Shane Oliver, Head of Investment Strategy
& Chief Economist

AMP CAPITAL

The end of US quantitative easing

EDITION 35 – 30 OCTOBER 2014

Key points

> After phasing down its quantitative easing (QE) program all year the US Fed has finally ended it. Monetary tightening still looks unlikely until mid-next year at the earliest and is contingent on further improvement in the economy and higher inflation.

> QE has worked – the US economy is now well into expansion mode and looking a lot stronger than Europe and Japan that have taken longer to adopt it.

> While the ending of QE could contribute more volatility to shares it has largely been anticipated. With the US likely to continue growing & monetary conditions expected to remain easy for some time to come the cyclical bull market in shares likely has further to go.

> The ending of US QE is also positive for Australia as it is a sign that the world's biggest economy is better and removes a source of upwards pressure on the $A.

Introduction

I have long thought of the US Federal Reserve's quantitative easing program (QE) as a bit like a drip keeping a patient in a coma alive until it can be brought out of the coma and survive on its own. The patient was the US economy post the GFC and the Fed was administering the drip. Quantitative easing involved the Fed using printed money to pump cash into the struggling US economy by buying up government bonds and mortgage backed securities. The first two rounds of QE ended prematurely in 2010 and 2011 before the US economy was ready to be taken off life support. However, having learned its lesson the phasing down of the latest round – commonly called QE3 – was made contingent on the economy strengthening. The Fed has concluded that this has happened so has been "tapering" its bond purchases all year and is now bringing them to an end.

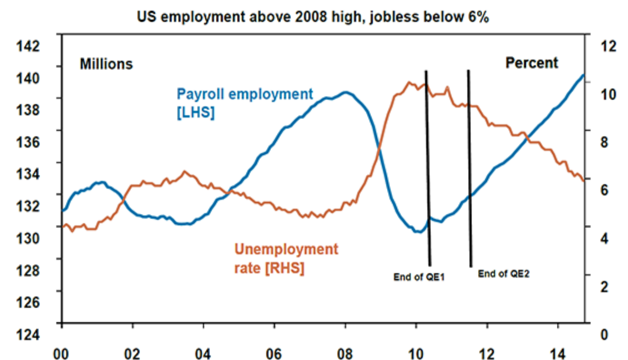
But has QE worked? Was it worth the costs? What next? What does it mean for investment markets?

Has QE worked?

Quantitative easing sounds extraordinary – and in the context of the inflation prone world we all became used to it would have been. But given the deflationary shock delivered to the global economy from the GFC it is not. QE was needed to boost the supply of money in the US economy given the difficulties in pushing interest rates negative.

Quantitative easing helps the economy via: lower borrowing costs; more cash in the economy; forcing investors to take on more risks; and by boosting wealth, to the extent it drives shares higher, which boosts spending.

But has it worked? While there is much debate, at the end of the day the proof is in the pudding. And the evidence clearly suggests it has worked. While the US economy is still far from booming: growth has picked up pace; bank lending is strengthening; housing construction is recovering; consumer spending growth is reasonable; business investment is strengthening; business conditions are strong; employment is above its early 2008 high and unemployment has fallen to 5.9% (see the next chart); and deflation has been avoided.

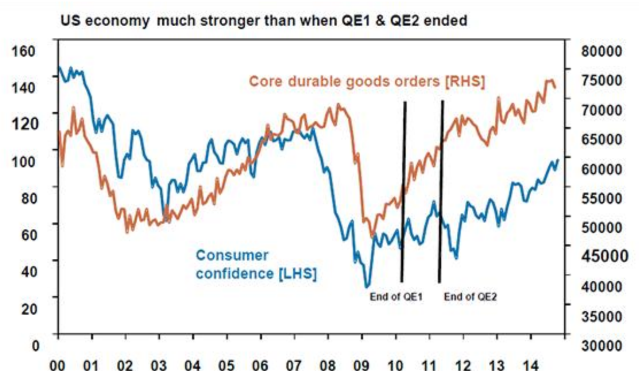


Source: Bloomberg, AMP Capital

By contrast, the European Central Bank has dragged the chain on QE and so the Eurozone has unemployment stuck at 11.5% and inflation at just 0.3% is flirting with deflation.

Could the Fed be too early again?

In 2010 and 2011 the Fed was too quick to end QE. There is a risk now too. The global economic expansion is still uneven and US inflation is below the Fed's 2% target. However, most US growth indicators are now in far better shape, so the risk is reduced. For example, compared to 2010 & 2011 unemployment is lower, employment is higher (previous chart) and consumer confidence and durable goods orders (a guide to investment) are higher (see next chart).



Source: Bloomberg, AMP Capital

But what about the costs – was it worth it?

Most of the arguments against doing QE don't hold water:

- **There has been no hyperinflation**. US inflation is less than 2%. The mistake the hyperinflationists made was to confuse a surge in narrow money such as cash and bank reserves which rose with QE with a surge in broader money supply measures such as M2 and credit which hasn't happened. And they ignored the spare capacity in US factories and in the labour market.
- **Financial market distortions are relatively modest**. Yes bond yields are low but this mainly reflects the reality of a long period of sub-par growth, low inflation and

excess savings rather than distortions caused by the Fed's holding of US bonds. And the forward price to earnings multiple on US shares at around 15 times is actually below its long term average and less than suggested by current bond yields. That said, maintaining easy money longer than need be does risk creating bubbles, but I doubt we are there yet.

- **Currency wars**. There was much concern in the emerging world that the $US would crash pushing emerging market currencies up or leading to uncontrollable capital inflows. In the event this was really much ado about nothing and more recently the argument has been run in reverse with some emerging market countries complaining the phasing down of US QE would cause capital outflows and a collapse in their currencies!
- **Inequality in the US had been worsening long before QE**. While it may be claimed that QE by boosting share prices accentuated inequality because more rich people hold shares, the alternative of allowing the economy to spiral on down and unemployment to surge would hardly have been good for equality. Moreover, other factors including technological innovation are arguably more important in explaining rising inequality in the US.
- **The exit problem**. This is the biggest risk. Given the lack of experience with quantitative easing there is a degree of unknown regarding the impact of exiting from it.

Much of the critique of the Fed has come from gold bugs and disciples of the Austrian school of economic thought that holds that periods of financial excess should be allowed to fully unwind to allow a proper cleansing of the system. As such they saw the Fed as interfering with the natural order of things and so foresaw dire consequences. The problem with this is that it ignores the role of free market forces in causing the problem in the first place and the likelihood that if free market forces are able to run their course numerous innocent bystanders would be adversely affected. This was what happened in the 1930s when US authorities stood by and allowed a 50% collapse in industrial production, the demise of hundreds of banks and 20% plus unemployment. Hardly a great outcome and hardly great for equality. So there is a case for monetary policy to smooth any adjustment in the economy, which of course is what QE has done. Knowing what the Fed knew about the risks around the GFC and the lessons of the 1930s they have done the right thing. To let the patient die (well not quite – but you know what I mean!) would have been morally indefensible.

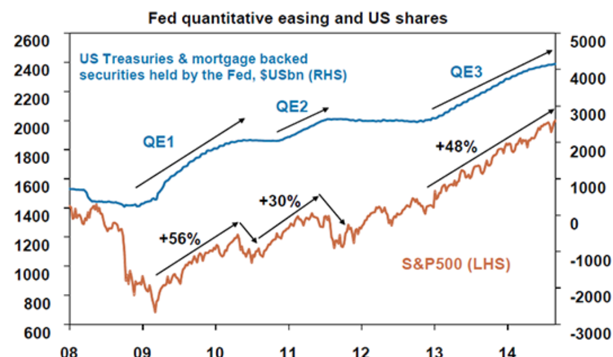
What next?

If things go according to plan the next step is that the Fed will actually start to tighten. This will come in the form of raising interest rates and starting to reverse its QE program. It looks like it will primarily unwind its bond holdings by not replacing them as they mature, as opposed to actually selling them.

However, the Fed has made it clear that tightening is contingent on the economy continuing to improve and signs inflation is moving up to target. It has also continued to point out that it anticipates a "considerable time" to elapse before it starts to tighten. This reflects the fact that growth is still far from booming, labour force underutilisation remains, inflation on the Fed's preferred measures is just 1.5% and inflation expectations have been falling. Our base case is the Fed will start raising rates and allowing maturing bonds to run down its bond holdings from around mid-2015. But if economic conditions are weaker than expected it could come later and a renewed round of quantitative easing cannot be ruled out.

What does the end of QE mean for shares?

Memories of the last two times when QE ended are fresh. After QE1 ended in March 2010 US, global and Australian shares fell around 15% and soon after QE2 ended in June 2011 shares fell around 20%. Fears of a re-run when QE3 ends have been one factor behind the recent roughly 10% correction in shares, so investors have partly pre-empted it.



Source: Bloomberg, AMP Capital

However, while the ending of QE3 may add to volatility it's very different to the premature ending of QE1 and QE2, which occurred when the US was a lot weaker. Now the US economy is on a sounder footing. And while US QE has ended, it's being replaced by QE in Japan and Europe.

It's also worth noting that the rally in shares over the last five years is not just due to easy money. It has helped, but the rally has been underpinned by record profit levels in the US.

Source: Bloomberg, AMP Capital

Finally, it should be noted that US QE is ending because the economy is stronger, which is a positive for shares.

What about the impact on Australia?

The ending of US quantitative easing is a positive for Australia for two reasons. First, it's another sign the US economy is on its feet again and a stronger US is good news for Australia as it means a stronger global economy. Second, it removes a source of upwards pressure on the $A, allowing it to continue its downtrend, once current oversold conditions are relieved, which will likely see it fall to around $US0.80 over the next year or so. This will help the Australian economy rebalance as the mining boom fades.

Concluding comments

With the US economy now on a sounder footing, the Fed is right to end its quantitative easing program. While this could contribute to short term volatility in shares, providing the US continues to grow as we think it will and given that we are a long way from tight monetary conditions the cyclical rally in shares that got underway back in 2011 is likely to continue.

Dr Shane Oliver
Head of Investment Strategy and Chief Economist
AMP Capital

Important note: While every care has been taken in the preparation of this document, AMP Capital Investors Limited (ABN 59 001 777 591, AFSL 232497) and AMP Capital Funds Management Limited (ABN 15 159 557 721, AFSL 426455) make no representations or warranties as to the accuracy or completeness of any statement in it including, without limitation, any forecasts. Past performance is not a reliable indicator of future performance. This document has been prepared for the purpose of providing general information, without taking account of any particular investor's objectives, financial situation or needs. An investor should, before making any investment decisions, consider the appropriateness of the information in this document, and seek professional advice, having regard to the investor's objectives, financial situation and needs. This document is solely for the use of the party to whom it is provided.