combined with a turnaround in sentiment, helped the stock market to double its value from March 2009 through March 2010.

- *The assets of the Federal Reserve have skyrocketed from under USD 900 billion to almost USD 2,400 billion today. Money supply has also expanded dramatically.*
- *Returning these figures to pre-crisis levels is a major challenge for the future.*

Exhibit 1: **Quantitative easing and its effects**



Source: Federal Reserve, J.P. Morgan.

Repeat refrain

There are substantial risks to further unorthodox monetary stimulus.

What might another round of QE look like? It is less clear what the targets of Fed intervention would be this time. Fed funds and market interest rates are already at very low levels, and sluggish credit growth is the result of lacklustre demand on the part of both consumers and businesses, not the cost of credit. The dearth of mortgage issuance and refinancings results from housing prices still being almost 30% below 2006 levels. Interbank lending is functioning normally. The goal may simply be to increase the money supply further (as a percent of GDP, money supply is not unusually high). This could have the effect of inflating risks assets as it did to some degree in early 2009, but that rally took place when sentiment was extremely negative and markets had already collapsed. Currently, sentiment is more realistically cautious and markets valuations are not unduly depressed.

There are also substantial risks to further unorthodox monetary stimulus. While realised core inflation is perhaps uncomfortably low (it's been below 1% for the last five months), inflation expectations remain stable at around 2.5% per year. One point of the announcement may simply be to signal the bank's intentions to keep inflation expectations positive, thus avoiding the need to actually implement the proposal. This is risky, though, because if they do ultimately expand the money supply expectations could get out of hand. The dollar has suffered, falling 9% over the last 18 months on a trade-weighted basis. Most importantly, further stimulus is making the long-term challenge of unwinding QE that much more difficult. The Fed must wait until the economy is strong enough that it can sell the assets it has purchased back into the market and reduce the money supply without the subsequent increase in interest rates damaging the economy, but not wait so long that inflation expectations begin to rise.

Pushing on a string

The need for another round of quantitative easing would not be a good sign.

Clearly the Fed will only unleash another wave of QE if economic indicators continue to weaken, so it will self-evidently not be a good sign. We are also concerned that the efforts will be relatively ineffective, especially compared to the first version, all the while storing up problems for the future. Although risk assets such as equities should benefit, and bond yields should fall, we do not expect the magnitude will be great. We believe that finding new measures to address the USD 2.5 trillion of mortgages that are underwater (i.e., in negative equity) is more urgent and will have a greater effect on the performance of the broader economy by improving sentiment, increasing labour market mobility, and stimulating consumer and business demand.

Dan Morris, *vice president*, is a strategist responsible for delivering market analysis and insight to clients in Europe. Prior to joining J.P. Morgan Asset Management, Dan was the Senior Equity Strategist at Lombard Street Research and before that part of the Institutional Investor-ranked portfolio strategy team at Banc of America Securities in New York. Dan began his career covering Latin American equity markets at BT Alex. Brown and Dresdner Kleinwort Benson. He holds an MBA from the Wharton School and a Masters in International Relations from Johns Hopkins' School of Advanced International Studies. His undergraduate degree is in Mathematics from Pomona College and he is a CFA charterholder.