

Q&A on QE3

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Key points

- > Open ended quantitative easing (QE3) in the US is likely to continue into 2014. While it can't solve all America's problems it should help growth recover to 2.5% in 2013.
- > Notwithstanding inevitable corrections, QE3 is positive for shares, commodities, gold and cyclical stocks. It is likely to result in modest upwards pressure in bond yields.

Introduction

After foreshadowing it in recent months the US Federal Reserve is commencing another round of quantitative easing (QE3), but this time on an open ended basis until it achieves the growth it wants. The news was greeted positively by investment markets. However, many are sceptical and it raises numerous questions that this note seeks to address.

What is it? Why do it?

Quantitative easing involves a central bank – in this case the US Federal Reserve – using printed money to buy government and private sector securities to pump cash into the economy and boost the rate of economic growth.

Normally central banks implement monetary policy by changing interest rates. But when companies and households are focussed on reducing debt, interest rates can fall to zero and still growth remains weak as no one wants borrow. In order to continue boosting the economy one way is to switch to boosting the quantity of money in the economy. Hence quantitative easing.

Right now the US economy is growing but it's below the pace needed to sustainably reduce unemployment. Hence the latest efforts from the US Federal Reserve.

Why open ended QE3 & mortgage securities?

The first two US quantitative easing rounds focussed on buying set amounts of Government bonds and mortgage backed securities (MBS or pools of mortgages) over set periods. QE3 is different as it involves buying \$US40bn of MBS a month until there is a "substantial" improvement in the labour market outlook. There are several reasons for the change. First, Government bond yields are already exceptionally low so the Fed perhaps reasoned it makes sense to focus on reducing private sector long term borrowing rates. Focussing on the mortgage market via MBS is a low risk way of doing so and helping a sector that has been very weak.

Second, by not buying any Government bonds the Fed is less likely to be accused of monetising public debt.

Thirdly, by making QE3 open ended, with a \$US40bn monthly rate, until it achieves a desired outcome sends a stronger signal to households and businesses that the Fed means business and avoids the end point problems of QE1 and QE2 where the economy and share market experienced a soft patch around the scheduled end dates for each in 2010 and 2011.

How long will it last?

The Fed has said it will continue QE3 until the labour market outlook improves substantially. Given the Fed is only forecasting the US unemployment rate to fall to a range of 7.6%-7.9% by the end of 2013 and 6.7%-7.3% in 2014 from 8.1% now, this could be some time. So, barring a stronger response in the economy, QE3 could be running into 2014.

How does QE boost growth?

There are several ways quantitative easing can boost growth. First, by pumping money into the mortgage market it lowers long term borrowing costs which are important in the US given the greater use of fixed rate loans.

Second, by injecting more cash into the economy – mostly into the banking system – some of this may be lent out, boosting growth further. So far this has not happened in a big way, but bank lending has at least been picking up.

Third, by displacing investors in risk free assets such as government bonds and on mortgaged backed securities it forces private investors (eg fund managers) to invest more in risky assets such as corporate bonds or shares boosting the supply of capital to businesses.

Fourth, to the extent that it boosts share markets it boosts wealth, which in turn helps drive spending.

Finally, an increase in the supply of US dollars may reduce the value of the \$US making it easier for US exporters.

Has QE worked so far?

It's very hard to tell what would have happened in the absence of quantitative easing over the last few years, but the likelihood is, were it not for the Fed's quantitative easing the US economy would have been far worse. Since the GFC US households and businesses have sought to reduce their debt ratios following a sharp loss of wealth and more recently fiscal drag of around 1% pa as the budget deficit is reduced. QE in 2009-10 and 2010-11 provided an offset to these forces enabling the US economy to at least grow.

The US is a bit like a patient in a coma with the Fed acting as the drip keeping the economy alive until it has healed enough to exit the coma. The Fed's liquidity can't heal the economy but it can support it until it is healthy.

Certainly the US with 8.1% unemployment is in far better shape than the EU with 11.3% unemployment, where QE has not been aggressively used.

Will it work going forward?

It's almost inevitable QE3 will have less of an impact than QE1 and QE2 – eg borrowing costs are lower, shares are higher. However, there is still likely to be a positive impact:

- It will help push mortgage rates even lower.
- A further expansion of bank excess reserves will help continue a gradual increase in bank lending;
- By buying low risk mortgage backed securities, the Fed will further force investors to take on more risk in their portfolios such as by buying corporate debt or shares;
- An increase in the supply of US dollars will likely take some of the upwards pressure off the \$US, which helps US companies that compete internationally.

Our assessment is that QE3 will probably help boost US GDP growth to 2.5% next year.

But, what are the costs?

The more extreme fears about quantitative easing have been wrong. There is no sign of the hyperinflation many feared from quantitative easing in 2009. So far QE has boosted cash and bank reserves but in an economy with lots of spare capacity this needs to be lent out and spent for inflationary pressures to build and this hasn't happened. And when it does, the Fed can withdraw the stimulus.

The problem with the argument the Fed should not intervene because free market forces should be able to run their course, is, it ignores the role of free market forces in causing the problem in the first place and if free market forces are able to run their course numerous innocent bystanders will be adversely affected, as in the 1930s. So there is a case for monetary policy to smooth any adjustment in debt levels.

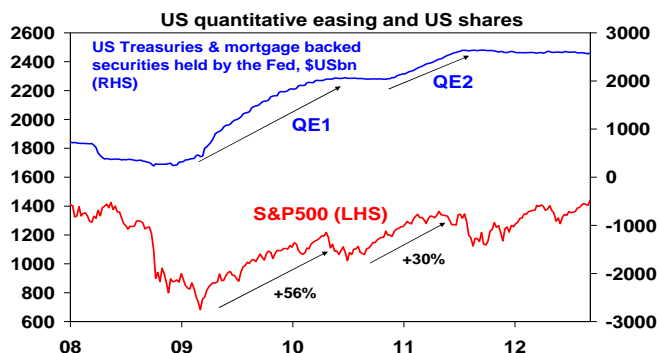
Finally, there is no doubt that large scale Fed buying of US Treasuries or MBS is creating distortions in financial markets and it does create uncertainty around what happens when the stimulus is withdrawn. But these costs are justified if quantitative easing heads off tougher economic conditions.

What about the global impact?

QE2 in 2010 created some angst around the world, as it meant countries would either have to accept super easy US monetary policy or allow their currencies to rise against the \$US. This time around the reaction is likely to be more positive given the growth slowdown seen in the emerging world and sharp falls in some currencies such as the Brazilian Real. So now the emerging world is more likely to welcome the boost to their exports that may result and may be more comfortable with further monetary easing (in order to limit gains in their currencies). Countries with inflation concerns, such as India, may be less inclined to cut interest rates but the easing bias of countries such as Brazil and South Korea may be enhanced. To the extent it causes global central banks to run easier monetary policies to stop their currencies rising, QE3 helps boost global growth.

What are the investment implications?

There are likely to be several investment implications from QE3. First, to the extent it boosts expectations for growth and liquidity in the economy it's positive for US shares, just as QE1 and QE2 were, and global shares generally. See the next chart which shows the relationship between US shares and Fed holdings of US Treasuries and MBS.



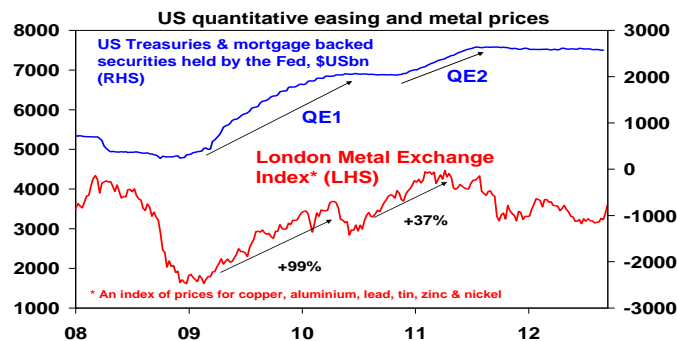
Source: Bloomberg, AMP Capital

Australian shares saw a 41% rally in association with QE1 but saw just a 15% boost from QE2 as worries about high Australian interest rates, the strong \$A and China all weighed. Given ongoing worries about China and the still strong \$A, Australian shares are likely to remain a relatively underperformer in response to QE3 as well.

The boost to investor confidence is also likely to result in a bounce in cyclical shares versus defensive sectors.

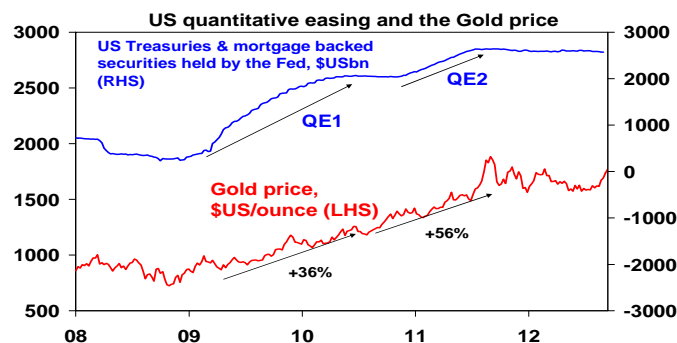
Second, as QE3 boosts the supply of US dollars it's a negative for the \$US, with both QE1 and QE2 triggering 10-15% falls in the \$US. But any fall is likely to be limited as Europe and Japan have their own problems, and emerging countries have issues which are likely to cap their currencies.

Thirdly, it's positive for commodity prices on the back of any boost to global growth and as they are priced in US dollars. This was seen with QE1 and QE2. Soft growth in China may limit the upside this time around though.



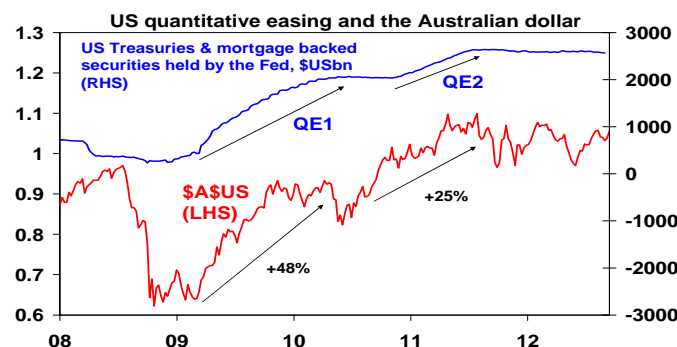
Source: Bloomberg, AMP Capital

Gold is likely to be a big beneficiary to the extent that it's one of the best hedges against a falling US dollar.



Source: Bloomberg, AMP Capital

Fourth, the combination of higher spot commodity prices and potentially the resumption of carry trades could see the \$A push higher. It rose substantially through QE1 and QE2.



Source: Bloomberg, AMP Capital

This is the last thing Australia needs now particularly if bulk commodity prices remain subdued on Chinese softness. As a result it adds more pressure for the Reserve Bank of Australia to resume rate cuts – which we expect next month. This in turn should help limit the upside in the \$A.

Finally, if QE3 boosts global confidence it should see some reversal of safe haven bond buying and hence modest ongoing upwards pressure in government bond yields.

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