Quantitative Easing Round Two
As widely expected, on November 3rd the Federal Reserve announced a plan to purchase up to $600 billion USD of U.S. Treasury securities through June 2011. With short-term interest rates practically zero, the stated goal of this bond-buying initiative is to lower longer-term interest rates and encourage more borrowing, thus spurring economic growth. This is the second time in recent years that the central bank has embarked on such a quantitative easing program. During the height of the financial crisis and recession, the Fed implemented a similar program to purchase securities in an effort to provide support for the banking system and the broader economy. In general, the previous round of quantitative easing helped alleviate many of the worst strains from the credit crisis. Yet while economic and financial conditions have improved since that low point, the economy still faces serious obstacles such as a lack of job growth and slack leftover from the recession that has inflation running below the Fed’s target range. Stressing its dual mandate of maximum employment and stable inflation, the Federal Reserve is using unconventional bond purchases to address these problems by attempting to promote economic growth. In this outlook paper, Manning and Napier Advisors, Inc. (“Manning & Napier”) reviews quantitative easing, provides the rationale behind this second round of quantitative easing (“QE2”), and discusses the potential risks and implications.

**What is Quantitative Easing (QE)?**

Before evaluating quantitative easing and its potential consequences, it is worth explaining what this frequently cited term means. Quantitative easing is a type of monetary policy used to increase the supply of money by a central bank purchasing securities from the market. This tool is typically invoked when normal methods to control the money supply are unavailable. In other words, quantitative easing may be employed when the discount rate and/or the interbank interest rate (i.e., the Fed Funds rate) are close to zero, limiting the effectiveness of the central bank’s traditional monetary policy tool of lowering short-term interest rates. A central bank implements quantitative easing by first crediting its own account with money it creates and then purchasing financial assets, including government bonds, agency (i.e., Fannie Mae and Freddie Mac) debt, and mortgage-backed securities (i.e., an asset-backed security that is secured by a mortgage or a group of mortgages) on the open market, thereby affecting yields in the financial markets. These purchases will create excess reserves in the banking system, which can then be used for lending.

**A Review of the First Round of QE**

In late 2008 and early 2009, the Fed started its first round of asset purchases, which included $1.25 trillion USD of agency mortgage-backed securities (i.e., mortgage-backed securities issued by Fannie Mae and Freddie Mac), about $200 billion USD of agency debt (i.e., the debt of Fannie Mae and Freddie Mac), and about $300 billion USD of Treasuries (Chart 1). Announced as the financial markets and economy were spiraling downward, the goals of this bond-buying program were to support the housing market, ease pressures on the banking sector, provide the financial markets with liquidity, and spur economic growth. These security purchases ended in March 2010.

**Chart 1**


Data Source: Bloomberg
For the most part, the Fed’s first round of quantitative easing achieved its primary goals and helped instill more confidence in the markets. While this accommodative monetary policy certainly did not solve all of the issues in the U.S., it did help stabilize the economy and the markets. Interest rates moved lower (Chart 2); credit yields fell (Chart 3); the housing market showed signs of stabilizing; and the economy turned the corner and started growing in the third quarter of 2009. The longer-term impacts of these large-scale asset purchases remain to be seen, but it appears that the Fed’s policy helped the financial markets and the economy emerge from the depths of the credit crisis.

The Rationale for Quantitative Easing Two

Under the Federal Reserve Act, the Fed is directed to “promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates.” With unemployment near 10% (Chart 4) and core consumer prices at a record low (Chart 5), the Fed believes it is falling short of this mandate, and thus the Fed has decided that more needs to be done to support the economy. In an attempt to spur economic activity, the Fed intends to purchase $600 billion USD of longer-term (i.e., maturities greater than 2-years) Treasury securities by June 2011, which comes out to about $75 billion USD per month. In addition, the Fed will continue to reinvest the principal payments from its existing security holdings as they roll over. Given the unconventional nature of these new asset-purchases, the Fed began discussing the potential for such monetary policy action in the months leading up to this announcement, emphasizing that the central bank would carefully review its options. As Federal Reserve Chairman Ben Bernanke wrote, “The FOMC (Federal Open Market Committee) has been cautious, balancing the costs and benefits before acting. We will review the purchase program regularly to ensure it is working as intended and to assess whether adjustments are needed as economic conditions change.”
The Fed’s Objectives

With the economy essentially stuck in a slow growth mode, the Fed is seeking to jumpstart a “virtuous cycle” of organic economic growth. In order to achieve this broader goal, the Fed has several specific objectives with this second round of quantitative easing:

1. The central bank is focused on lowering intermediate to longer-term interest rates. By buying assets in this range and thus driving rates down, the Fed hopes to support the housing market through lower mortgage rates. With cheaper borrowing costs, the Fed is also striving to encourage business investment. Lastly, the Fed is trying to push investors out of cash or safer Treasury securities, which offer little-to-no interest, and into riskier, higher-yielding assets.

2. The Fed wants to prevent inflation expectations from falling – if inflation expectations creep too low, the idea of falling prices could begin to enter the mindset of consumers and businesses, impacting their behavior (i.e., foregoing purchases today for lower prices tomorrow). To some degree, the talk leading up to the QE2 announcement has already lifted inflation expectations. Market-based and consumer-based inflation expectations have ticked back up in recent months.

3. The Fed is aiming to support financial assets. By encouraging a stock market rally, the Fed is seeking to boost consumer and small-business confidence, which could then increase spending and create a “wealth effect,” thus benefiting the economy. As with inflation expectations, the Fed’s speeches leading up to its QE2 decision helped spark an equity rally.

4. Without directly stating it, the Fed seems to implicitly welcome a lower dollar. The Fed’s Treasury purchases increase the amount of money in the system, which typically causes a currency to weaken. A weaker dollar would benefit U.S. exporters, which would contribute to economic growth.

Potential Risks

While the Fed’s monetary policy could produce several economic and market benefits, this second round of large-scale asset purchases presents certain risks as well. The Fed has limited experience with quantitative easing as a policy tool and no experience unwinding quantitative easing, which makes the long-term implications more difficult to assess. Indeed, the Fed has the necessary tools for an eventual exit, but the timing and balance of removing such liquidity from the market will be delicate. As is often the case, the Fed’s actions could have unintended consequences that may not seem obvious right now.

In addition to the minimal experience with quantitative easing, the effectiveness of the monetary policy could also be questioned. Interest rates are already quite low, so the economic traction associated with slightly lower rates is probably rather small. While the Fed is attempting to promote growth through lower interest rates, it is also seeking to raise inflation expectations. The two could work against each other. Also, the economic benefits from improved consumer confidence, the wealth effect, and a weaker dollar may be marginal. Another concern that has been voiced regarding QE2 relates to the inflation potential it could instigate down the road. Broad inflationary measures remain subdued today. However, flooding the system with reserves, which could be difficult to extract, introduces the potential for inflation in the future. Those reserves have the potential to be “multiplied” by the banking system into actual money. If the reserves prove hard to remove from the banking system, the money supply might grow at an excessive rate, which could cause uncomfortably high inflation. Furthermore, while a weaker dollar could benefit exporters and add to economic output, currency debasement could also be a potential risk down the road. The U.S. depends on foreigners to finance our debts through Treasury purchases. If dollar weakness becomes extreme in the future, foreigners may demand a higher yield for our government bonds, which would cause domestic interest rates to rise.

One final risk with QE2 relates to foreign markets. While the U.S. and most developed economies continue to muddle through fairly weak recoveries, emerging markets are experiencing more rapid rebounds. Money tends to flow into stronger areas that offer higher returns, and therefore emerging markets are seeing substantial capital inflows, contributing to their rapid growth. With such low interest rates in the U.S., excess money created by the Fed’s quantitative easing could find its way into these markets, which could add to inflationary pressures and eventually lead to overheating economies. Many of these emerging markets manipulate their currency by linking it to the dollar, which complicates matters further. Ultimately, looser monetary policy in the U.S. could force many emerging markets to tighten monetary policy and implement capital restrictions in an effort to control growth. Such action could slow the growth rates of these faster-growing countries and overall global GDP.
Conclusion

Given the lack of inflationary pressures in the U.S., the Federal Reserve has the flexibility to address high unemployment by attempting to stimulate self-sustaining growth through Treasury purchases. Importantly, this bond-buying program will be conducted in incremental steps over the next several months, which allows the central bank to evaluate the impact along the way. Overall, the second round of quantitative easing could produce certain economic and market benefits, yet it also contains noteworthy risks. We do not expect QE2 to provide a significant boost to U.S. growth, although this accommodative policy may promote investment, support financial assets, and increase inflation expectations to some extent. The longer-term implications are more difficult to predict. While the Fed has the tools to withdraw liquidity from the system when the need arises, inflation and currency debasement could be potential long-term risks that need to be monitored. Ultimately, we do not anticipate inflation becoming a concern any time soon. Despite the amount of attention and criticism that has been targeted at quantitative easing, the Fed's policy is not likely to change the fundamental outlook for the U.S. economy. We believe the U.S. will remain in a slow growth, low inflationary environment for a while. In such an environment, an active and flexible approach remains the key to uncovering investment opportunities.