Western Asset

The Fed's Adventures with QE2: Muddying the Waters

Executive Summary

- Under its new QE2 policy initiative, the Fed plans to inject an additional $600 billion of liquidity into the financial system through June 2011.
- While Fed officials have posited a number of reasons for this policy, we believe the dominant intent is to stimulate what has to date been a disappointingly slow economic recovery.
- The first round of QE in late 2008 provided liquidity to a financial system starving for it. The banking system stabilized, private-sector borrowing rates plunged, and recession ended.
- However, present conditions are much different. It is hard to see how broad-based monetary stimulus will meaningfully address structural problems in banking, housing and labor markets.
- The most worrisome aspect of QE at this time is that recent Fed comments suggest it will be continued until the economy revives sufficiently.
- An open-ended commitment to policies with little chance of success runs the risk of disrupting financial markets.

Introduction

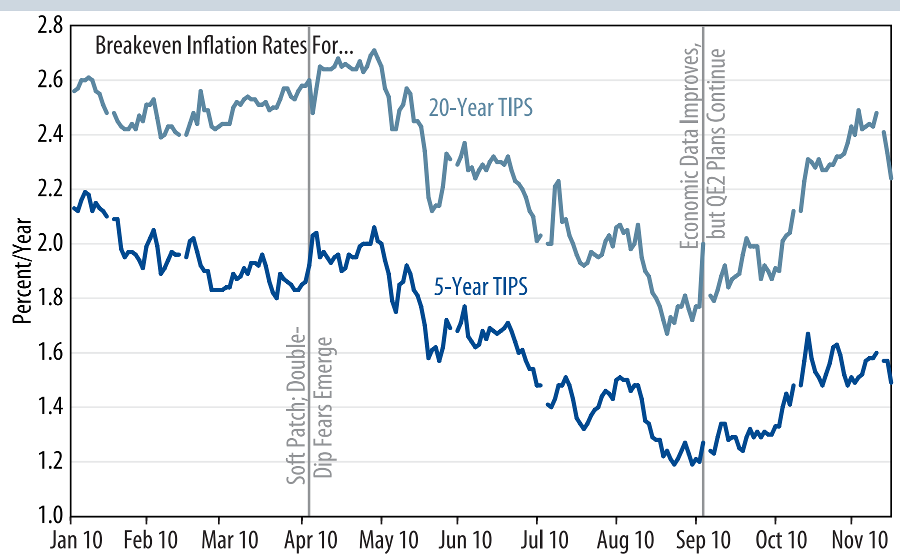
After a month-long campaign of preparing the financial markets, the Federal Reserve (Fed) has moved forward with plans to attempt to further stimulate the economy through additional asset purchases, known as Quantitative Easing Part II, or QE2. It will expand its balance sheet by $600 billion over the next eight months. The Fed has defined its schedule of purchases across maturities fairly precisely, and most purchases will occur within the maturity range of two to 10 years.

Public pronouncements by Fed officials on likely action began this summer, when fears of a double-dip recession were intensifying and risk markets were weakening. A skein of stronger economic data since early-September quashed double-dip fears and elevated risk markets, but the Fed nevertheless continued its discussion of possible further asset purchases, shifting the rationale from preventing recession to hastening the pace of recovery that has thus far been disappointing.

Of course, the various Fed officials' pronouncements have also mentioned intentions of raising inflation and inflation expectations, and the more extreme statements of those intentions have unsettled some financial market participants. The Fed's response has been that with inflation and economic growth both below target, further action is warranted and is unlikely to incur any significant downside risks.

At this time, despite both domestic and international criticism, the Fed appears intent on proceeding with the announced policy. Some of its statements have indicated that the ongoing state of the economy will be a factor in determining the extent of its stimulus. In other words, should the economy suddenly, noticeably strengthen, QE2 might be suspended mid-course. However, should such improvement not occur, QE2 could be intensified or followed up with QE3, QE4, QE5, and so on.

Exhibit 1
5- and 20-Year TIPS' Breakeven Inflation Rates



Source: Federal Reserve Board, Western Asset

While the Fed's statements indicate that it believes the downside risks of QE2 itself to be minimal, we argue that broad-based monetary stimulus at this time is not a sufficiently focused policy initiative to effectively improve economic conditions. Also, we are concerned about the potentially serious inflation consequences of an open-ended commitment to proceed with further stimulus until economic performance is satisfactory. We believe the principal goal of the Fed's actions is to stimulate the economy and that remarks about inflation and the dollar were incidental and unfortunate. Nevertheless, even with a narrow focus on the economy, misdirected and continuing Fed actions could well pose far greater risks than those currently perceived. Our doubts about QE2's effectiveness in terms of stimulating the economy stem from observations that remaining problems in the economy are structural and localized, quite unlike the generally liquidity-starved conditions in late 2008, when the first round of QE worked so well.

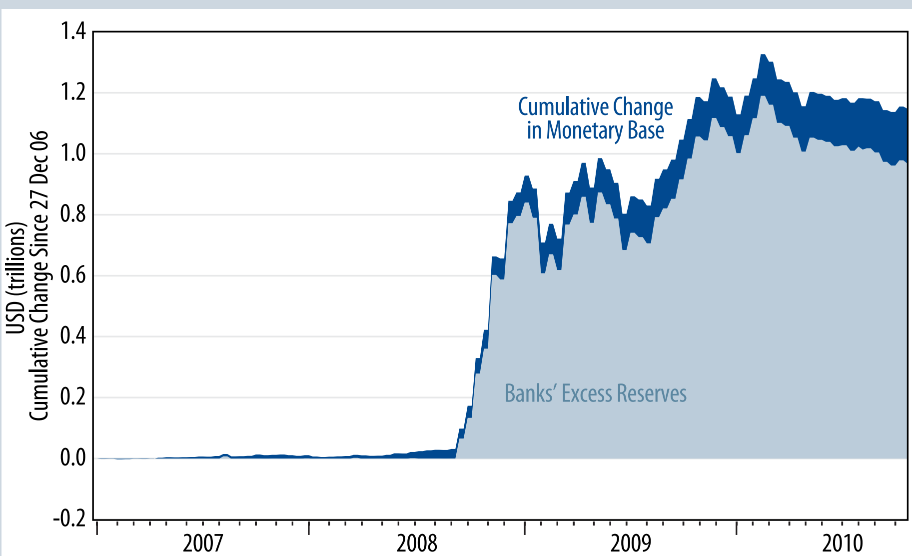
Our present concerns would be assuaged by concrete indications from the Fed that efforts at further QE will be limited. We believe such indications eventually will come. In the meantime, however, the tenor of the Fed's remarks and actions add an aspect of uncertainty to investment strategies that has not been present for 30 years.

The Fed's Intentions Behind QE2

The Fed's dual mandate, codified by the Humphrey-Hawkins Act of 1977, is to promote both price stability and full employment. US inflation measures have generally been below official Fed forecasts of 1.5%-2.0% (the Fed does not have an inflation target per se). For this reason, Fed officials believe that further stimulus is consistent with both elements of their mandate.

Still, with policy rates near zero and with economic recovery in place for more than a year, a program of further aggressive monetary policy stimulus is quite a departure from historical Fed practice. We believe that it is in order to better justify such unorthodox actions—in order to provide better "cover" for attempts to stimulate the economy—that Fed officials have mentioned their intentions to prevent deflation, raise inflation expectations, and even raise inflation temporarily in order to offset the supposedly ill effects of below-forecast inflation at present. Our guess is that if the economic recovery were proceeding more satisfactorily, the Fed might even applaud accompanying declines in inflation.

Exhibit 2
Fed Balance Sheet versus Banks' Excess Reserves



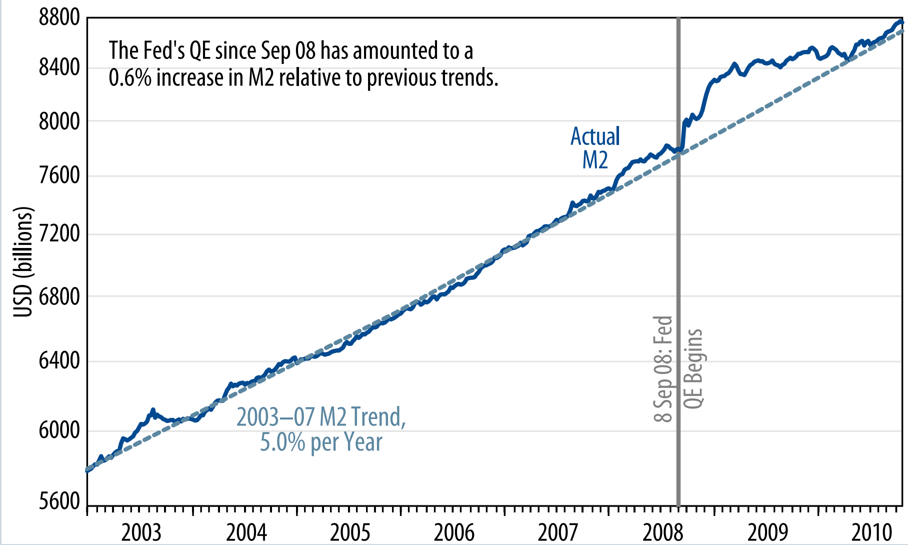
As of 03 Nov 10
Source: Federal Reserve Board

Nevertheless, some Fed officials' remarks concerning the desirability of raising inflation could be said to have been less than fully considered. The concerns voiced in response by officials outside the Federal Reserve system—both here and abroad—and by market participants is understandable. Moreover, even if one acknowledges that the Fed's dominant intentions are focused on stimulating the economy, questions remain about whether the stated policy actions are well-chosen to achieve that goal, and about what the Fed's follow-up actions will be should QE2 prove to be unsuccessful.

What QE1 Accomplished and What It Failed to Accomplish

We were unequivocally in favor of the

Exhibit 3
M2 Money Versus Pre-Sep 08 Trend



Source: Federal Reserve Board, Western Asset

Exhibit 4
Business and Real Estate Loans at Commercial Banks

Source: Federal Reserve Board, Western Asset

initial round of QE the Fed engaged two years ago. In the wake of the near financial meltdown of September 2008, commercial banks and the financial markets in general were starved for liquidity. Not only were major financial institutions failing en masse, but also private-sector interest rates were soaring and stock market prices were plunging alongside horrendous economic decline. The Fed's aggressive and massive provisions of liquidity then were exactly the right policy move.

The Fed began to inject liquidity into the system in mid-September. By early November, private-sector yields began to fall. In December, credit spreads began to narrow, and by the following March, the stock market began to rebound alongside the first "green shoots" of economic recovery. The Fed's injection of $1 trillion-plus into the financial system between September 2008 and January 2009 was easily the most effective action taken to arrest recession.

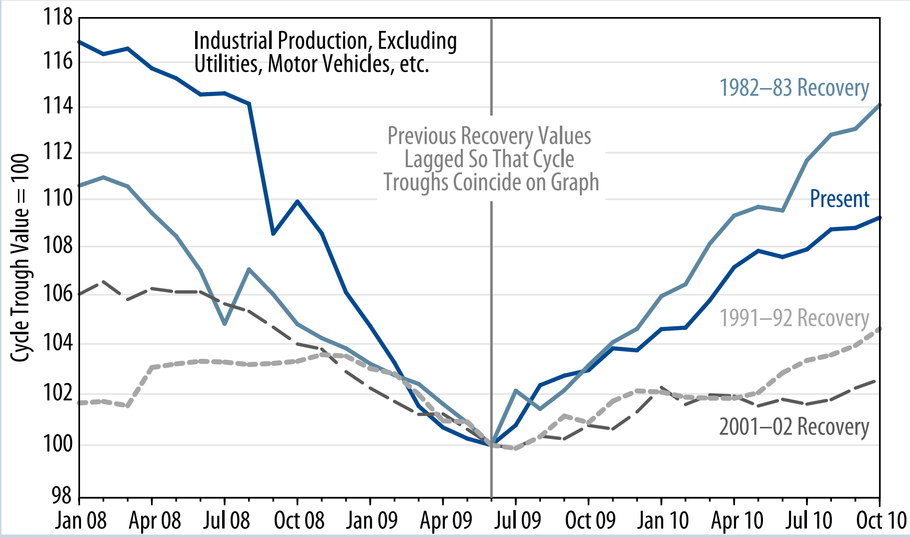
However, while QE1 almost single-handedly stemmed recession and promoted recovery, it has not been fully successful. The liquidity provisions prevented an implosion of the banking system, such as that seen in 1929-1933, but we have yet to see renewed expansion in the banking system. Virtually all the liquidity provided by the Fed sits idle as excess reserves in banks' vaults or on deposit at the Fed (Exhibit 2). The broad M2 monetary aggregate has failed to sustain any acceleration as a result of the Fed's action (Exhibit 3), and bank lending activity has yet to resume expansion (Exhibit 4).

Monetary stimulus typically works by triggering faster growth in bank lending and the money stock. These are the transmission mechanisms by which Fed actions on short-term interest rates and liquidity flow through to the economy at large. Presently, this transmission mechanism is if not broken at least tremendously impaired.

How Can QE2 Work?

Barring a sudden return to normalcy within the banking system, there is reason to believe that further monetary stimulus will have little effect beyond that already occasioned by QE1. Are high interest rates a serious impediment now to the recovery, and can further liquidity injections significantly reduce the rates paid by real people (other than the Treasury)? Can further declines in

Exhibit 5
Industrial Production, Relative Strength of Recoveries



Source: Federal Reserve Board

Treasury yields jar banks into expanding their loan portfolios when already sharp declines have not, when banks are already sitting on $1 trillion in excess reserves, and when banks are jealously guarding their capital in the face of newly intensified capital requirements and increased regulatory scrutiny?

Meanwhile, though it is certainly the case that recovery to date has been disappointing, it is important to realize that the sources of that disappointment are very narrowly focused. With factory production up 10.3% over the first 16 months of expansion, US industrial sectors have experienced a stronger recovery than those of the 1990s and 2000s and almost as strong as that of the 1980s (Exhibit 5). However, housing construction has seen essentially no recovery as yet, in stark contrast to the experience of previous business cycles, when housing invariably led the economy out of recession.

It's likely that would-be homebuyers are constrained by relatively tepid job growth following the horrendous job losses suffered during the recession (not to mention lack of funds for down payments). It is also likely that companies are delaying rebuilding their payrolls not only because of recurring jitters from the slump of 2008-2009, but also because of fears about potential increases in employment costs in the face of national health insurance reform and other pending regulatory and tax changes.

Similarly, recovery in the service sectors has, to date, been relatively sluggish. However, it is generally understood that spending on services is more sensitive to growth in income and jobs than it is to interest rates, in which case the ability of monetary policy to directly stimulate the service sectors is questionable.

A languid housing market and firms' reticence to hire would both appear to reflect structural problems within the US economy. This is materially different from conditions usually in place at the bottom of a recession, when no components of the economy are growing and when *all* could use a boost. As a result, one can legitimately question whether monetary stimulus is the right tool at present. Monetary policy is a macro-tool, useful for addressing macro problems, but it is now being directed at micro/structural problems.

What Is the Exit Plan for QE to Infinity?

Of course, the Federal Reserve is just as cognizant of these issues as are we, and still it has decided to proceed. Possibly in line with our own cautions, Fed officials have stated that they expect only incrementally positive effects of QE2 on the economy. They appear to have moved ahead with the initiative despite limited upside potential because they feel the need to take action and because downside risks are limited.

However, this begs the question of what the Fed will do should the pace of recovery still be unsatisfactory next summer when QE2 is complete. If the need for action is so imperative now, why would it be any less so after another year of disappointing growth? Furthermore, if the Fed is willing to proceed now with macro tactics to address micro problems, why would it not be willing to continue such policies in the future, especially when Fed officials seem to perceive an open-ended mandate to act?

For us, these down-the-road questions represent the crux of the matter concerning the risks of QE2. The Fed is right that an upturn in inflation is unlikely within the present circumstances. And with the financial system already sitting on $1 trillion of excess reserves, it is hard to see that an additional $600 billion would be disruptive. However, an open-ended commitment to continue stimulus until it succeeds raises the risks of first destroying the Fed's credibility as an inflation-fighter, thus destroying the "present circumstances" that minimize QE2's downside risks.

So far, the Fed's credibility has been strained, but not ruptured. Thus, both long-term bond yields and breakeven inflation rates on long Treasury Inflation-Protected Securities (TIPS) remain below the levels seen this spring, even though they have bounced since the beginning of September, as seen in Exhibit 1. If market participants here and abroad should become convinced en masse that the Fed will continue with aggressive stimulus no matter what, that credibility could vanish, in which case financial markets might descend into chaos. Such an outcome could engender inflation with little or no intermittent benefit to the economy, because inflationary pressures would be emanating not from the economy, but from a flight from dollar assets.

By way of metaphor, suppose your kitchen sink is clogged. Water won't flow through. Failing access to a rooter man, you might instead pour more water into the sink, expecting the gathering weight of the water to eventually force the clog to clear. The downside risk is that before that strategy can work, your sink first overflows, flooding your house and presenting quite a different problem …without even clearing the drain.

Applying this metaphor to Fed policy, our fear is that with the monetary transmission mechanism so impaired, continuing stimulus could disrupt financial markets before it materially changes the economy. Granted, the prospects of this are far-fetched and hopefully unlikely. However, they can't be dismissed as long as the Fed's commitment to further QE is potentially unlimited. Whether or not QE2 itself is a cause for worry, the prospects of what might come later certainly are.

How Might Things Turn Out?

These issues can be described by three relevant economic scenarios. In the first scenario, the recovery achieves a more satisfactory pace, either in spite of or because of QE2, and the Fed desists from further stimulus. In this event, it wouldn't matter much if the Fed backed off in the middle of QE2 or upon its completion. As an end to stimulus could be expected, inflation expectations would be anchored, and the existence of economic slack would temper inflationary behavior. The Fed would have to resume the plans for "exit strategy" from QE that were suspended earlier this year, and the amounts to be withdrawn would be larger, but the game would not be materially changed. Therefore, long-term prospects for interest rates would be essentially unchanged from what they were earlier this year.

A second possible scenario is that the recovery could remain unsatisfactory, but the Fed would respond to reality and outside pressure, backing off from further stimulus upon or before completion of QE2. In this event, economic conditions would be less benign than those in the first scenario, but inflation conditions would be very similar, as would the outlook for interest rates.

A third scenario is that QE2 does not succeed, the recovery remains unsatisfactory, and the Fed then follows up with further stimulus until it shakes something loose. Should an unhinging of

Fed credibility and market inflation expectations shake loose before the economy does, one can imagine a financial/economic environment similar to that in England and in South American and Asian economies in the 1960s and 1970s. In those economies, chronic structural problems continued unaddressed. The central banks provided more than ample liquidity, but investors disposed of those funds as quickly as they could to avoid the losses from holding an inflating, devaluing currency. Rather than investing in domestic opportunities, individuals and businesses with available funds stashed them abroad or in hard, fungible assets. In the current circumstances in the US, the perversity of such developments would be intensified by the fact that they would be happening to what has been the world's reserve currency. Needless to say, interest rates and inflation would soar regardless of the Fed's stated intention to keep both in line.

Thankfully, the conditions in the third scenario are very far removed from what we are currently experiencing. Nevertheless, it is difficult to peremptorily dismiss them in light of current policy intentions and accompanying commentary by Fed officials. The critical difference across these three scenarios is whether an end to Fed's stimulus can clearly be envisioned—and whether that end will be occasioned by a better economy or a newfound sense of restraint by Fed officials. Certainly, at present, one could expect Fed stimulus to cease if the economy should quickly accelerate. Until such acceleration becomes highly probable, investors' best protection would be reassurances from the Fed that it sees some limits to its mandate to stimulate the economy.

If our concerns here seem overdone, remember that Fed officials have openly stated that they believe the downside risks to be minimal or non-existent. Consider also some of the advice they are getting. Professor Kenneth Rogoff, co-author of the currently popular book *This Time is Different*, has stated that "the important thing is to say that you are not going to stop QE until you achieve your inflation target." Martin Wolff, chief economics commentator for the *Financial Times*, wrote that "there is no limit to the dollars the Fed can create." Obviously, we believe that both of these commentators underestimate the unintended consequences that stimulative policy could have irrespective of its direct effect on the economy. We hope the Fed proves to be more wary.

Conclusion

The Fed appears to believe that the depressed economy makes inflation impossible. We agree that it is most unlikely given current financial market conditions, but a perverse change in financial market operating conditions could superimpose inflation even on the currently depressed economy. A Fed policy virulent enough to change that financial market environment is unlikely, but it cannot be dismissed out of hand now given the events of recent months.

Our inclination is to continue to give the Fed the benefit of the doubt in view of the bank's record over the last 30 years. However, given the concerns raised in the last few months, we intend to pay closer attention both to Fed actions and statements in the months ahead and to be ready to act should a clear sense of Fed moderation not be forthcoming.