The End Of Quantitive Easing Chapter 2

By June 2011, Quantitative Easing 2 will be over. But it will not be the end of the book, only of a chapter. I have always suspected that Quantitative Easing 2 was driven not so much by the need for monetary stimulus but by the need to monetize government debt. I suspect that going forward the Fed will have to find some other way of aiding and abetting Treasury. In some ways, its near zero nominal interest rate policy has mobilized the banking system to be part of the consortium for monetization. For this reason, I believe that it is no mystery why loan growth has been so weak, despite an apparent recovery in the real economy. Banks are presented with the opportunity to pay near zero short rates and receive a significantly higher long rate of over 3.5%. Levering this 20 times can be very profitable indeed. As long as the curve sits in this position, bank lending will be muted.

The other possible consequences of the expiry of QE2 are very much unclear, especially in the short term. In the longer term, more debt needs to be raised or refinanced than natural buyers can be found and a resumption of some sort of monetization is very likely. In the meantime, the Fed’s balance sheet will remain highly levered with an asset portfolio of some questionable loans to cash flow insolvent homeowners and one very large cash flow insolvent sovereign.

The short term effects are much murkier and could include a sharp reversal in the USD (yes, USD strength) as the force of debasement is turned off, a sharp reversal in nominal output, which is a risky outcome as it may expose weakness in the velocity of money previously masked by QE, or it could reverse inflation, at this point not a bad thing to see. It might impact gold and other commodities as investors substitute into USD assets. The prospects for cyclical metals is certainly highly uncertain, metals being cyclical and thus correlated with real output growth but also being priced in USD. Equities could fall as valuations are impacted by higher discount rates and companies face higher funding costs. Interest sensitive emerging markets with USD pegs or managed floats could suffer disproportionately as well.

Investors may take the end of QE as a sign of confidence by the Fed and thus continue to drive equities and other risky assets higher. Perversely, with the end of QE2 telegraphed to the market and higher rates built in to the front end of the curve, the end may drive investors back to the bond market depressing yields at the short end. Banks might begin to lend to the private sector again to earn a higher yield. (If they do not, one has to ask serious and seriously awkward questions about banks' ability, not willingness to lend, questions which will ultimately focus on the quality of their assets.)

The range of possible outcomes is diverse and highly uncertain as the scale of Fed intervention is unprecedented and its withdrawal similarly on an unprecedented scale.

Most of the structural ills stem from the fact that you cannot cure morphine addiction with more morphine. The Fed has thrown its considerable resources at reviving credit creation in an economy which has imploded on the back of excessive credit in unsustainable structures. Debt has been transferred wholesale from private balance sheets to public balance sheets where they can be monetized. But debt is only eroded through inflation, repayment or default and reorganization.

The process of ending quantitative easing is one best watched from a distance. In this time of inflation, I am with cash.