First Trust
Monday Morning OUTLOOK
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Is QE4 Really Coming?

Brian S. Wesbury – *Chief Economist*
Robert Stein, CFA – *Senior Economist*
Strider Elass – *Economic Analyst*

The Federal Reserve meets this week. Analysts are supposing and predicting what the statement will say and if the Fed will change its economic projections.

We think this is all much ado about not much. The Fed won't change the federal funds rate, the short-term interest rate it targets for interbank lending. It appears that Ben Bernanke wants it where it is for the rest of our lifetimes. And it is way too low. Nominal GDP – real GDP growth plus inflation – grew at a 5.5% annual rate in Q3 and is up 4.2% in the past year. With nominal growth this far above the funds rate, monetary policy is truly accommodative.

So, the key issue on the table is what the Fed will do about "Operation Twist." Since September 2011, the Fed has been buying $45 billion per month in long-term Treasury securities and simultaneously selling $45 billion in short-term securities. The program is designed to bring down long-term interest rates, but is supposed to end at year end.

Our best bet is that given how aggressively the Fed wants to use monetary policy to try to stimulate the economy – despite the fact that fiscal and regulatory mistakes are the real problem – the Fed is not willing to just let Twist die. Instead, it's likely to continue to purchase $45 billion per month in long-term securities and just stop selling the short-term securities.

What's important to recognize is that this would not be some cosmetic change in policy. Operation Twist shifted the *composition* of the Fed's balance sheet (more long-term, less short-term), but it did not change the *size* of the balance sheet. By contrast, continuing to buy long-dated Treasuries but no longer selling shorter-term Treasuries would add to the size of the balance sheet and can be looked at like QE4.

If the Fed embarks on this for the next year it would add about $540 billion to a balance sheet that is now $2.8 trillion. The Fed is already committed to buying $40 billion per month in mortgage securities, so we're on a path for a balance sheet of nearly $4 trillion.

This expansion in the balance sheet is not going to help the economy. The vast majority of the expansion will simply add to excess reserves in the banking system that's already overstuffed with $1.4 trillion in excess reserves. Banks, knowing the Fed will eventually retract this liquidity are not eager to lend it out.

The Fed may claim that by driving down long-term rates, it can generate some improvement in the housing market. But notice how home building is recovering much faster than home buying. This recovery in housing would have happened anyway. Another issue at the Fed's meeting will be how to handle the drop in unemployment. In September, the Fed said the jobless rate would finish the year at about 8.1% and not get to 6.5% until mid-2015.

But the unemployment rate is more likely to finish the year at 7.7% and hit 6.5% sometime in 2014. So, is the Fed willing to move up its potential first rate hike? Not likely. The Fed is committed to a course of super-ease and will stay that way. The result will be more inflation and some real difficultly when the Fed finally decides to do something about it.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
12-11 / 7:30 am	Int'l Trade Balance – Oct	-$42.5 Bil	**-$43.0 Bil**		-$41.5 Bil
12-12 / 7:30 am	Import Prices – Nov	-0.5%	**-0.6%**		+0.5%
7:30 am	Export Prices – Nov	+0.1%	**+0.3%**		+0.0%
12-13 / 7:30 am	Initial Claims – Dec 8	370K	**370K**		370K
7:30 am	PPI – Nov	-0.5%	**-0.5%**		-0.2%
7:30 am	"Core" PPI – Nov	+0.2%	**+0.2%**		-0.2%
7:30 am	Retail Sales – Nov	+0.5%	**+0.6%**		-0.3%
7:30 am	Retail Sales Ex-Auto – Nov	+0.0%	**-0.3%**		+0.0%
9:00 am	Business Inventories – Oct	+0.4%	**+0.2%**		+0.7%
12-14 / 7:30 am	CPI – Nov	-0.2%	**-0.3%**		+0.1%
7:30 am	"Core" CPI – Nov	+0.2%	**+0.2%**		+0.2%
7:30 am	Industrial Production – Nov	+0.2%	**+0.2%**		-0.4%
7:30 am	Capacity Utilization – Nov	78.0%	**77.8%**		**77.8%**