



William Sterling
Chief Investment Officer, Trilogy Global Advisors

Will QE2 Work?

Global equity markets experienced the best September in 70 years as market participants began to anticipate that the U.S. Federal Reserve Bank would initiate another round of quantitative easing (QE) before the end of the year. At the same time, the U.S. dollar had its second-worst month in two decades, with the U.S. dollar trade-weighted index declining by 4% during the month. Market sentiment toward equities was also boosted by positive economic data from both the U.S. and China suggesting reduced risks of a double-dip recession in the U.S. or a sharp slowdown in China.

Two key questions for investors now are:

Will QE2 work as hoped?

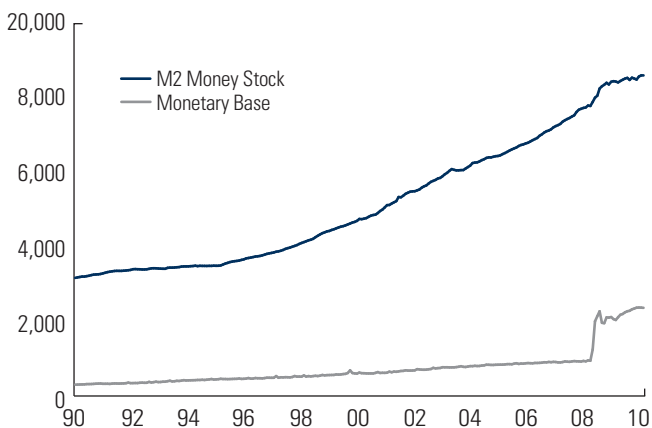
What are potentially undesirable side effects of this powerful medicine?

It's already helped once

In response to the first question, we are inclined to believe that further rounds of quantitative easing in the U.S. and elsewhere will have the desired effect of raising nominal GDP growth and preventing deflation. We have already seen the power of quantitative easing in the wake of the Lehman bankruptcy shock when the Fed expanded its balance sheet from around US\$984 billion to \$2.2 trillion in the eight weeks following the Lehman shock (see Chart 1). Although it took several months after that for the stock market to turn around and more than six months for the economy to start to recover, many indicators of financial conditions began to respond immediately. Such indicators included interbank borrowing rates, high-yield bond rates, and a number of other barometers of the health of money markets and credit markets that make up the Bloomberg Financial Conditions Index (see Chart 2).

Quantitative Easing Helped prevent Disaster in 2008

Billions of U.S. Dollars



Source: Haver Analytics

Chart 1: An unprecedented surge in the Fed's balance sheet was critical to restoring global growth after the 2008 financial crisis.

Using large-scale asset purchases over the course of 2009, the Fed was able to engineer an impressive recovery in financial conditions that set the stage for much improved economic activity as the year progressed. Not coincidentally, the improvement in financial conditions resulted in improving credit availability, with the most recent data from the Federal Reserve's Senior Loan Officer Survey showing that virtually no banks are tightening credit standards, while some banks are relaxing credit terms. Such survey results have been a good leading indicator of improving economic activity in the past (see Chart 3).

During the post-Lehman panic, the Fed had to improvise in a radical manner by stepping in as a buyer of last resort in markets like commercial paper and mortgages, that had effectively stopped functioning. So, with hindsight, it looks like it had a relatively easy job of restoring normal pricing of securities by providing liquidity and making markets in situations where private markets had almost entirely ceased functioning. But at the time, the Fed was clearly operating in a trial-and-error mode, without an established playbook and in the face of a cacophony of criticism from many back-seat drivers.

The circumstances it faces now are quite different from the financial panic following Lehman's bankruptcy. Instead of panic, in recent months there has been a progressively more sluggish recovery keeping U.S. unemployment at an

unacceptably high level. Additionally, underlying inflation has reached such a low rate that any further decline could jeopardize the Fed's ability to achieve its dual mandate of maximum employment and price stability. Importantly, the Fed made it clear in its September federal open market committee meeting that the Fed is committed to seeing the underlying rate of inflation move higher, in a policy that economists at J.P. Morgan dubbed "Whip-up inflation now".

To our knowledge, this is the first time the Fed has ever pledged to work toward raising the inflation rate, which suggests a rather important regime shift. Translation: they mean business. The clear implication for market participants was "Don't fight the Fed," and they responded by promptly bidding up the price of risky assets like stocks and corporate bonds while simultaneously selling the U.S. dollar on foreign exchange markets.

Back to Normal: Bloomberg Financial Conditions Index

Standard Deviations from Norm



Source: Bloomberg

Chart 2: The Bloomberg Financial Conditions Index has recovered to close to its average level from 1992-2008, but to the Fed unemployment remains unacceptably high.

The Fed's shift had been foreshadowed by its decision in early August to keep its large level of security holdings unchanged and by a subsequent dovish speech by Bernanke in Jackson Hole, Wyoming, toward the end of August. The Fed's shift was also reinforced by indications from the Bank of England and the Bank of Japan that their institutions were also inclined to resume quantitative easing, suggesting "more hands on deck" in the effort to boost nominal GDP growth in the developed nations.

The case for an aggressive QE2

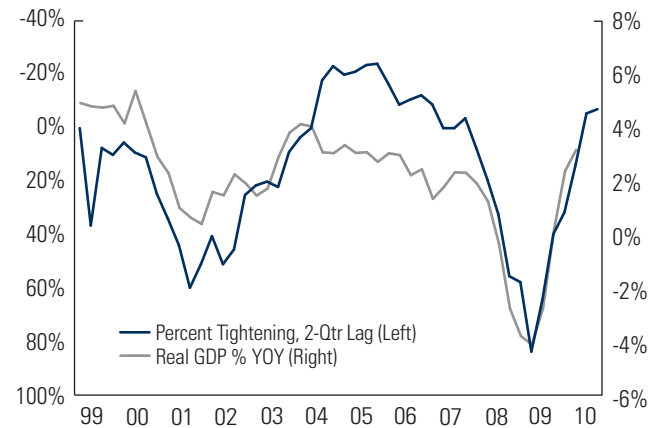
Among international policymakers, one of the most impassioned voices in favour of a more aggressive approach toward quantitative easing has been that of Adam Posen, an American economist who sits on the Bank of England's monetary policy committee. Posen expressed impatience with central bankers around the world who want to take a wait-and-see approach toward monetary policy:

“We will only know we will have done enough with QE [quantitative easing] or other monetary stimulus when we have clear indications that our policies are moving the desired variables – market interest rates, wages, output, employment, and inflation expectations – sufficiently and in the right directions on a sustained basis. I do not think it is enough for a central bank to say, ‘Look, we expanded our balance sheet more than any time in history,’ or ‘We did things we never did before,’ and argue that therefore we must have done a lot, if not too much (not that the Bank of England has done so). In my opinion, that is backwards logic. It would be like saying ‘That fire must be out, because we’ve already pumped more water than for any previous fire we’ve fought,’ or ‘we must have gotten to our destination, because I’ve been driving for hours and we’ve already used a full tank of gas.’

“This is a worse fire than any of us have ever seen in our lifetimes, and we are farther from home than we have ever been, and so we cannot judge our progress by how much effort or resources we have already put in. We can only gauge the success of our efforts by our results, and until we achieve those results, there is no danger from our heavy use of the available instruments. This is not a normal situation with finely balanced risks on both sides or with monetary policy able to finely calibrate to an outcome...”

We think Posen's views are worth noting because we suspect that they are not too distant from those of Fed Chairman Ben Bernanke, who in 2001 co-edited with Posen (and other authors) a book called *Inflation Targeting: Lessons from the International Experience*. Bernanke's speech at Jackson Hole was more measured in tone than Posen's, with an emphasis on using a cost-benefit framework for assessing whether to engage in further quantitative easing. Despite its measured tone, Bernanke's speech made it clear that he believed that further quantitative easing was a tool that could be effective in boosting growth and raising inflation expectations and that the Fed “will do all that it can to ensure continuation of the economic recovery.”

Federal Senior Loan Officer Survey Leads U.S. Real GDP Growth



Source: Haver Analytics

Chart 3: Data on U.S. bank credit standards show much improved credit availability, but U.S. economic growth remains disappointingly tepid.

We think there are few reasons to doubt that a sufficiently determined central bank can generate higher nominal GDP growth and higher inflation in a “rinse, lather, repeat” approach toward large-scale asset purchases. Using large-scale asset purchases on government bonds alone, Fed buying can push up bond prices and drive down long-term interest rates in a way that is highly likely to lower borrowing costs – at least in the short run – for corporate and consumer borrowers alike.

If, after the passage of some time, that has not generated stronger growth, the Fed could also make outright purchases of mortgage debt, particularly if it had the assurance of the Treasury that it would be willing to backstop any private-sector credit risk associated with such policies. With outstanding mortgage debt of more than US\$10 trillion, a Fed-led drop in mortgage rates of 100 or 200 basis points could save consumers hundreds of billions of dollars in interest rate costs. That may not be the same as “dropping money from helicopters,” to use another Bernanke metaphor, but it is a close approximation.

Anchors away? – the case for a measured QE2

In our view, there is almost no theoretical reason why aggressive quantitative easing would be unable to generate higher nominal GDP growth and a higher rate of inflation. If QE2 fails to do so, it would more likely be due to a failure in execution based on either (1) understandable concerns about serious side effects or (2) political constraints that prevent the Fed from being aggressive. Thus, it is important to understand what the key concerns are about QE2, and whether those concerns will lead to a more measured approach that fails to achieve the desired results.

The concerns are serious. The first is political in nature. If the Fed engages in large-scale debt purchases at a time when the government is running large fiscal deficits, then it is essentially monetizing the deficits and encouraging irresponsible spending behaviour among politicians. At a time when the U.S. faces serious long-term fiscal challenges associated with the aging of the baby boomers, it may be a dangerous precedent to let politicians believe that the easiest choice is for Fed monetary creation to finance deficits instead of either raising taxes or controlling spending. That is eventually a recipe for accelerating inflation and serial financial crises that should give officials serious pause.

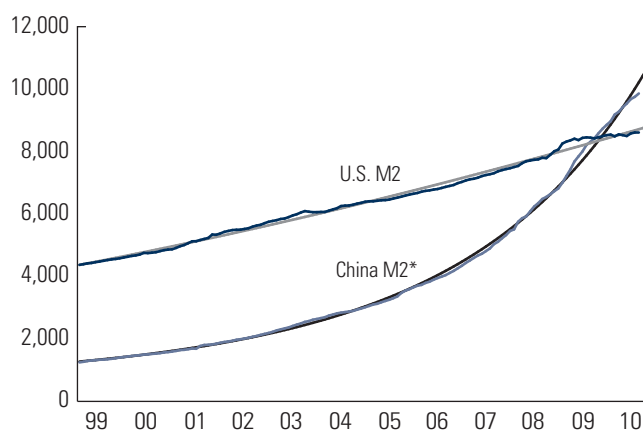
A second closely related concern is that large-scale asset purchases will eventually subject the central bank to a great deal of interest rate risk. When interest rates are low and stable that may not seem like much of an issue. However, if quantitative easing is successful in restoring growth, interest rates should eventually rise. That will result in falling long-term government bond prices and potentially large capital losses on the Fed's holdings. Suppose the Fed ends up with a \$5 trillion balance sheet and then suffers losses of 5% on its bonds. That would amount to a \$250 billion loss and could ignite a political firestorm as Congress had to deal with the hit to the nation's finances.

A third concern is that aggressive quantitative easing is, almost by definition, experimental and difficult to calibrate. As a result, the move toward easing could destabilize investor expectations about future inflation and/or the value of the U.S. dollar, which could conceivably lead to a huge spike in oil and non-oil commodity prices and potentially trigger a currency crisis. If those developments were to occur at a time when unemployment remains high, the U.S. could find itself facing 1970s-style stagflation.

A fourth concern is that, even if QE2 was successful in stimulating U.S. growth, it might lead to financial asset bubbles or high inflation elsewhere in the world due to the dollar's role as the world's lead reserve currency. This is a problem particularly for nations like China that peg their currency's value to the U.S. dollar. With China running a large trade and current account surplus, its efforts to keep its currency from appreciating have required its central bank to conduct its own large-scale asset purchases – notably U.S. Treasuries – which have resulted in accelerating monetary growth over the past decade (see Chart 4). Remarkably, China's M2 money supply outstripped America's in 2009 even though China's \$4.8 trillion economy was about one-third the size of the American economy.

China's Money Supply Overtakes America's: Actual vs. Trend 1999-2010

Billions of U.S. Dollars



Source: Haver Analytics, Trilogy Global Advisors

Note: China's money supply is converted to US\$ at each month's average USD/CNY exchange rate; *Quadratic trend estimated for China to capture accelerating growth.

Chart 4: The risk is that QE2 could fuel bubbles in emerging markets like China, which has already clearly experienced explosive money growth in recent years.

Even without QE2 acting as an accelerant, China's money supply will be double America's in 2012 and quadruple America's in 2015 if the trends of the last decade were to continue. China's authorities are well aware that such a trajectory for growth in its money supply could eventually lead to a Japan-type property bubble. But they remain deeply reluctant to let their currency float against the dollar because of the blow that could strike to their export industries and to their entire export-led growth model. Against this backdrop, it is easy to understand why they are reluctant to see the U.S. pursue policies that could lead to even more rapid liquidity growth in China.

Along with other emerging market policymakers, they are frustrated with the attitude of U.S. policymakers made famous by U.S. Treasury Secretary John Connally's remark to Europeans in the early 1970s that the U.S. dollar "is our currency, but it's your problem." Whether such frustrations will act as a major constraint on U.S. policy is not clear, but the concerns of China and other large creditors to the U.S. can no longer be entirely dismissed.

The compromise: small-scale QE2

In view of all of these concerns, it looks increasingly unlikely that the Fed will adopt a "shock and awe" approach toward QE2, unlike its approach in March 2009 when it said it would buy \$1.7 trillion worth of Treasury and mortgage-backed securities over six to nine months. Instead, it looks increasingly likely to move in "baby steps," by announcing some still-undecided target for bond buying – like \$100 billion or less per month. It would then retain the option to make a judgment at each FOMC meeting whether continued action was needed.

Since Fed officials have signalled in recent weeks that a compromise, small-scale approach to QE2 was probable, the large moves up in the price of risky assets suggests that the small-scale approach may be successful in boosting growth and reducing the odds of a double-dip recession. The Fed's policy shift is also occurring against the backdrop of equities being cheaper relative to bonds than any time in the past 50 years, suggesting reasonably high odds that equities will outperform bonds in the year ahead. It also suggests that the knee-jerk response of financial markets to the Fed's policy shift in recent weeks are exactly what the U.S. authorities would like to see continue: stronger equity prices, narrower credit spreads, higher commodity prices and a weaker U.S. dollar. And for emerging market nations worried about the impact of surging liquidity and capital inflows: It's their problem.



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