

QEIII: Why Not (!?)

The recent string of US economic data has been simply dreadful. Estimates for growth are being revised down. The Federal Reserve's purchases of Treasuries, under what has been dubbed QEII, are coming to an end in a few weeks. The discord that is preventing raising the debt ceiling reflects disagreements over the pace of fiscal consolidation. It is not clear what kind of policy response to further economic weakness can be delivered.

The rating agencies recent warnings and the political considerations suggest that the scope for a fiscal response is minimal at best. Instead of talking about a new fiscal compromise, like the unexpected one for this year, talk of a monetary response, QEIII, has begun. To help further the discussion, let's consider three aspects here: efficacy, probability of QEIII, and other potential actions.

Efficacy

To evaluate whether the Fed's purchases of Treasuries has been successful, we have to appreciate what it was trying to achieve. Most important to note is that the Fed itself does not call these operations quantitative easing. The market does. Do not confuse the market's short hand with the facts. The Fed calls what it is doing Long-Term Asset Purchases. Its explicit goal, then, is not targeting its balance sheet—like the Bank of Japan. It was not to boost money supply nor was it to increase bank credit. Altogether, there are many other things the Fed's Treasury purchases have failed to accomplish. Many observers cite these and conclude QEII has not been successful.

The problem may lie more with the metric than QEII. Federal Reserve Chairman Bernanke addressed the issue head on at his first regular press conference following the April FOMC meeting: "The conclusion that the second round was ineffective could be validated only if some thought this was a panacea. Relative to what we expected, and anticipated, the program was successful."

In recent comments, Bernanke has referred to the stock market's rise as part of the evidence that the Fed's bond purchases have been effective in boosting the demand for riskier assets, as it removes risk free assets from the market. Through early June, the S&P 500 is indeed out performing all other G7 bourses, the BRICs and most of Asia. To be sure it is not so much that US equities are posting a sharp advance. In fact, the gain thus far this year of 3.4% is, if anything lagging behind its long-run historic pace.

The Fed's point is that the stock market is higher than it would have otherwise been. The same case it makes about bond yields. The 10-year bond yield is higher than it was when Bernanke made clear at the end of last August at Jackson Hole that the Fed would most likely resume its Treasury purchase program.

Credit spreads are tighter as well. One set of risk assets the Fed does not believe it has caused to run-up are commodity prices. The rally in commodity prices seem to line up better with supply shocks, such as the droughts and floods for food and fibers, and geopolitical issues, like the unrest in the Middle East and North Africa, especially in terms of oil prices.

The counter-factual argument of what would have been the case had the Fed not bought Treasuries is rather weak. The problem with all counter-factual arguments is that they often cannot be tested (or falsified as Karl Popper taught) and that holds here. Nevertheless, it is important that the Fed thinks its Treasury purchases were effective. If nothing else, it means that the long-term asset purchase will remain in its repertoire and could be used again, if conditions warrant.

Probability of QEIII

The Federal Reserve justified its resort to extraordinary measure because the Fed funds rate was already near zero and its mandated goals of full employment and price stability were not being achieved fast enough. This is more profound than many appreciate. The US economy grew 2.8% year-over-year in 2010. Japan expanded 2.2% and the euro zone 2.0%, while the UK trailed at 1.5%. What most other countries would have been quite content with was insufficient for the US.

When the Fed embarked on new Treasury purchases, it had appeared fiscal policy was going to become more of a headwind. The fiscal deal struck early this year was not anticipated. Yet the increased stimulus on the federal level barely has offset the drag from states and local governments. The overall contribution of the government on US GDP has been net negative in three of the past five quarters.

The US economy has not reached what economists have dubbed the “escape velocity” which is growth that is sufficient to absorb the excess capacity. This excess growth in turn would lead to a decline in the unemployment rate. Quite to the contrary, the decline in the unemployment rate that has occurred is more a result of people leaving the labor market rather than the creation of a sufficient amount of jobs (~1.7 mln have been created over the past year). Nor does it look like the US economy will reach escape velocity any time soon.

Meanwhile, a case for QEIII can be made and is likely to increasingly be debated. Recall that before QEII was formally announced there was speculation of an even larger purchase program, with some talk of amounts double of what the Fed decided. The same is true of fiscal policy. There are some voices that contend that it also was too small and at the time advocated a larger deficit (and different policy priorities).

Nevertheless, the bar seems relatively high for extending the bond purchases. Bernanke was quite clear about this at the April press conference, noting that the “trade-off was less effective”. The lack of desire may be coupled with political considerations. QEIII would be terribly unpopular in some congressional circles that could very well cut their proverbial nose to spite their face and tinker with Fed’s independence.

In addition, again, from the Fed’s point of view, which is the most important in trying to understand what they are likely to do, the impact of its Treasury purchases lies more with the holding than the buying. The Fed’s balance sheet of almost \$3 trillion is supportive of the economy.

The Fed’s assessment of the economy is probably not as volatile as short-term investors who often exaggerate the significance of high frequency economic data. Several shocks have hit a fragile economy. The commodity, including oil, shock, the disaster in Japan, the weather in the US Midwest, the European debt crisis have taken some toll though it is not clear precisely how much.

The combination of a high bar for action coupled with weak visibility reinforces the Fed's caution. The impact from the shocks is likely to fade in Q3 and oil prices appear to be stabilizing (perhaps in the face of disappointing growth figures and strong inventories). This may restore some consumer confidence and real demand. Although the May jobs data was poor, the fact that the work week expanded (0.1% is the equivalent output of about 375k full-time equivalents) may be suggestive of employers who's uncertainty prevented them from expanding their work force and instead chose to work their current employees longer.

Potential Actions

Without expanding its Treasury purchases, there are several steps the Federal Reserve is likely make. First, it is likely to revise its assessment in the next FOMC statement to recognize the recent string of disappointing data. In April it said that the "recovery was proceeding at a moderate pace". This no longer seems true. It may now say something to the effect that the recovery has slowed, but it is expected to be temporary.

Second, the (controversial) phrase about interest rates low for "an extended period" may be strengthened rather than diluted as some of the hawks wanted. It may also be strengthened by the Fed signaling it does not intend allow its balance sheet to shrink for an "extended period" either and this means that it continues to recycle its mortgage-backed securities proceeds into the Treasury market beyond when the market anticipated them to stop (late this year or early next year). Ideas, encouraged by some Fed officials themselves, about potentially tightening this year, will be corrected and the market may push its expectation for the first hike into H2 2012 or even into H1 2013.

Third, if the economy continues to deteriorate, as some are warning, there are a number of policy options for the Federal Reserve besides expanding its balance sheet. It may require, in part, a culling of the Fed's own history and duplicate some of the functions during the Great Depression—such as direct loans to businesses—as well as creatively using its full range of policy tools, such as adjusting the interest rates on reserves or the margin requirement for equities.

Taken together, the Fed cannot rule out renewed Treasury purchases. It does not or should not deny itself its policy options. It is committed to do what is necessary to prevent a slide into deflation, which indeed is a forgotten element of price stability. Yet the central bank cannot do everything and shy of a politically untenable expansion of its power, there is little it can do to support the housing market or to stop the necessary de-leveraging of the private sector: both major retardants on the growth of the economy. On the whole, it can just hope to mitigate the impact, and thus we return to the counter-factual case.

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