First Trust
Monday Morning OUTLOOK
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Bet Against QE3

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Since the financial crisis in 2008 the Federal Reserve has done extraordinary things – lowered interest rates to essentially zero, increased the size of its balance sheet by $2 trillion and announced Operation Twist.

With unemployment still relatively high and real GDP growing at a 2% rate in the past year, there are many on (and off) the Fed who think more should be done.

If we thought liquidity was a problem, we might agree, but it's not. The reason the economy is growing more slowly than many Americans would like is because of bad fiscal policy. We are anti-Keynesians…we think government spending (when it has gone beyond the things government can actually do efficiently) is a drag on economic growth. The bigger the government, the smaller and less dynamic is the private sector.

But our belief will not sway the Fed. It apparently wants to act again, but does not have anything close to unanimous support. As a result, we think QE3 is extremely unlikely unless some kind if international contagion emanating from Europe were to occur. But, given essentially zero percent short-term interest rates in the US and the absence of mark-to-market accounting, we just don't find this a plausible scenario.

As a compromise we could see the Fed extending Operation Twist beyond the end of June, which means it will continue to sell short-term Treasury bills and buy longer-term Treasury notes and bonds. This action does nothing for monetary policy. In fact, it is really more of a "fiscal" activity, no different than if the Treasury Department decided to sell more short-term bills and fewer longer term securities.

More importantly, we don't think quantitative easing made a dime's worth of difference for the economy.

From late 2010 through mid-2011, during QE2, the Fed bought $600 billion in Treasury securities from the banks. In that time, excess reserves held by the banks went up from slightly more than $1 trillion to more than $1.6 trillion. In other words, all of the money the Fed injected came right back to the Fed and did virtually nothing. Excluding excess bank reserves, the Fed's balance sheet is actually smaller than it was in late 2008 and has been little changed in the past three years.

Of course, the Fed likes to say that QE2 and Op Twist lifted stock prices, but if this were really true then price-earnings ratios would be higher. They aren't. In fact, the ratio of the S&P 500 to operating earnings was 13.3 in May 2012, exactly the same level it was in August 2010 when QE2 started. P/E ratios are lower today than they were back in 2006, 2007, 2008 or 2009. Unless the Fed can magically lift corporate earnings without boosting economic growth above 2% or pulling unemployment below 8%, we don't see the connection.

It's time we stopped looking to the Fed as our economic savior. Loose monetary policy cannot fix every economic problem. Imagine if Congress suddenly boosted the minimum wage to $50 per hour! Unemployment would skyrocket and real GDP would plummet. Obviously the Fed couldn't stop the short term pain.

In the end, if we want more growth, there is no substitute for reducing government spending and excessive regulation. And that's just not the Fed's job.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
6-12 / 7:30 am	Import Prices – May	-1.0%	**-0.9%**		-0.5%
7:30 am	Export Prices – May	-0.2%	**-0.2%**		+0.4%
6-13 / 7:30 am	PPI – May	-0.6%	**-0.6%**		-0.2%
7:30 am	"Core" PPI – May	+0.2%	**+0.2%**		+0.2%
7:30 am	Retail Sales – May	-0.2%	**-0.4%**		+0.1%
7:30 am	Retail Sales Ex-Auto – May	+0.0%	**+0.0%**		+0.1%
9:00 am	Business Inventories - Apr	+0.3%	**+0.3%**		+0.3%
6-14 / 7:30 am	CPI – May	-0.2%	**-0.2%**		+0.0%
7:30 am	"Core" CPI – May	+0.2%	**+0.2%**		+0.2%
7:30 am	Initial Claims – June 9	375K	**374K**		377K
6-15 / 7:30 am	Empire State Mfg Index – Jun	13.5	**11.0**		17.1
8:15 am	Industrial Production – May	+0.1%	**+0.0%**		+1.1%
8:15 am	Capacity Utilization - May	79.2%	**79.2%**		79.2%
8:55 am	U. Mich Consumer Sentiment	77.5	**78.0**		79.3

Consensus forecasts come from Bloomberg. This report was prepared by First Trust Advisors L. P., and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.