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Bernanke Hints of Possible QE3

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Fed Chairman Ben Bernanke, in his speech to the National Association for Business Economics, was skeptical that the improvement in the labor market was sustainable. He started the speech by stating that the "better job numbers seem somewhat out of sync with the overall pace of economic expansion". He spent a large part of his presentation arguing that the improvement in employment was neither understandable nor sustainable.

The overall tone of his speech suggested that in order to have further gains in employment, the economy would have to grow at a faster pace than it is currently. More specifically, he stated that further significant improvements in the unemployment rate will likely require a more rapid expansion of production and demand from consumers and businesses. He went further to say that this process "could be supported by continued accommodative policies".

In our view, the mention of "continued accommodative policies" hints at a possible QE3, should the monthly employment data begin to soften. We will know this Friday, April 6th whether we can have a fourth consecutive monthly jobs gain of 200K plus.

The timing of another round of quantitative easing could be sooner than most expect if the data warrants. The next Federal Open Market Committee (FOMC) meeting is scheduled for April 25th, followed by a June 20th meeting. The absence of a meeting in May suggests that the Fed may move to ease further as early as April 25th if this week's employment data proves weak.

As has been the case since the start of QE1 (November 25, 2008), financial markets have responded quite sharply with the S&P 500 Index gaining nearly 75% to date. In the bond market, the total return from the high yield market has been up a staggering 116% during the same period.

Looking forward, it is our view that equities will provide the best returns should the Federal Reserve engage in further easing. Regardless, equities are expected to outperform fixed income assets over the course of the next 12 months barring that the US economy doesn't dip into a recession - a scenario that we do not believe will occur.

The equity rally of the first quarter has been led by financials, technology and consumer discretionary stocks. Also, the Fed stress test for banks last week proved positive for the banking sector. Consumer confidence, as measured by the University of Michigan, has now risen to near its highest levels since January 2008. Even a tepid improvement in the labor market by historical standards is having a positive influence on consumer sentiment and this is translating into an increase in consumer spending. We see further gains from those sectors that are currently leading the markets.

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