

QE2: what happens when it ends?

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 Published: April 1 2011 18:14 | Last updated: April 1 2011 23:16

The US Treasury is due to lose the biggest buyer of its debt within a few months. Already, however, investors are asking what will happen when the Fed stops being the dominant buyer of US government debt. Will the end of its second round of asset purchases under quantitative easing – dubbed QE2 – change the direction of financial markets?

Views are divided about what impact this will have on bond yields, stock markets and other risky assets such as junk and emerging market bonds which have all notched up two years of spectacular gains.

Those investors who believe the strong “risk on” rally has been fuelled by a huge influx of central bank liquidity say that pulling this back may have sharply negative effects on markets as investors switch gears.

“I’ve been surprised by the magnitude of the asset price surges and QE2 has sent ripples and cascades through the capital markets,” says Robert Arnott, chairman of Research Affiliates, an investment management firm. “When you stop QE2 a major source of stimulus disappears. The end of QE2 – if it’s not renewed with QE3 – may trigger a recession and a pull back in risk markets.”



To date, however, such a scenario is not being priced in. Indeed, March employment data published on Friday were better than expected, supporting the view of investors who bet that the US recovery is self-sustaining and can continue even as monetary stimulus is withdrawn.

Such economic improvements, increases in inflation and eventually a potential shift in expectations of when the Fed might raise official interest rates are a bigger driver for bond yields than Fed buying, some analysts argue.

“The completion of Fed purchases of Treasury securities is only likely to result in sustained increases in their yields if it leads to a reassessment of the outlook for short-term interest rates,” say analysts at Capital Economics.

Some prominent investors – notably Pimco’s Bill Gross – have moved out of Treasury debt in anticipation that yields will rise and prices will fall.

Mr Gross, co-chief investment officer at Pimco, says the Fed believes that, since it has bought so much of Treasury supply, it “must mean that Pimco and the insurance companies need to fill up the cupboard. It comes down to the delicate decision point of price. At what price do we fill up the cupboard?” Mr Gross says.

Central bank liquidity is not, of course, the only factor that has driven prices higher, particularly in the stock markets. Stocks have rallied as corporate profits and margins have improved dramatically, while the weaker dollar – which has resulted from low US interest rates – has helped US companies make profits from their international businesses.

Yet even the equity bulls say that the QE2 factor cannot be ignored. “It [the end of QE2] is one of the few bearish arguments that does have some validity,” says Laszlo Birinyi, founder of Birinyi Associates, who called the bottom of the S&P in 2009.

Another impact of reduced liquidity could be felt in the levels of investor demand for new bonds. Both junk bonds and emerging market bond sales have reached record levels in the past two years, for example. Robert Rauch, director of research at Gramercy, a hedge fund which specialises in emerging markets, says an end to the Fed’s purchases could reverse the relative ease with which companies have been able to borrow.

“We may be about to turn the corner and see a reversal, with liquidity becoming less available,” he says.

“In the absence of QE3, QE4 or QE5, many borrowers in emerging markets do not have alternatives to bond markets and we could see another spate of restructurings.”

Although many investors do not expect another round of quantitative easing, whether or not the Fed embarks on another round is still subject to fierce debate. Much will depend on economic indicators. After all, the Fed’s initial post-crisis round of quantitative easing was only followed by QE2 when the US economy stumbled last year and deflationary expectations began to take hold. Now, with signs of inflation amid soaring commodity and oil prices, the picture looks different.

“There is a low probability of more quantitative easing after QE2 ends in June, because the US monetary base has already expanded so dramatically,” says Michael Hintze, chief executive of the \$10bn London-based hedge fund QFS. “I can’t see them throwing more fuel onto the fire.”

Bob Auwaerter, head of the fixed income group at Vanguard, the mutual fund company, also does not expect QE3. "The only factor that would change my expectation would be a spike in the oil price to the \$140/\$150 range," he says. "Then the economy would start to fall down."

In the meantime, talk about whether the Fed embarks on QE3 will not go away. "Markets are trying to guess what will happen," says Mr Arnott. "If quantitative easing does not continue, risk assets – stocks, commodities and credit spreads – could sell off. It is a dangerous situation."

Additional reporting by Michael Mackenzie and James Mackintosh

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