

## **The End of QE2 (May 27, 2011)**

The Federal Reserve's quantitative easing (QE2) program, a temporary policy designed to increase the money supply, keep interest rates low, and stimulate the economy, will officially end on June 30<sup>th</sup>. QE2's impact, both on the economy and on the Central Bank's balance sheet, has sparked plenty of debate among economists. However, its positive impact on asset prices has been obvious.

From the time Ben Bernanke, Chairman of the Federal Reserve, first alluded to further quantitative easing in an August 2010 speech, stock and commodity prices have rallied substantially higher. With the June 30<sup>th</sup> deadline fast approaching and economic data something of a mixed bag, stocks have recently pulled back and commodity prices pulled back even further. And, while the recent pullback in commodities of about 8% may have seemed steep, this asset class has actually experienced three previous corrections of more than 10% in just the past two years, only to move higher.

To some observers, the recent sell off in stocks and commodities reflects that the markets are preemptively pricing in the end of QE2, and may actually be anticipating a round of "quantitative tightening". Such speculation may be premature.

The latest economic data has been somewhat uninspiring, suggesting another mid-cycle slowing of economic growth, not unlike what we experienced about this time last year. If the current economic scorecard was the Fed's one and only consideration in conducting monetary policy, we would find it hard to believe that they would contemplate tightening anytime soon. If anything, we might guess that there is a greater chance of further quantitative easing, or a similar facility to keep the U.S. Dollar printing presses running, perpetuating Bernanke's one trick pony approach to spurring economic growth.

Of course, Fed policy ends up being driven by several competing factors. On the one hand, the Fed has to be feeling pressure relative to their ever-expanding balance sheet that has swelled to disturbing levels. Our federal government is encumbered with a \$1.6 trillion deficit, as well as the need to replace currently maturing debt, requiring regularly scheduled Treasury auctions. If sufficient buyers are present at each auction, all is well. However, if the U.S. Treasury Department can not find enough buyers, and assuming the Fed doesn't step in to cover the shortfall (as they have done under QE2), we would expect interest rates to go higher to entice demand.

Do we actually think this high interest rate scenario will play out? Anything is possible, but as we stated earlier, Fed policy is the net result of several factors. For example, stable prices and low inflation are one goal, but so is full employment. Persistent high unemployment (and the resulting effect on consumer spending) is sure to be giving Ben Bernanke some restless nights. Additionally, the political pressure to use whatever tools are necessary to sustain an economic upswing as we enter the 2012 election cycle will be very real.

So, we believe the Fed will say one thing, but quietly do another. They will promote the positives of ending QE2 as a necessary step to fiscal sanity and holding off the inflation menace. But, if there is a disruption to economic growth or interest rates are perceived as crippling, another QE-type plan will make it to the table.

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