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Director of Research

Exaggerated Importance of QE Redux

*Based on a November 2014
client bulletin.

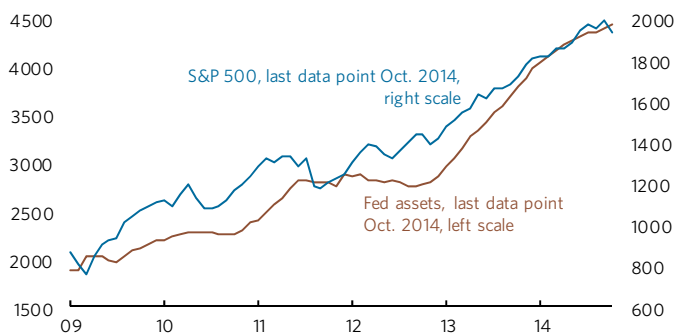
Many analysts are worried that the ending of quantitative easing (QE) in the United States removes fuel from the domestic stock market. There is little doubt that news about QE has a powerful, short-term influence on financial markets, especially when it is unexpected. However, as we have consistently written (see July 2011 memo, “The Exaggerated Importance of Quantitative Easing,” available upon request), QE’s direct influence on the economy is not meaningful, and its impact on the financial markets, beyond the short term, is not clearly discernible. If QE has any longer-lasting impact at all, it is perhaps in stoking animal spirits.

Misleading Correlation of QE to the Stock Market

There is a widespread consensus that even if QE has not *directly* affected the economy, it has heavily influenced the stock market and, more broadly, asset prices. One popular chart overlays the S&P 500 against the Fed’s balance sheet (chart 1) to show the supposedly powerful influence of QE on the market. Yet, the correlation between the S&P 500 and the Fed’s balance sheet is spurious for two reasons.

S&P 500 & Fed Balance Sheet Appear Related CHART 1

FRB: Federal Reserve Bank Credit Outstanding, end-of-period, \$ billions
S&P 500 Composite Price Index, end-of-period



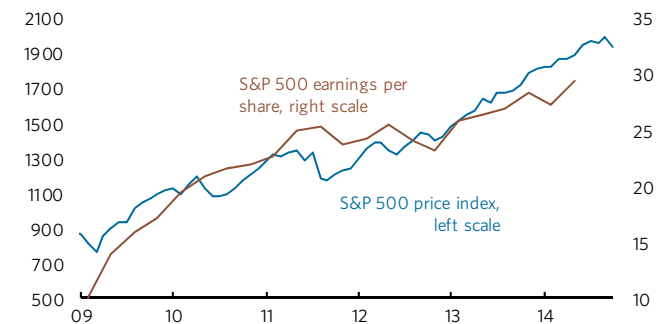
What We Mean By “QE”

Not all expansions of central bank balance sheets are the same. In this discussion, quantitative easing (QE) refers to the expansion of central bank balance sheets resulting from the outright purchase of securities in the secondary market during relatively calm financial market conditions. We specifically exclude the expansions of central bank balance sheets that result from lender-of-last-resort operations conducted during financial crisis. These operations—such as the emergency and other discount window lending by the Fed during the 2008-2009 crisis, and the lending by the ECB under LTRO conducted during the 2011-2012 euro area crisis—do have an enormous influence in stabilizing the economy and the financial markets.

First, the market has largely tracked earnings as they have risen (chart 2). It is hard to argue that QE has driven earnings. One might think QE has influenced earnings through interest rates and credit creation—a channel of debatable effectiveness—

S&P 500 Has Tracked with Earnings CHART 2

S&P 500: Composite Price Index, end-of-period, last data point Oct 2014
S&P 500: Operating Earnings per share, \$/share, last data point Q2 2014



but QE's influence on interest rates and credit creation has hardly been evident (see next section). It is therefore extremely difficult to envisage how QE could affect the profits sources, which are determined in large part by business decisions to invest and household decisions to save and to purchase homes. Thus, the correlation between QE and the market simply reflects the fact that the expansion of the Fed's balance sheet has coincided with rising earnings. Now, if QE does not affect earnings, it can only affect stock prices by influencing valuations, but there is little correlation between QE and valuations (chart 3).

Second, the correlation between the Fed's balance sheet and the stock market is exaggerated by a coincidence—the two major eruptions of European crisis each happened to occur between QE programs (chart 4). Once we account for the European crisis and earnings, the correlation of the S&P with the Fed's balance sheet largely fades.

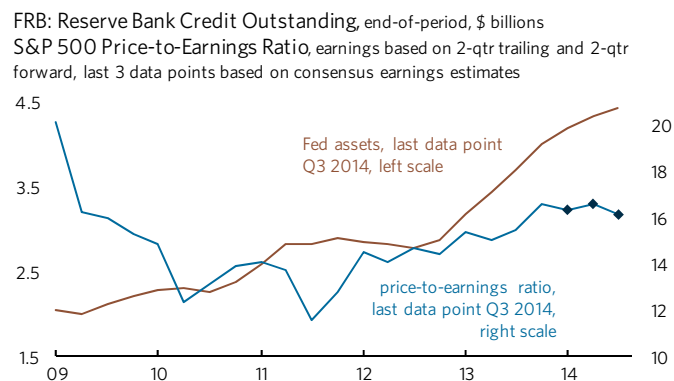
Why QE's Impact is Limited

There are several reasons why QE's influence on the economy and even the markets is limited. First, unlike cuts in the federal funds rate, QE has little influence on interest rates. In fact, the moves in interest rates in the United States during periods of QE have generally been contrary to what QE was supposed to do (chart 5).

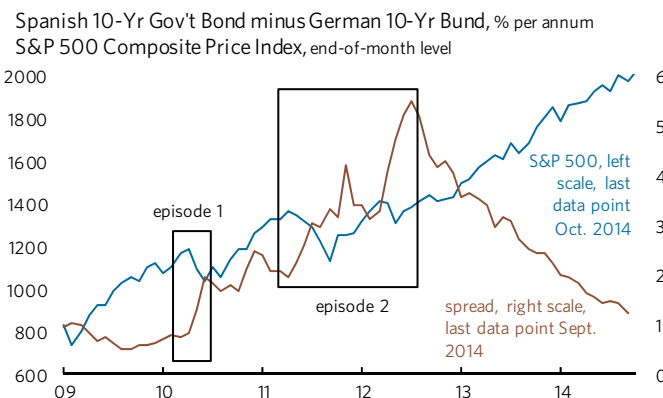
Second, QE pumps excess reserves into the banking system, yet bank lending is constrained not by reserves but by capital, credit quality, and demand. Nagging questions about bank capital (at least until about two years ago) and still historically high delinquency rates have constrained credit availability. Meanwhile, still-high debt levels and weak income growth have dampened credit demand from the household sector.

Third, QE's influence on asset prices is questionable. Although the cumulative purchases of Treasuries and mortgage-backed securities appear to be large in relation to the net issuance of

Valuations & Fed Balance Sheet Don't Track Well CHART 3

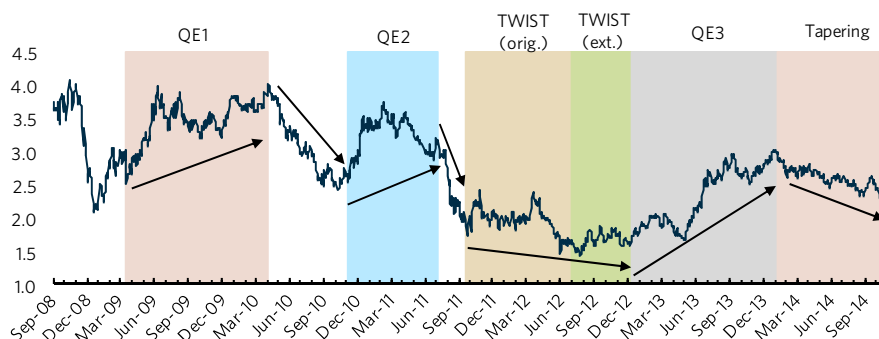


S&P 500 Declines Correlate with Eurocrisis CHART 4



Interest Rates Generally Rose During Periods of QE CHART 5

10-year U.S. Treasury Yield, % per annum, daily data Sept 1, 2008 to October 27, 2014
QE Timeline, shaded areas represent actual Fed Treasury purchases



these securities, they amount to only 3% of the \$75 trillion of aggregate financial assets in the United States, according to IMF data. So, QE may have shifted 3% of the aggregate portfolio from a relatively safe, low interest-yielding asset to zero-interest cash. At low interest rates, Treasuries and cash are close substitutes, and replacing Treasuries with cash will not necessarily cause substantial shifts in asset prices. Some investors may seek out the closest substitute to Treasuries to replace the loss in yield and thereby drive investors selling those close substitutes to seek out slightly riskier assets, and so on and so forth. However, given the shortage of safe assets, it is likely that most investors will be content holding more cash and not take on additional interest-rate or credit risk. Moreover, when considering Treasury purchases, we probably need to account for global balance sheets as well—because foreigners own roughly half of Treasuries—which further dilutes the impact of QE.

Fourth, QE does not seem to affect the economy by raising inflation expectations, either. Inflation expectations in the United States have been erratically declining during the past few years (chart 6).

QE's Effect on Exchange Rates and Trade

QE appears to weaken the exchange rate. Although the effect of QE on the U.S. dollar is not apparent, the relationship between QE and the exchange rate is quite dramatic in Japan (chart 7). In Europe, too, Draghi's announcement in May of this year that the ECB was willing to consider "unconventional" policy measures corresponded with the beginning of a +10% depreciation of the euro versus the dollar.

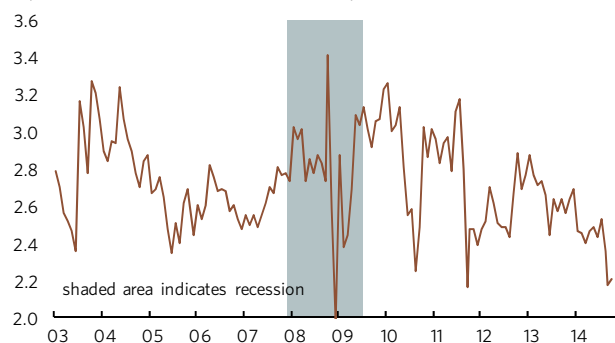
More important, in a weak global economy, it is not clear that encouraging the depreciation of the currency is as potent as it would be if global economic conditions were robust. In a world with weak domestic profit sources in many countries, efforts to weaken the currency beget retaliatory efforts by others and at most shift weakness from one region to another.

Conclusion

While there are other reasons to worry about the U.S. stock market, especially the prospect of a global downturn starting sometime in 2015, the U.S. economy will in all probability outperform that of Europe and much of the rest of the world. We remain long U.S. equities against short positions in European and emerging market equities.

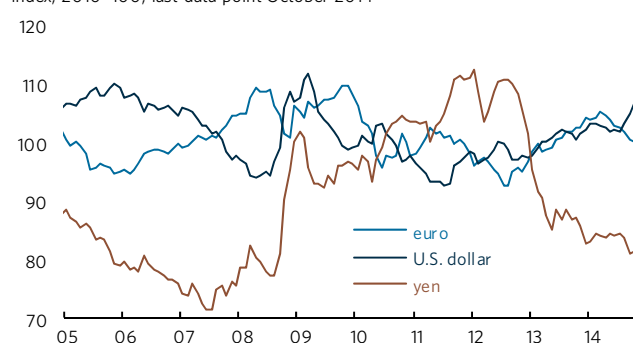
Inflation Expectations Trending Downward CHART 6

TIPS 5yr/5yr Forward Breakeven Inflation Rates
% per annum, end-of-month level, last data point October 2014



Currency Moves CHART 7

JP Morgan Broad Nominal Trade-Weighted Currencies
index, 2010=100, last data point October 2014





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