Its Time To Wean the Economy Off QE.

With consistent central bank asset purchases, the term structure of interest rates cannot find its natural market clearing level. It is difficult to know if asset bubbles are being inflated or not, and it is hard to tell if the economy is yet on a self sustaining growth path. The only way to tell, to discover the price of things, is to wind down the asset purchase programs.

The constant feeding of liquidity into the financial system has failed to revive labour markets even if it has revived markets for equities, bonds and real estate. GDP growth while positive has fallen short of expectations.

Asset purchases may be stifling credit market liquidity. As more market liquidity has migrated to secured lending markets, the availability of eligible collateral becomes more important. As the Fed does not lend out its assets for collateral, it is possible that the Fed is in fact starving the credit markets of suitable collateral with which to lubricate the flow of short term credit. This mode of liquidity injection definitively precludes any sort of multiplier effect since it creates no bank capital to be multiplied. For this reason, the velocity of money falls almost in perfect reaction and in inverse proportion to the magnitude of balance sheet expansion.

By suppressing interest rates, central banks are making it more attractive for companies to finance themselves with debt instead of equity. In the US, share buybacks have reduced the free float of equity markets even as high yield issuance remains robust. Equity market capitalization growth has lagged the S&P index level growth by almost 3% per annum since 2005

for a -30% lag. The economy seems preoccupied with equity returns rather than growth of income and employment. The Modigliani Miller theorem's assumptions are certainly violated by the convoluted US tax code which generally favors equity finance, for the businesses, and equity investment, for investors.

The benefit of lower interest rates favors large companies with access to debt capital markets. Small and medium businesses which rely on bank loans for financing continue to be starved of capital as Basel III and a lack of bank capital impedes bank lending. As employment tends to be created in small and medium enterprises compared with large businesses, which on balance tend to consolidate, the impact of low interest rates do not encourage job creation.

What then does QE do? It does inflate asset and house prices and supports consumption through the wealth effect. It supports equity and debt valuations by suppressing rates across the term structure. It monetizes debt which may not obtain sufficiently robust bid to cover ratios thereby maintaining confidence in the treasury and agency MBS markets. It supports co-investors in treasury and MBS assets.

It would be unfair to say that QE wasn't working, employment has improved, manufacturing has rebounded and growth has stabilized, but the improvements have been small and slow to gain traction, and the side effects are potentially serious. Given that the economy has stabilized, there are grounds for the withdrawal of QE simply to understand the distortionary effects of having QE in force.