Trend Macro

Trend Macrolytics, LLC
Donald Luskin,
Chief Investment Officer
Thomas Demas,
Managing Director

MACROCOSM

Will the World End when QE2 Does?

Monday, April 4, 2011

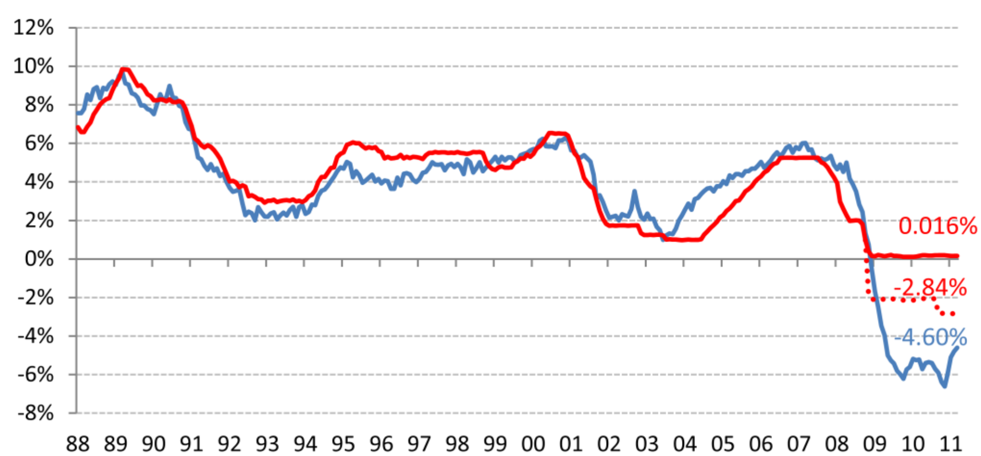
Donald Luskin

No -- because it won't be the "end" of QE, only its completion.

Almost a year ago when we first predicted that the Fed would launch QE2 (see "So Much For The 'V'" May 21, 2010), it seemed that a predominant view among our clients was that it couldn't possibly help. Ironically, now that QE2's midsummer end is in sight, there is a widespread concern that the economy can't do without it.

- Our view is that it definitely helped. It always helps when a central bank stops being too tight -- and before QE2 the Fed *was* too tight.
- Our belief that the Fed was too tight then, despite more than a year at a zero funds rate, was based on a version of the Taylor Rule showing that the ideal funds rate should have been negative 6.4% (see "Fixed Income Strategy: Take The Low Road" June 16, 2010). QE1 had gotten the actual funds rate, synthetically, to negative 2%.
- Under the same analytical framework today, everything has improved (please see the chart below). Today, with the unemployment rate lower and the inflation rate higher -- both positive results of QE2 -- the rule-based funds rate has risen to

Rule-based funds rate — Actual .... Adjusted for balance sheet
Rule = 2.07 + 1.28 x 12-mo core PCE inflation - 1.95 x (UE - CBO natural rate)



Source: Federal Reserve, BEA, BLS, CBO, TrendMacro calculations per Rudebusch (2009) and Chung *et al* (2011)

Update to strategic view

US MACRO: The US economy won't stop growing when QE2 is completed midsummer. We do not expect QE3, nor any dismantling of existing asset holdings. The Fed will have approximately met the market's demand for liquidity, and that will provide the platform for continued recovery. We see no *imminent* threat of an inflation breakout that would force the Fed to drain liquidity.

US BONDS: We don't expect a catastrophic move higher in yields when QE2 is completed midsummer. If the Fed has indeed supplied approximately the quantity of liquidity demanded by the market, then ongoing growth and improving inflation expectations should move the 10-year yield back to 4% this year in an orderly manner.

[Strategy Dashboard home]

negative 4.6%. At the same time, QE2 has reduced, synthetically, the actual funds rate to negative 2.84%. So the rule-based rate and the synthetic-actual funds rate have considerably converged -- *which means that the Fed has succeeded in becoming less excessively tight*.

- By the time QE is concluded midsummer, we don't expect to see enough improvement in either unemployment or inflation to bring the rule-based rate and the synthetic-actual rate completely together -- *which means the Fed will still be somewhat tight, but it's probably close enough for government work.*
- This brings us to the strong expectation that there will be no QE3. Given the political firestorm that erupted after QE2 (see "Stock Outlook: Differences Make a Difference" November 10, 2010), it's just not worth it at this point.
- At the same time, with the synthetic-actual funds rate still above the rules-based rate, we see no chance whatsoever that the Fed will begin to reduce its long-term asset portfolio once QE2 is complete. In fact we think it likely that the Fed will continue to reinvest proceeds from its MBS portfolio, to avoid any *de facto* reduction.

With the Fed completing -- but maintaining -- its long-term asset purchases, we see it having successfully maneuvered itself from being far too tight to being just about right, at least within the margin of error of our analytical tools. For the economy, it's a good thing for the Fed to be just about right -- so we don't expect any problems this summer when QE2 is completed.

How does this sanguine view about the completion of QE2 square with the more pessimistic outlook we hear from many clients? We'll address some of the concerns in a question-and-answer format.

- **QE2 was a "stimulus" program, so when it stops, won't the economy stall without it?**
- QE2 was not a stimulus program. It was never designed to "print money" so that consumers could spend it, or so that investors could throw it at the stock market. All the money created by QE2 sits on the liability side of the Fed's balance sheet in the form of excess reserves.
- QE2 was designed to increase effective liquidity -- that is, the ability of asset markets and credit markets to clear large transactions without delay, without excessive price impact, and without excessive cost. In normal times this can be done by tweaking the funds rate, which changes the *cost* of liquidity at the margin. In these extraordinary times, it was necessary to instead increase the *quantity* of liquidity -- hence the term *quantitative* easing.
- Think of liquidity as the depth of water in a swimming pool. People won't dive into the pool unless there's sufficient water to make doing so safe -- and when they are scared, they need some extra water just to be sure. So the Fed brings up a mighty firehose and fills the pool. When it is sufficiently full, diving resumes. Diving will continue so long as the water is sufficiently deep -- *it does not*

Contact TrendMacro

On the web at
trendmacro.com

Follow us on Twitter at
twitter.com/TweetMacro

Donald Luskin
Menlo Park CA
650 429 2112
don@trendmacro.com

Thomas Demas
Charlotte NC
704 552 3625
tdemas@trendmacro.com

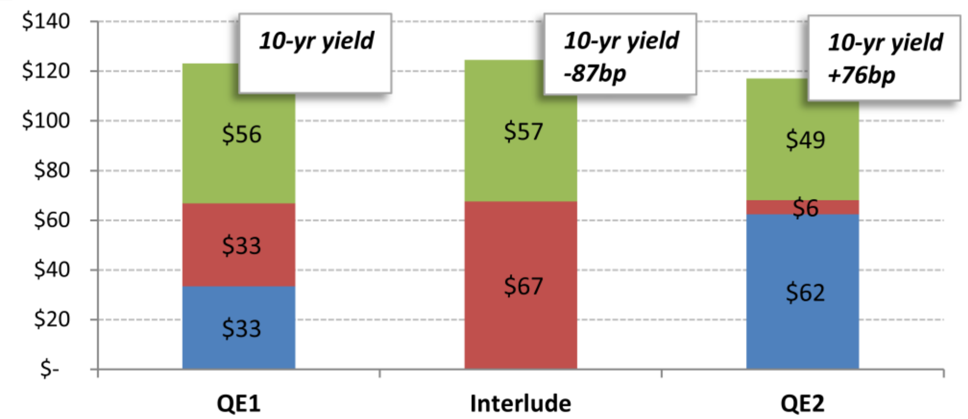
[About us]

require continued filling after that point -- it's already full. We think we're about to that point now.

- The "stimulus" view of QE treats the flow from the firehose as an end in itself -- as though instead of simply filling the pool, the flow turns a turbine that generates power. In that thought-model, when the firehose is turned off, the power stops. But in our view, QE2 has never been about the flow -- it's always been about establishing the correct *quantity* (or *stock*, as opposed to *flow*), of liquidity.

- **Won't bond yields rise catastrophically when QE2 is completed?**
- This is another flow argument, based on idea that the Fed's huge daily open market bond purchase must be crowding out other investors and forcing yields lower. But in reality it hasn't worked that way (please see the chart below). From the onset of QE1 through

Monthly net Treasury buys, USD billions: Foreign Domestic Fed



Source: US Treasury, Federal Reserve, TrendMacro calculations

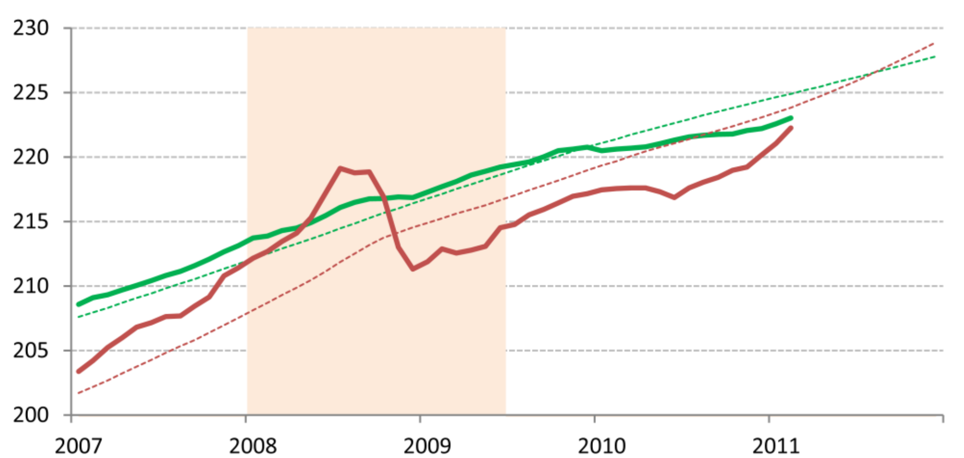
QE2 so far, net Treasury issuance has been fairly consistent at about $120 billion per month, and foreign buyers have consistently taken a little less than half of it. During QE1, the Fed substituted for about half of domestic net buys -- yet the 10-year Treasury yield *rose* by about 50bp. In the interlude between the QEs, the Fed took none, and 10-year yield *fell* about 75bp. With the onset of QE2, the Fed has almost entirely substituted for domestic buyers, yet the 10-year yield has *risen* by about 75bp. Incidentally, when this analysis is tweaked with appropriate lags to reflect the role of expectations, the data are even more compelling.

- Surely this demolishes the flow argument, and we think it supports our quantity argument. In the QE1 period yields rose as growth and inflation expectations improved, because the Fed was taking the first big step away from being too tight. In the interlude, yields fell as growth and inflation expectations deteriorated, because the Fed had not done enough. With QE2, yields rose again because the Fed was taking another big step away from tightness, and also demonstrating its ability to learn from prior errors.
- If, at the completion of QE2, the quantity of liquidity is about right, then we would expect to see Treasury yields drift higher as growth

and inflation expectations continue to improve. But we expect no catastrophic jump higher simply because the Fed will be out of the market.

- **Won't rapidly rising inflation force the Fed to take back QE?**
- Bernanke has said over and over throughout the QE2 period that inflation is too low. There is still room for inflation to rise before Bernanke will think that anything must be done to reduce it.
- Both headline and core inflation are still far below trend (please see the chart below). Headline CPI inflation would have to jump 5.6% over the coming 12 months just to catch up with its 10-year trend level, and core would have to jump 1.8%.

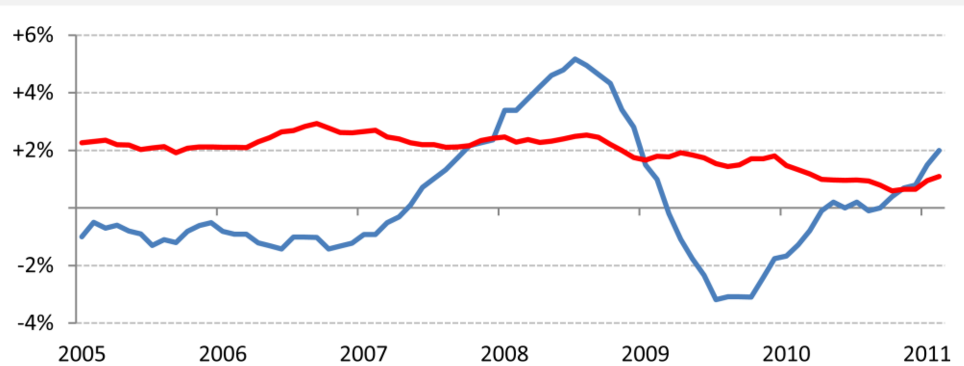
US CPI ··· 10-year trend — US core CPI ··· 10-year trend — US recession



Source: BLS, TrendMacro calculations

- We caution against over-interpreting evidence such as the statement last week by Wal-Mart's CEO that "serious" inflation is coming, or the closely related popular narrative that China is now "exporting" inflation (please see the chart below). Chinese imports to the US are only 3.5% of US consumption, and last time Chinese

Inflation in US imports from China — US core CPI inflation
Year over year



Source: BLS, TrendMacro calculations

imports experienced significant inflation in 2007 and 2008, US core inflation *fell*.

- Finally, we don't think continued high oil prices will motivate the Fed to tighten on inflation grounds -- though the ECB seems poised to make just that mistake (see "The Fed is from Venus, The ECB is from Mars" March 9, 2011). For one thing, oil prices would have to *keep rising* in order to have more than a one-time transitory effect on inflation *rates*. For another, we know from the last time oil prices rose sharply on Bernanke's watch that he sees the risks there more on the side of growth than inflation (see "An Oil Shock Tipping Point?" March 3, 2011).

Bottom line

The US economy won't stop growing when QE2 is completed midsummer. We do not expect QE3, nor any dismantling of existing asset holdings. The Fed will have approximately met the market's demand for liquidity, and that will provide the platform for continued recovery. We see no imminent threat of an inflation breakout that would force the Fed to drain liquidity. We don't expect a catastrophic move higher in yields when QE2 is completed midsummer. If the Fed has indeed supplied approximately the quantity of liquidity demanded by the market, then ongoing growth and improving inflation expectations should move the 10-year yield back to 4% this year in an orderly manner.