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# Saying Q.E.D. to QE?[1]

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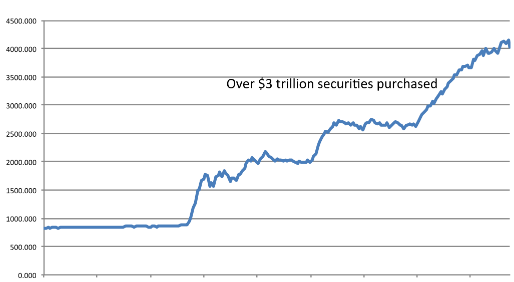
**Fed purchases end in October**

This month the Federal Reserve will end 5 years of monthly purchases of government-issued and government-backed securities. In the intervening years, the Fed expanded its balance sheet more than 5 times to an unprecedented $4.4 trillion. This month's perspective is not an obituary on QE; it is rather a simple reminder of the implications that the demise of the Fed's taper will bring.

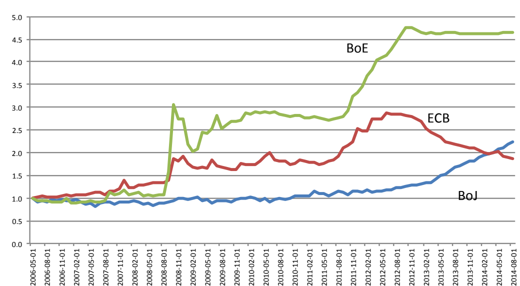
QE by the Federal Reserve Ends October 2014




**QE is not dead!**

It's too soon to say goodbye to QE globally; several prominent central banks throughout the world are currently still committed to continue QE. The European Central Bank and the Bank of Japan are currently avid practitioners of QE.

QE is Ongoing in EU and Japan




**It's too early to judge**

It is premature to judge the success of QE. To answer it we would have to know what would have happened to the economy without QE. All we can point to

[1] Q.E.D. = Quod Erat Demonstrandum

is that the US economy has continued to grow over the past 5 years in spite of the many headwinds it had to overcome since the great credit crisis. The unemployment rate has fallen significantly, and annual employment gains have finally recovered to normal business-cycle-expansion standards: 2.6 million new jobs in the past 12 months.

**Costs are not visible**

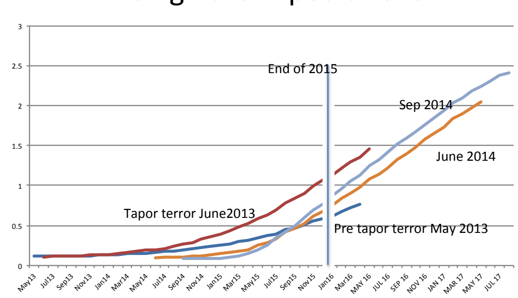
It is also far too soon to estimate the costs associated with this atypical monetary policy. The textbook concern for printing money is that it promotes rising inflation. There is no evidence of that occurring now, or in the immediate future. There simply is not excessive demand for goods and services in the US, or throughout the world. However, there have been large spillover effects associated with QE. Piles of money have shown up in the real estate markets of Asia, and due to the presence of exceedingly low central bank rates everywhere, investors have sought greater returns in the riskier stock market and in the high yield bond market. Concern about asset price bubbles has therefore increased.

**The end of QE heralds the normalization of policy**

The end of security purchases by the Fed will soon lead the Fed towards normalization of its policy. A host of recently strong economic signals suggest that the start for gradual normalization is quickly approaching. Because that time is drawing near, the Fed at the conclusion of the last FOMC meeting in September released this statement about their approach to normalization:

*"The Committee intends to reduce the Federal Reserve's securities holdings in a gradual and predictable manner primarily by ceasing to reinvest repayments of principal on securities held in the SOMA. The Committee expects to cease or commence phasing out reinvestments after it begins increasing the target range for the federal funds rate; the timing will depend on how economic and financial conditions and the economic outlook evolve."*

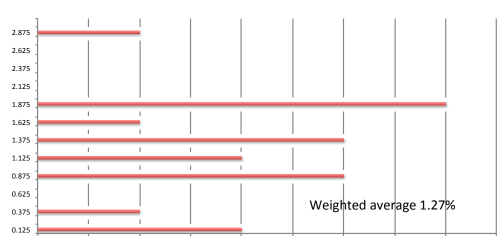
Fed Funds Futures Point to Steady Rising Rate Expectations



**Normalization will be sooner than the market thinks**

The timing to start normalization is probably nearer than most market participants believe because the economic data has improved significantly; the unemployment rate fell below 6% in September; the number of new payroll jobs created each month has averaged 220k over the past year or above the average in the past 4 cyclical expansions; employment growth has steadily climbed to 1.9% y/y, up from 1.7% in the past 2 years; GDP growth has improved significantly in the past two quarters growing at an estimated 4% annualized rate, after being trapped by adverse winter weather in Q1 2014; and headline CPI inflation is flirting with the bottom of the Fed's tolerance zone.

FOMC members estimates of year-end Fed funds rate in 2015




Market participants anticipate that the funds rate will begin to rise in June 2015 and climb very gently to 0.77% by the end of 2015. In comparison, the average FOMC members' estimate of the year-end Fed funds rate in 2015 is 1.27%. My estimate is that the FOMC will begin raising its base rate in March 2015, and continue throughout the year (7 remaining meetings), reaching a year-end level of 1.75%.

**The beginning of divergence**

The Fed's decision to end QE is also the beginning of the end of consistency in the direction of global monetary policy. Soon, interest rates in the US will slowly start to rise and they will probably cause rates in many other countries to rise in sympathy. However, economic growth is neither strong enough, nor stable enough for other major central banks to follow suit. Consequently, interest rates in the US will rise relative to Japan and the EU in 2015.

**Another recession in Japan is forming**

The Japanese economy has had a relapse. GDP growth in Q2 and Q3 has slumped badly and inflation is decelerating rapidly. While another economic recession was highly predictable following the imposition of a consumption tax (and very reminiscent of the same tax and same outcome as in 1997), the Abe government went ahead with it. Now the pressure has been placed on the Bank of Japan to create greater stimulus. Mr. Kuroda, the current head of the Bank of Japan reassured all that he would do what it takes to rekindle growth, and then set about a program to purchase trillions of Japanese securities.

The Policy Board of the Bank of Japan decided by a unanimous vote, to set the following guideline for money market operations for the intermeeting period: The Bank of Japan will conduct money market operations so that the monetary base will increase at an annual pace of about 60 - 70 trillion yen. With regard to the asset purchases, the Bank will continue with the following guidelines:

The Bank will purchase Japanese government bonds (JGBs) so that their amount outstanding will increase at an annual pace of about 50 trillion yen, The Bank will purchase exchange-traded funds (ETFs) and Japan real estate investment trusts (J-REITs) so that their amounts outstanding will increase at an annual pace of about 1 trillion yen and about 30 billion yen, respectively.

Rapid monetary expansion and promise of more to come caused the yen to depreciate 9% against the dollar, and 11% against the Chinese RMB, in the past 3 months. It is widely expected to depreciate further.

**ECB needs to do more**

Mr. Draghi of the European Central Bank made similar comments and initiated a program to purchase private debt starting from November this year. The ECB will increase its balance sheet to 2012 levels. The current balance sheet is 2.04 trillion euros, compared to roughly 3 trillion euros in 2012. Thus, the ECB will have to buy a significant amount of private debt in the coming months. The measures introduced are “credit-easing oriented,” said Draghi. Ideally, the asset backed securities (ABS) and covered bond purchases should reinforce TLTROs (targeted long-term refinancing operations), as they will free space in banks’ balance sheet to lend credit to non-financial companies through the TLTROs. Mr. Draghi remarked that ‘this is not considered as QE, as we do not refer to the government rate curve’. If further action is needed, sovereign debt purchases would be a logical next step.

Nevertheless, his policy announcement helped push the Euro lower against the dollar and the Chinese RMB. It was a welcomed development for EU exporters, however, the Euro will have to depreciate significantly before it contributes to EU GDP growth.

**China’s policy has fluctuated this year**

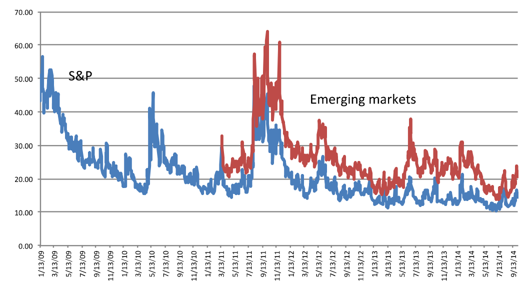
The Peoples Bank of China chose a different approach to stimulate lending by directly injecting liquidity into its 5 biggest banks this summer. Over the past year monetary policy had been mildly stimulatory after the central bank lowered reserve requirements*. However, in the spring they began to restrain off balance lending especially to state-owned companies and local governments. Late this summer the bank opened its window and injected liquidity into the banks after fresh economic data reflected softening industrial demand and output.

The RMB has continued to appreciate throughout this year irrespective of other monetary policy decisions by the central bank. The RMB is not a fully convertible currency, consequently its value will continue to be driven by the reserve bank's policy of gradual appreciation. Therefore, it will probably continue to gradually appreciate vs. the dollar and appreciate more rapidly vs. the Yen and the Euro.

**Some global implications**

The most obvious implication is that interest rates in the US will rise relative to other advanced economies and quite possibly relative to many less advanced economies. An increase in relative interest rate differentials traditionally draws capital to that higher-yielding capital market and away from others. Consequently, the dollar should be a major beneficiary of this process, particularly against the Yen and the Euro.

VIX volatility for S&P and Emerging Markets are both low




**The search for yield will shift to a search for security**

Secondly, as interest rates normalize in the US and capital gradually shifts back to US markets, uncertainty will rise, and with it market volatility. Measures of market volatility, like VIX, have been remarkably low in recent years in spite of several geopolitical storms, which in the past have created much greater volatility. Increases in market volatility will increase investors' risk aversion, drawing investment from riskier assets like high yield bonds and emerging market assets and sending it to safer investments like highly-regarded sovereign bonds.

Third, as investor uncertainty replaces confidence, the threatening geopolitical risks will exert greater weight on investors' preferences and exaggerate the shift to investment safety.

Fourth, recently released positive US economic data has caused an abrupt increase in financial market volatility in the US setting off new fears of rising rates coming sooner than the market has anticipated. Volatility struck equity markets hard, erasing 50% of the years' gains in one week. This should be a stern test to determine whether the lofty equity valuations are dependent upon Fed liquidity injections and miniscule interest rates, or economic reality.

**Conclusion**

In summary, the dollar should appreciate substantially over the next 12 to 24 months against nearly all currencies, except the Chinese RMB. The US economy can better afford this competitive threat today than in past years because its trade deficit has shrunk to 2.7% of GDP, down from its peak of 6% in 2005. A more expensive dollar should also contribute to the growth outcome in other high-income economies like the EU and Japan.

Extended financial markets and real asset markets in emerging market countries will be especially vulnerable to this shift in investor risk preference. Emerging market borrowers in dollars will also have additional stress to service their dollar-denominated debts. Central banks in emerging markets will need to be sensitive to these financial vulnerabilities as interest rates normalize in the US.

*Has China's Economy Become More "Standard"? By John G. Fernald, Eric Hsu, and Mark M. Spiegel. Federal Reserve Bank of San Francisco, October 6, 2014.

*For more information, please contact camri@nus.edu.sg*

| | KEY INDICATORS TABLE (AS OF 10 October 2014) | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| **INDEX** | **LEVEL (LC)** | **%1MO (LC)** | **%1MO (USD)** | **%1YR (LC)** | **%1YR (USD)** | **INDEX** | **LEVEL** | **%1YR** |
| S&P500 | 1906.13 | -4.33 | -4.33 | 14.94 | 14.94 | 3MO LIBOR | 0.23 | -5.39 |
| FTSE | 6339.97 | -7.11 | -7.76 | 2.38 | 3.02 | 10YR UST | 2.28 | -14.96 |
| NIKKEI | 15300.55 | -2.61 | -3.60 | 9.50 | -0.40 | 10YR BUND | 0.89 | -52.52 |
| HANG SENG | 23088.54 | -6.32 | -6.42 | 4.57 | 4.51 | 10YR SPG | 2.07 | -52.37 |
| STI | 3223.87 | -3.39 | -4.21 | 4.87 | 2.74 | 10YR SGS | 2.32 | -2.73 |
| EUR | 1.26 | -2.24 | | -6.60 | | US ISM | 56.60 | 1.10 |
| YEN | 107.66 | 0.75 | | 9.68 | | EU PMI | 50.30 | -1.60 |
| CMCI | 1327.76 | -4.67 | | -9.66 | | JP TANKAN | 4.00 | 100.00 |
| Oil | 85.82 | -6.38 | | -16.69 | | CHINA IP | 6.90 | -32.40 |

*Source: Bloomberg*

## APPENDIX

**GLOSSARY OF KEY TERMS (Source: Bloomberg, with tickers in parenthesis. In US$ where applicable)**
**S&P500:** capitalization-weighted index of the prices of 500 US large-cap stocks (SPX)
**FTSE:** capitalization-weighted index of the prices of the 100 largest LSE-listed stocks (UKX)
**NIKKEI:** capitalization-weighted index of the largest 225 stocks of the Tokyo Stock Exchange (NKY)
**HANG SENG:** capitalization-weighted index of companies from the Hong Kong Stock Exchange (HSI)
**STI:** cap-weighted index of the top 30 companies listed on the Singapore Exchange (FSSTI)
**EUR:** USD/EUR exchange rate: 1 EUR = xx USD (EUR)
**YEN:** YEN/USD exchange rate: 1 USD = xx YEN (JPY)
**CMCI:** Constant Maturity Commodity Index (CMCIPI)
**Oil**: West Texas Intermediate prices, $ per barrel (CLK1)
**3MO LIBOR:** interbank lending rate for 3-month US dollar loans (US0003M)
**10YR UST:** 10-year US Treasury yield (IYC8 – Sovereigns)
**10YR BUND:** 10-year German government bond yield (IYC8 – Sovereigns)
**10YR SPG:** 10-year Spanish government bond yield, proxy for EU funding problems (IYC8 – Sovereigns)
**10YR SGS:** 10-year Singapore government bond yield (IYC8 – Sovereigns)
**US ISM:** US business survey of more than 300 manufacturing firms by the Institute of Supply Management that monitors employment, production inventories, new orders, etc. (NAPMPMI)
**EU PMI**: Purchasing Managers' index for the 17 country EU region (PMITMEZ)
**JP TANKAN:** Bank of Japan business survey on the outlook of Japanese capital expenditures, employment and the overall economy, quarterly index (JNTGALLI)
**CHINA IP**: China's Industrial Production index, with 1-month lag (CHVAIOY)
**LC:** Local Currency