November 2010

Quantitative Easing (QE) – What does it really mean?

Quantitative Easing (QE) by our central bank (the Federal Reserve) has been much talked about in recent weeks. The Fed has two basic mandates (set by Congress): to promote a high level of employment and low, stable inflation. In normal times, the Fed addresses its two mandates by raising or lowering interest rates. Raising interest rates tends to slow growth and curb inflation (money becomes more expensive to borrow). Lowering rates usually stimulates borrowing and serves as a catalyst for growth and employment. QE is used when the Fed is down to its last bullets – interest rates are at or near zero and therefore "Plan B" (QE) is required to try and avert deflation (falling prices and wages). QE is money that really is printed "out of thin air" – the US Government literally gives itself money to purchase securities such as mortgages and US Treasury bonds from existing bondholders (in the secondary (or open) market). This process creates new demand which pushes bond prices higher and yields lower. The sellers of these securities, large commercial banks, pension funds and companies, benefit from selling at a high price and converting an asset to cash that can then be reinvested (preferably in job-creating endeavors or other assets).

The current reality is that lower long-term interest rates are doing little to boost domestic demand (for loans and spending), mainly because of a lack of confidence in the future. As a result, the impact of QE on asset prices and the dollar have been getting more press. Headline topics include:

- QE and the US Dollar:
  The US dollar has declined in value relative to other world currencies because of the increased supply of dollars and the lessening demand for US Treasuries (priced in dollars) with their low interest rates (yields). An asset's price is based on its desirability (demand) and availability (supply).

- QE & Currency Wars:
  Many of our foreign trading partners have been complaining about QE and its affect on the value of the US dollar. A lower dollar makes our exports more attractive (less expensive to foreign buyers) but at the same time a lower dollar makes goods and services made overseas more expensive to US consumers so we will tend to import less. The USA is the largest customer for most other countries, so if we buy less of their exports, those foreign economies suffer.

- QE & Asset Bubbles:
  Most securities (stocks, commodities and even bonds) have appreciated in price lately to the point that the Fed is being accused of creating new bubbles in these "risk assets". Because these assets are priced in US dollars, as the value of the dollar declines, it takes more dollars to buy these assets, so in US dollar terms, stocks and commodities (oil, corn, wheat, gold) have risen sharply in price. Additionally, as more dollars are created by the Fed, there are more dollars chasing after the same stocks and commodities and their prices rise.

What happens next is up for debate. If the Fed continues to print money, at some point inflation will occur. The Fed is very concerned about deflation (declining prices, wages, GDP) and will do whatever it can to prevent deflation from occurring. The balancing act between inflation and deflation is a tricky one – time will tell where we end up. In the meantime, the markets remain high-risk and we are managing your investments accordingly.