How the Fed got from eternity to here

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Infinity, it turns out, lasted a little more than two years. In September 2012, the Federal Reserve administered one of the greatest market shocks of recent years by announcing that it would buy $40bn of mortgage-backed securities every month (subsequently raised to $85bn, including Treasury bonds), and do so indefinitely.

This was unprecedented. The third dose of “QE” bond purchases was soon dubbed QE Eternity, or QE∞. As the market was not signalling any great concern over deflation at the time, and bond yields were low, the complaints were that QE∞ was unnecessary, and meant the abandonment of the dollar. The Fed was telling investors to buy gold, avoid paper money, and invest anywhere in the world but the US.

It has not worked out that way. Now that eternity is over, inflation expectations are lower than when QE∞ started. As QE is generally justified as a means to push up inflation expectations and fight deflation, this is the exact opposite of what might have been expected.
Meanwhile, ten-year bond yields are higher. Gold has tanked. The dollar stayed weak against its main trading partners until June this year; since then it has appreciated by about 7 per cent as the end of bond purchases nears.

Benchmark mortgage rates, about 2 per cent at the time, briefly dipped, but are now about 3 per cent.

Rather than the assets the Fed was buying, those that profited most were equities. The S&P 500 is up 42.75 per cent over the infinity era, trouncing every other major stock market. Again, this is the exact opposite of what might have been expected.

Even more dramatically, given the hype about gold when QE∞ was announced, the S&P’s value in terms of gold has doubled.

Even if its effects on financial markets were counter-intuitive, however, the QE∞ period overlapped with some of the improvements in the economy that the Fed most desired. House prices were still in the doldrums in September 2012. Since then, judging by the S&P Case-Shiller indices, they have made a meaningful recovery - which in turn means relief for many consumers, and far less concern for banks’ balance sheets.
Also, and by far the most important, employment has moved in the right direction. As of September 2012, a gradual improvement in the unemployment rate had stalled at 8.1 per cent. It has since fallen to a politically conscionable 5.9 per cent.

When announcing QE∞, the Fed said it would carry on “if the outlook for the labour market does not improve substantially”. Whether or not QE was sufficient, or even necessary for this to happen, the latest period of aggressively loose monetary policy has seen the labour market log the kind of improvements that the Fed was hoping to achieve.

Now, however, comes the reckoning. Eternity is over. The dollar is rising, now that investors expect US rates to start rising, and this puts pressure on US exporters, while pressing down on inflation. There are also QE’s other consequences. Stocks look overvalued and bubbly, just as the bond market is signalling concern about an economic slowdown.

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