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THE END OF QUANTITATIVE EASING

By Dr. Scott Sumner, *Economist*
#15 of the "Top 100 Global Thinkers"

$85 BILLION

Up to this point, the central banks have been buying $85 billion a month in bonds to encourage economic growth.

RECENT FEDERAL RESERVE POLICY AND OUTLOOK FOR THE ECONOMY AND THE INVESTMENT MARKET

During recent weeks there has been a great deal of market turmoil, much of it centred around Ben Bernanke's "tapering" comment, which suggests that "quantitative easing" might be scaled back sooner than investors had been anticipating. Bernanke indicated that the Fed would probably begin reducing their monthly bond purchases by the end of the year, and might stop them altogether by mid-2014. Stock and bond prices fell on the news, as long-term interest rates increased.

The Fed instituted two major policy changes in late 2012. The first, dubbed "QE3," called for the Fed to purchase $85 billion worth of Treasury bonds and mortgage-backed securities each month. In December, they announced the so-called "Evans Rule," where the Fed would promise to keep interest rates very low, until unemployment fell to 7%, or until inflation rose above 2.5% for a significant period of time.

These initiatives were done for two reasons. First, the Fed was dissatisfied with the pace of economic recovery, particularly the slow pace of job creation (less than 200,000/month.) In addition, Fed officials worried that "fiscal austerity" could further slow the recovery in 2013 by 1% to 2% of GDP. Recall that Congress passed several tax increases in late 2012, and the "sequester" has led to a cut in Federal spending, particularly military spending.

Given that the Fed's monetary initiatives were conditional on the rate of economic recovery, it is somewhat unexpected to see the Fed hinting that the programs might be scaled back in the near future. After all, unemployment remains at 7.6% and the inflation index the Fed focuses on (PCE inflation) is running at only about 1%/year, well below the 2.5% target. But Fed officials see signs that the economy is strengthening, especially the housing sector. And given that the sequester doesn't seem to have impacted the pace of job creation, the Fed may be expecting a pickup in growth as fiscal policy gradually returns to normal.

The market reaction to the tapering talk suggests that investors are worried (correctly in my view) that Fed tightening might slow the recovery. In the end, I believe the Fed will go slow in raising interest rates, as they are very aware that other countries have prematurely exited from the zero interest rate level. The US in 1937, Japan in 2000 and 2006, and Europe in 2011, all raised rates before the economy was healthy enough to absorb the monetary policy tightening. All slid back into recession and/or deflation. Bernanke knows this history and is not likely to make the same mistake. He may end up retiring in 2014, but his replacement will probably hold similar policy views.

The Fed is likely to do just enough to keep the recovery progressing, but not enough to create an outright boom and/or high inflation. If we continue with modest growth and low inflation, then interest rates will stay fairly low, although short term rates will eventually rise. Banks will gradually loosen their lending standards, boosting credit growth in the US. In that case, real GDP growth might rise above 3% or 4%, which would push the Fed to raise rates sooner. Even after rates rise, however, longer term rates on mortgages and other loans will remain low by historical standards. This is actually a pretty good scenario for a wide range of investments, especially real assets such as stocks, real estate, and collectables.

Real estate has obviously been depressed for many years, even as the US population continues to grow by nearly 3 million per year. As the economy gradually recovers the housing market will strengthen. Obviously, this process is already underway with the home prices up substantially over the past 12 months. What's different this time is that interest rates will remain lower than the historical norm, which will tend to support housing prices. Indeed, all asset prices are helped by low interest rates, unless the low rates are due to a weak economy. One should never draw any conclusions from interest rates alone, it's important to consider the context---why are rates low? In early 2009, asset prices fell as interest rates fell. That's why I emphasize the combination of low rates and economic recovery. Even if rates gradually rise over time, as seems likely, they will remain lower than normal for an economic expansion, and this combination will boost asset prices.

"The committee currently anticipates that it will be appropriate to moderate the monthly pace of purchases later this year, and if the subsequent data remain broadly aligned with our current expectations for the economy, we will continue to reduce the pace of purchases in measured steps through the first half of next year, ending purchases around mid-year."

-BEN BERNANKE -

EMPLOYERS ADDED 195,000 WORKERS IN JUNE 2013 ACCORDING TO NEW LABOR DEPARTMENT DATA.

"The job growth suggests a stronger economy and means the Federal Reserve could slow its bond purchases as early as September. June's job gain was fueled by consumer spending and the housing recovery. Consumer confidence has reached a 5½ year high and is helping drive up sales of homes and cars."

-CHRISTOPHER RUGABER-

Source: "US economy adds 195K jobs; Unemployment 7.6 pct." Yahoo Finance

Stock prices have done very well, because there have been high corporate profits despite a weak economy. Corporations have boosted earnings through efficiency gains, wage cuts, and globalization. The fracking boom in oil and gas will make US manufacturers even more competitive. Note that it is very costly to export natural gas, which means that US firms will pay lower prices for energy than European, Japanese or Chinese firms. The combination of low interest rates and high corporate profits equates to high equity prices. We've already seen a large run-up in stock prices, but if I'm right that low interest rates are the "new normal," then historical rules of thumb about price/earnings ratios may become obsolete and stocks should move even higher over time.

OIL CAUSING ENERGY BOOM IN US

The International Energy Agency revealed that North America is set to dominate global oil production over the next five years.

Economic growth combined with low interest rates is also good for collectables as alternative investments like bank accounts and bonds will become less attractive in a relative sense. In one respect this could also help the gold market, but in my view gold faces some headwinds that other assets do not face. For example, economic weakness in China and Europe will continue to put downward pressure on commodity prices, including gold (which until recently had been rising on Asian demand.) If the current Chinese credit crunch leads to much slower Chinese growth, look for gold prices to go substantially lower. One of the main reason people invest in gold is that it is a form of insurance in case of economic disaster, such as depression or hyperinflation. However, I see continued economic growth combined with very low inflation.

Many gold bugs have assumed that the Fed's QE programs would eventually lead to high inflation. But the Fed has not really been "printing money" in the sense that Germany did in the early 1920s, or Zimbabwe did more recently. Rather, they've injected interest-bearing bank reserves, in exchange for interest-bearing Treasury securities. Most of this new "money" is actually just excess reserves which banks park at the Fed; it is not circulating through the economy. If there were signs that the money was moving into circulation, and leading to rising inflation, the Fed would either pay a higher interest rate on reserves (to tie up the money) or withdraw it from circulation. Savvy investors know that hyperinflation is not just around the corner which is why T-bond yields remain very low.

In my view, the US has entered a period of slower growth, which is likely to last for several decades. Even so, we are likely to continue growing faster than Japan or Europe, which face even greater demographic and debt problems. Thus, the US dollar will probably do well over the next few decades. Indeed, Japan is intentionally depreciating its' currency to boost growth, and policy makers in the Eurozone are likely to eventually adopt some form of "Abenomics," meaning a more

expansionary monetary policy aimed at boosting growth and depreciating the euro. Right now the euro is too strong for almost all of the Eurozone countries, with the notable exception of Germany.

There are murmurs in places like France that maybe the ECB should follow the Japanese playbook and weaken the euro. But the Germans are allergic to high inflation and may well veto that idea. If so, it could cause a split in the euro in one of two ways. The best solution would be for Germany to return to the Deutschmark. This would cause the U.S. dollar to strengthen as investors lose faith in the euro, which might easily decline by more than 20%. Alternatively, the Germans might stay in the euro, and some of the weaker members might leave, perhaps under pressure from the street demonstrations of the type that we are currently seeing in Turkey and Brazil.

Surprisingly, a collapse of the euro would actually help the weaker members over time, because their economies are hopelessly uncompetitive at the current exchange rate. But it would be a very messy breakup, with major defaults on government debt, banking crises, etc. Global stock markets would undoubtedly fall sharply, probably at least 10% to 20%. And keep in mind that although the euro is clearly not an optimal currency zone, the Europeans are determined to make it work. Thus, it will take a serious crisis to trigger a collapse.

The wild card in growth forecasts is immigration. If Congress passes an immigration reform measure, the rate of immigration into the U.S. will rise sharply, particularly among the so-called STEM workers (science, technology, engineering, math.) When combined with the fracking boom, and the recent decision by the Obama administration to delay the employer health care mandate (with more delays to come?), it seems the growth prospects for the U.S. are suddenly brightening. Any factor that boosts growth from the "supply-side" tends to strengthen the dollar. As with interest rates, you need to look beyond the price, and ask why the price (i.e. exchange rate) changed. For example, Abenomics has sped up growth in Japan by weakening the yen; however, supply-side developments in the US could both strengthen the dollar and boost growth.

On June 19th, the Federal Reserve indicated it will begin winding down QE3 and Operation Twist. As noted earlier, all this is relatively good news for investors in US assets like stocks, real estate and collectables. Gold may do less well as doomsday predictions will not pan out. The dollar should stay fairly strong over the next few years, because (despite all our problems), the rest of the world faces even greater headwinds. Steady economic growth, a strong dollar and low interest rates are a good environment for domestic US investments such as stocks, real estate and collectables. Of course stocks and real estate have already risen in anticipation of this economic recovery but they probably have more room to appreciate.

ABOUT THE AUTHOR

Scott Sumner studied economics at the University of Wisconsin, and received a PhD from the University of Chicago. He has done extensive research on the role of the gold standard in the Great Depression and is currently a professor of economics at Bentley University, where he has taught since 1982. Sumner has spent 25 years researching the Great Depression, liquidity traps, and forward-looking monetary policy (especially policies that utilize market forecasts.) He has published articles in the Journal of Political Economy, the Journal of Money, Credit and Banking, and the Bulletin of Economic Research. Dr. Sumner received recognition as #15 of the 2012, "Top 100 Global Thinkers", by ForeignPolicy.com, tied with Ben Bernanke. Dr. Sumner is credited with developing the "NGDP targeting" policy which was adopted by the Federal Reserve and Bernanke.

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