IMPLICATIONS OF THE FED’S EXIT FROM QE

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What Are The Implications of The Fed’s Exit From QE?

With markets taking fright at recent comments by the Federal Reserve (the “Fed”) on an eventual end to Quantitative Easing (QE) it is worth considering now what a slowing down or indeed an exit could mean for economies and markets.

In summary, we think that:

- The Fed may start to reduce the size of its bond buying program this year and end new buying next year
- A complete exit is likely to take many years
- The exit is only likely to take place in an environment of stronger economic growth. As a result any negative implications on growth are limited
- The Fed is likely to have a pro-growth bias for many years to come, (reflected in a slow unwinding of its balance sheet and a low fed funds rate) and this could lead to greater tolerance for inflation in the second half of this decade
- The exit from QE and the conditions that will cause that exit (as well as eventual rises in the Fed funds rate) – stronger growth – should lead to bond yields returning to more normal levels over the medium term. Some of that move has already taken place
- The Fed is likely to signal its actions well in advance in an attempt to prevent a 1994 type bond market collapse, although as recent market movements show, those signals can also cause volatility
- Rising bond yields will make equities less attractive on a relative basis
- However, the improving economy and rising corporate profits may more than offset the headwinds from the eventual end of QE

At the time of writing (June 2013) Mercer’s dynamic asset allocation team continues to prefer equities relative to bonds. We also think that equities are likely to rise over the medium term. The key risk to this view is that inflation starts to rise.
What is QE?

In normal times central banks try to influence an economy through changing the cost of money by adjusting interest rates. However, following the 2008 financial crisis (GFC), many developed central banks lost the ability to lower interest rates further as they had already reached 0%. As a result, they switched their focus to boosting the economy by increasing the quantity of money. They did this by buying government and other bonds in large quantities funded in the money markets where they issued treasury bills and other short term instruments. The primary purpose of QE was to stabilise the financial system, which when QE was launched, risked further economic weakness and deflation. Even though the financial system stabilised, the Fed continued with QE in order to lower government bond yields. This, it was hoped, would also lower corporate yields, increase the attractiveness of other risk assets such as equities and boost confidence more generally.

The Bank of Japan was the first major central bank to employ QE, embarking on its first bond buying operation in 2001. In late November 2008, following the collapse of Lehman’s and the subsequent turmoil, the Fed announced plans to buy $600 billion of mortgage backed debt. Further bond purchases took the total to almost $2,000 billion by the summer of 2010. This period is generally referred to as QE1. QE2 was launched in November 2010, while QE3 set sail in September 2012. Under QE3, the Fed promised to buy $85 billion worth of bonds per month until it thought the labour market had improved substantially, subject to inflation remaining under control.

The Fed has also provided the market guidance on when its policy might change. At its December 2008 meeting, the Fed said that ‘economic conditions are likely to warrant exceptionally low levels of the federal funds rate for some time to come’. In August 2011, they strengthened the commitment by adding that rates were likely to stay exceptionally low until ‘at least though mid 2013’. By October 2012, the promise had been pushed out to mid-2015. In December 2012 they changed their forward guidance to being threshold based rather than calendar based, committing to keep interest rates at their current level while unemployment is above 6.5%, subject to inflation being contained.

What impact has QE had?

US ECONOMY

It is difficult to know what would have happened had there been no QE. QE1 was initiated at the depths of the financial crisis in late 2008, and played an important role in returning liquidity to stressed financial markets and laying the groundwork for economic recovery over the course of 2009. The impact on the economy of subsequent asset purchase programs (QE2 and QE3) is likely to have been more indirect, largely through curbing perceptions of downside risk, supporting asset prices, and the accompanying improvements in confidence.

QE appears thus far to have had no impact on inflation, over and above the impact through economic growth. Inflation and inflation expectations have stayed fairly stable at low levels over the last few years (next two charts). At the time of writing core and headline inflation are both below 2% and hence lower than the level sought by the Fed. In addition, the US dollar has also been fairly stable with little obvious link between QE and the US dollar’s value.

CHART 1

PCE and Core PCE

Source: Thomson Reuters Datastream

CHART 2

Inflation Expectations

Source: GSAM

Financial markets

It appears that even allowing for the recent market turmoil, QE has substantially boosted equity, bond and other markets, while lowering financial stress. The chart on the next page shows that government bonds and equities have performed well since the program began while financial stress has declined. Indeed, government and corporate bond yields remain close to record low levels, while US equities have recently reached their highest level ever (they have fallen off these levels in recent weeks). The US property market has also recovered with prices up over 10% over the last year.

CHART 3

MSCI World Treasury, BofA ML Global financial stress index

Source: Thomson Reuters Datastream

1 Case Schiller, June 25, 13 via Bloomberg
How will the QE program be wound up?
The Fed has said that it will keep interest rates at close to 0% as long as the unemployment rate remains above 6.5% - it is currently 7.6% - as long as inflation is contained. However, although interest rates will remain unchanged until that point, this does not mean that its QE program will be unchanged. The Fed’s exit from QE and eventual return to a more normal monetary policy setting is likely to be in 4 main steps and may take several years. As each new stage is approached, the moves are likely to be well signalled by the Fed. Recent Fed comments on the possibility of reducing the Fed's purchases can be seen as the start of the build up to stage 1.

1. Reduce (or taper) the size of the monthly bond purchases from the $85bn/month to perhaps $40bn/month.

2. Cease to buy any new bonds (other than those it buys when bonds mature, mortgage bonds have the principal repaid or from bond coupons).

3. Cease to reinvest cash flow from coupons, maturing bonds or principal repayments from its mortgage/agency bonds.

4. Raise interest rates.

At its meeting on 19 June and at the press conference at its meeting the Fed gave further information on its exit plan. It confirmed that it was likely to begin tapering this year (stage one) and cease buying new bonds (stage two) in the middle of next year if unemployment falls to 7% as they expect. The Fed also lowered its forecast for the unemployment rate by the of 2014 to 6.5% suggesting they would start to consider raising interest rates at the end of 2014, although Bernanke also said they might lower that threshold. Bernanke also said their plans were very data dependent and could change as the economy evolves. The charts below show that unemployment has been falling recently while non farm payroll growth has been solid.

What impact will the Fed’s exit have?
One of the challenges in assessing what impact the end of QE will have in isolation is that the exit will only take place if the US economy is performing well. The other difficulty is that as QE is such an unusual policy there is no roadmap for investors (or the Fed) to follow. Nonetheless, there are some general points that can be made.

THE US ECONOMY

The economic impact on the ending and eventual unwind of QE is likely to muted, unless there is a significant negative financial market response. Interest rates are likely to remain exceptionally low for a number of years, regardless of the speed with which the Fed unwinds QE. Should the financial market response be more negative than we expect, the Fed would slow, or even stop, its exit to ensure that its goal of full employment is met, subject to inflation remaining in line with target.

Some have speculated that such a long period of exceptionally low interest rates could have caused a mis-allocation of capital, which could lead to bad debts and financial stress in the future. While such a mis-allocation is likely to have happened in some cases, it seems unlikely to have happened enough to be material at a whole economy level up to this point.

A number of investors are concerned that past QE will inevitably lead to inflation. These fears are largely driven by monetarist economic teachings which say that there is a direct link between the aggregate price level in an economy and the amount of money in an economy (MV=PQ). In theory, any increase in M will lead to an increase in P as the velocity of money (V) is assumed to be constant.

While this theory is analytically appealing, it does not work well in practice. The velocity of money is not stable and has collapsed in recent years, with the additional liquidity created staying with the banks and not being lent on to the private sector. When the economy picks up, bank credit growth is likely to pick up. In the absence of a reduction in QE, this could well lead to a surge in economic activity and inflation further down the line.

It is precisely for this reason that such a pick up in the economy should lead the Fed to withdraw QE. It is possible that the Fed may be too slow in removing the excess liquidity, which would lead to the risk of rising inflation in the second half of this decade.

What impact will the Fed’s exit have on markets?

BONDS

The end of QE and the normalization of the Fed Funds rate will inevitably lead to higher government bond yields. The US Treasury has bought over 50% of all new bonds issued and these purchases have contributed to record low yield levels. When the Fed starts to exit QE, yields are already likely to be under upward pressure because of the recovery in the economy. The rise in yields is unlikely to be either in a straight line or necessarily smooth. However, the Fed will seek to maintain overall stability by varying the exit’s pace if that is necessary, while a still low Fed funds rate should ensure that yields do not rise too far too fast.

CHART 5
Unemployment

Source: Thomson Reuters Datastream

CHART 6
US Non-farm Payroll

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CORPORATE BOND YIELDS AND SPREADS

Overall corporate bond yields are likely to rise on the back of the overall rise in yields. However, credit spreads may not be affected to a significant degree as the Fed will not be selling corporate bonds. Corporate bond spreads are likely to be driven by other drivers such as corporate profitability and leverage, and these should remain supportive for some time to come.

EQUITIES

On its own, the ending of the QE program is not supportive of equity markets because rising bond yields will reduce the relative attractiveness of equities relative to bonds. At the moment equities are cheap relative to bonds, according to most valuation measures such as the equity risk premium (ERP). However, if bonds were at a more normal yield level of (say) 5% (that is levels more consistent with nominal GDP growth), equities would be much closer to fair value. This is why it is important to consider absolute measures of value in equities as well as bond-relative valuations.

The eventual ending of QE does not necessarily mean that equities will fall however as there may be other new reasons to buy equities. QE will only be withdrawn and yields rise if the US economy is strong. Stronger demand and sales growth should at least partly offset any decline in margins from current high levels, helping to sustain reasonable corporate earnings growth.

50%

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