

QE2, inflation and interest rates

AT A GLANCE

- There are worries that the end of QE2 could trigger a tightening in financial conditions and a deterioration in investor sentiment
- This may not happen as the Fed remains committed to promoting economic growth
- There are concerns that the Fed may need to extend QE2 or even introduce QE3
- Some believe we need to wait and see the results of QE2 first as additional QE could prove inflationary
- QE has been linked to imbalances within emerging markets
- Other developed economies have not implemented additional QE – the UK cannot due to rising inflation and the eurozone raised rates in April

At the end of June 2011, the controversial second round of quantitative easing in the US, dubbed “QE2”, will come to an end. QE2 – an asset purchase program amounting to \$600bn in US Treasuries – has added to the US Federal Reserve’s already bloated balance sheet. The motivation for this asset purchase program was to protect the US economy at a time when significant headwinds posed a real threat to economic growth. As we near the end of QE2, economic data remain mixed and investor uncertainty is high. So what’s next? Will QE2 be extended or is QE3 in the offing?

THE BIRTH OF QE2

It is worth reflecting on how QE2 came to be. During the summer of 2010, equity markets were rocked by heightened levels of volatility, while a flight to quality pushed down government yields to historic low levels. There appeared to be a real risk that the global economic recovery was losing its momentum and that major economies, such as the US, were at risk of “double dipping” back into recession.

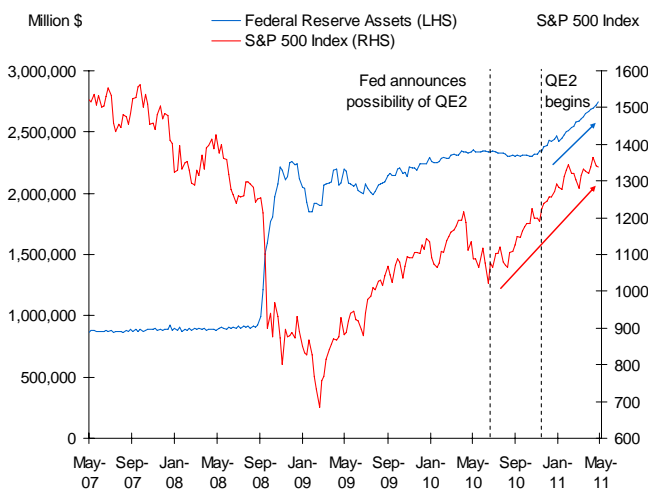
Eventually in September 2010, monetary authorities in the US, Eurozone and the UK announced that they were prepared to implement additional rounds of quantitative easing if necessary. The news provided a major boost to sentiment and, unsurprisingly, global equity markets responded positively.

In the end, only the US followed through with its proposal – it launched QE2 in November 2010. As we approach the end of this massive stimulus package, worries are growing about what might happen when support is withdrawn. With certain recent data showing that the recovery is losing momentum, some commentators argue that little has fundamentally changed since QE2 was introduced - there is a sense of déjà vu among investors in terms of how 2011 is playing out.

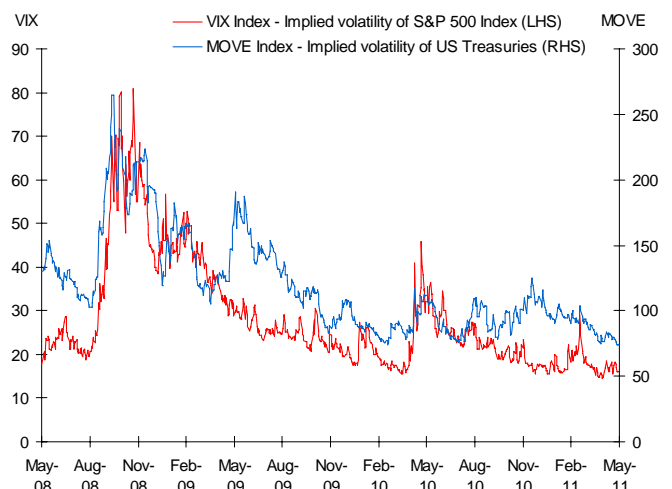
SO WHAT IS ALL THE WORRY?

One concern is that the end of QE2 could trigger a dramatic tightening in financial conditions. The desired outcome of a large scale asset purchase program like QE2 is an increase in demand for government bonds, which drives down yields. This encourages investors to shift into riskier assets such as higher-yielding corporate bonds and equities, which should serve to ease financial conditions for the overall economy. So far, quantitative easing has been very effective in reducing implied volatility for both US equities (S&P 500 Index) and US Treasuries. The worry is that the end of QE2 could be perceived negatively by markets, causing bond yields to rise significantly and US equities to sell off.

FED BALANCE SHEET AND S&P 500 INDEX



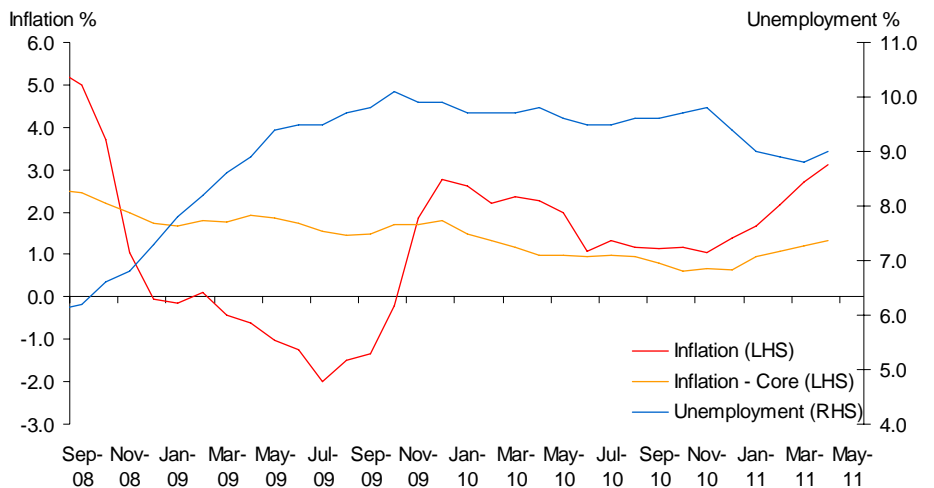
IMPLIED VOLATILITY OF S&P 500 INDEX AND US TREASURIES



To understand whether this scenario will play out, it is instructive to look at what actually moves markets. In the case of US equities, after a brief correction during the summer of 2010, the US equity market recovered in September, following the Federal Reserve's announcement that it was considering the possibility of QE2. By the time it was actually implemented, two months later, US equities had already rallied strongly. US markets were boosted by the news that the Federal Reserve was prepared to protect economic growth, rather than by the actual implementation of QE2 itself. As we come to the end of QE2, it is unlikely that the Federal Reserve will waiver from its commitment to protect growth, unless it drastically unwinds the Treasuries bought during this latest asset purchase program. This seems fairly unlikely given the present vulnerability of US economic growth, which moves us onto the next concern.

The worry is that the recovery in the US economy has been relatively modest, unemployment is high and core inflation remains subdued (this excludes food and energy prices). Concerns have already been voiced by a number of regional federal reserve banks. Recently, William Dudley, the President of the Federal Reserve Bank of New York, commented that, "we have a considerable way to go to meet the Fed's dual mandate of full employment and price stability". Charles Evans, President of the Federal Reserve Bank of Chicago, argued along similar lines that improvements in the economy, labour market and the outlook for inflation are not sufficient enough for the Fed to begin pulling back record monetary stimulus. He said: "slow progress in closing resource gaps and a medium-term outlook for inflation that is too low, lead me to conclude that substantial policy accommodation continues to be appropriate".

UNEMPLOYMENT AND INFLATION IN THE UNITED STATES



Source: Datastream, 18.05.2011

There are others who believe we need to wait a little bit longer to see if QE2 has worked before introducing more of the same. Core inflation is now starting to tick upwards as headline inflation starts to feed through to rising wages – the danger is that this could lead to inflation becoming entrenched at uncomfortably high levels. Additionally, although unemployment remains high (above 7.0%), it is a lagging indicator and could start falling as a result of QE2, several months from now.

Warren Buffett recently raised these concerns in an interview with CNBC. He has already stated publicly that he does not believe we need QE3: "I have an enormous respect for Ben Bernanke. He knows more about the Fed than I do by about a factor of 100-to-1. But, in the end, I don't think we need more of that now." Buffett believes that the government is on track to overspend massively even though the economy is recovering largely under its own power – he has predicted that unemployment could be in the "low 7%" range by Election Day in 2012.

On the other hand, worries over weak economic growth do appear warranted, particularly in the context of the public debt position. In contrast to the UK, the US has only just started to consider the spending cuts that most observers believe are necessary in the long-term. Congress recently approved a paltry \$38.5 billion spending cut, which pales in comparison with the US government's ballooning budget deficit that is expected to hit \$1.5 trillion this year. A growing chorus of support for larger cuts is emanating from Republicans and "Tea Party" advocates, meaning larger cutbacks are a real possibility next year.

Monetary policymakers in the US will be inclined to factor in these cutbacks by either keeping headline interest rates range-bound or carrying out additional quantitative easing to protect economic growth. The problem is that the US, along with other developed economies, has already created a number of imbalances in the global economy via its monetary policy. If it continues to expand its quantitative easing program, it runs the risk of upsetting other nations, particularly emerging markets which have been the target of significant capital flows.

THE EFFECTS OF QUANTITATIVE EASING ON EMERGING MARKETS

Quantitative easing has created additional global liquidity but much of that capital has flowed to emerging markets, thanks to the lure of more attractive investment returns via 'carry trades', where investors borrow in low interest rate (developed market) currencies to invest in higher-yielding assets in emerging market currencies. This has helped to push up emerging market currencies, raise commodity prices (since they are priced in dollars, commodities become more attractive to buyers using stronger currencies and represent a hedge against further dollar depreciation) and spur inflation in emerging economies.

These economies are now showing signs of overheating, prompting them to tighten monetary policy. Meanwhile, investor inflows into these economies have created frothiness in emerging market risk assets, particularly real estate and commodities. The fear is that additional quantitative easing after QE2 would exacerbate this situation. What makes expanding quantitative easing even more difficult for the US is that other developed economies have so far not followed suit.

THE UK IS MORE WORRIED ABOUT INFLATION AND AUSTERITY

In the UK, additional quantitative easing seems unlikely as the threat of rising inflation is already worrying UK policy makers. Unlike the US, inflation in the UK is now considered to be uncomfortably high at over double its government-set target rate of 2.0%. During the Bank of England's latest Monetary Policy Committee (MPC) meeting, only one member out of nine voted for a new round of quantitative easing. In contrast, three members, including the Bank's chief economist, Spencer Dale, voted for a rise in interest rates.

In general, the message coming from the MPC is that the UK is going through a soft patch and should continue to recover; this removes the need for additional quantitative easing. Nevertheless, the British government's decision to address its budget deficit through tough austerity measures (taking the pain now, unlike the US) rather than grow its way out through stimulus has forced the MPC to keep interest rates on hold.

THE EUROZONE TRADITIONALLY PUTS INFLATION FIRST

In stark contrast to the US, the ECB has chosen to raise rates rather than implement quantitative easing, despite an ongoing fiscal crisis in the "periphery". Its prime and enduring concern is that inflation could rise in the "core" economies, an anxiety that has been reinforced by better-than-expected first quarter GDP growth in Germany and France. Despite this rise, monetary policy in the eurozone still remains very accommodative. The ECB emphasised that the decision to raise rates by 25bps represented a rise from an emergency level of 1.0%, and not the first move in a series of hikes.

The ECB, which has traditionally stuck to its one-track remit of focusing only on inflation and not growth, has chosen not to use monetary stimulus to aid the "periphery". Instead, EU members have decided to implement the EFSF (European Financial Stabilisation Facility), a temporary three-year financing mechanism with a triple-A rating that aims to assist struggling Eurozone members. It will eventually be replaced with a more permanent ESM (Economic Stabilisation Facility). An inherent flaw with the eurozone is that although monetary policy is centrally coordinated, fiscal policy has not been – it is hoped that these new mechanisms will address this issue and the fiscal problems faced in the periphery.

CONCLUSION

There is certainly a rational case for introducing more quantitative easing in the US once QE2 ends and the public statements of Federal Reserve members will be picked over meticulously in the coming weeks. However, whether more QE is necessary is another question, particularly if it raises "core" inflation or exacerbates global imbalances with emerging markets. Other developed economies, which did not launch a second round of quantitative easing, namely the UK and Eurozone, have not returned to recession and have seen their stock markets rally.

The next few weeks of economic data and the behaviour of financial markets will be critical as the story they tell will be instrumental in determining the Fed's actions. The outcome is likely to set the tone for financial markets for the second half of the year.



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