Returns from QE1 & QE2, & the outlook for QE3

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Summary and key implications

- The US Federal Reserve has implemented two rounds of QE.
- QE1 was designed to prevent total collapse of the global economy, while QE2 helped to shore up confidence.
- Slowing growth and a renewed crisis has led to calls for more stimulus, but the impact of a third round of QE may be limited.
- Instead, the Fed may attempt to drive down longer-term interest rates in what has been dubbed 'Operation Twist'.

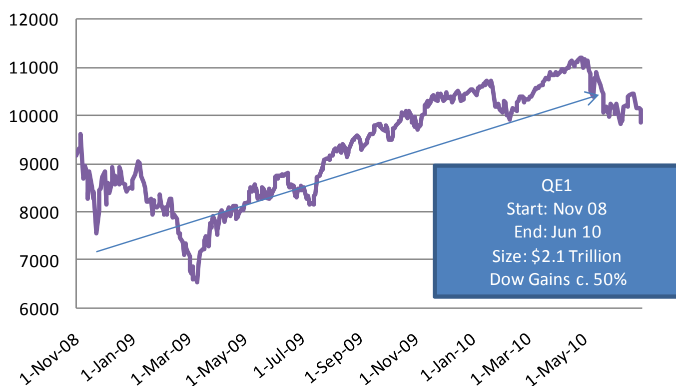
QE1

In November 2008, the Federal Reserve announced its intention to begin large-scale asset purchases, a programme known as 'quantitative easing' (QE). It began by buying $600 billion in mortgage-backed securities (MBS), in a bid to remove these so-called 'toxic assets' from bank balance sheets. The programme was enlarged in March 2009, with the ultimate size reaching $2.1 trillion, encompassing bank debt, MBS and Treasuries.

The programme was undertaken to prevent a general collapse of the US and global economy, and to ease the functioning of credit markets, which had come close to complete shutdown in the financial crisis of 2008/9.

The Federal Reserve's pre-emptive action helped to inject confidence back into global markets, and in the period to June 2010, when the first QE programme ended, the Dow Jones Industrial Average (DJIA) gained 50%, as shown in Chart 1:

Chart 1: The Impact of QE1 on the Dow Jones Industrial Average, November 2009 – June 2010



It is important to note that 'correlation is not causation', and that it was not QE on its own that caused a general recovery in the global economy. Low interest rates and continued growth in emerging markets (especially China) also played a major part. However, the activist stance of the Federal Reserve (and other central banks, which also embarked on their own easing measures) provided a powerful boost at a difficult time.

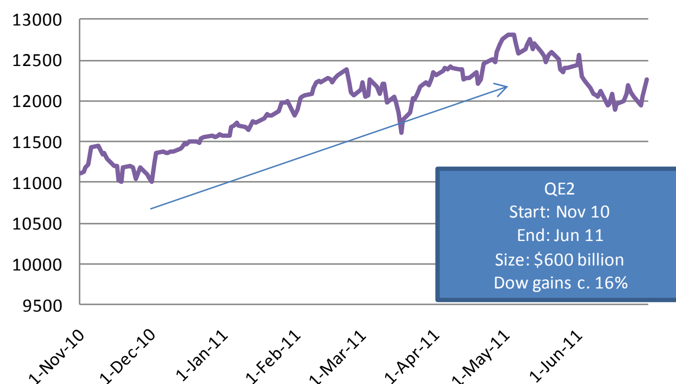
QE2

In June 2010, the first programme of QE came to an end. However, a combination of slowing US growth and the first ructions of the eurozone sovereign debt crisis caused world markets to retreat, with the Dow Jones losing 13% from its 2010 peak.

As a result, Ben Bernanke used his speech at the Federal Reserve's economic symposium in Jackson Hole in August 2010 to hint at the possibility of a further round of active central bank support. This second programme of easing, which was inevitably referred to as 'QE2' by financial media, saw the Fed ultimately purchase $600 billion more in assets. QE1 (as it was retrospectively christened) was deemed a 'defensive' measure to prevent collapse, but QE2 was more 'offensive', providing loans to hedge funds and other institutions, which then invested the proceeds in high-yield assets.

Chart 2 shows that QE2 did indeed help to push the Dow Jones up once again, although the index was unable to sustain its gains beyond the end of the programme.

Chart 2: The Impact of QE2 on the Dow Jones Industrial Average, November 2010 – June 2011



It can be seen that QE1 and QE2 both had an appreciable effect on stock markets, with the impact of QE2 being, in proportional terms, only marginally less than QE1 (ie QE1 was 3.5 times the size of QE2, and had a effect that was about 3.1 times the size of its smaller sister – excluding reinvestment of QE proceeds). In approximate terms, every $40 billion of QE translated into a 1% gain in the DJIA.

QE3 & other policy options

Now that the twin problems of eurozone debt and slowing US economic growth have returned to haunt markets, talk of a third bout of QE (therefore called 'QE3') has emerged. Debate has raged about whether there is sufficient justification for more easing, with the main argument being that deflation is no longer such a threat, unlike in August 2010. The Fed came under fire for helping to stoke commodity price inflation as a result of its easing efforts, which has political ramifications as US citizens see the price of ordinary goods increasing.

Questions are also being asked about whether the Fed can opt for QE once again without endangering its credibility, given that QE1 and QE2 significantly weakened the US dollar and ultimately provided no real long-term boost to the global economy.

Instead, the Fed may choose to enact a new version of 'Operation Twist', a move that was carried out in 1961 and resulted in a 30% gain in the DJIA. Operation Twist involves the sale of short-dated securities and the purchase of long-dated ones, pushing down the longer-term interest yield. This then encourages business investment and housing demand, as businesses and individuals take advantage of low long-term rates to borrow and invest in plant, equipment and houses.

Another possibility in place of asset purchases is that the Fed could cut interest rates on excess bank reserves held at the Fed. This would act as a spur to banks to lend more assets in a bid to seek higher returns for their funds, prompting increased economic growth.

Conclusion

It is undeniable that QE1 helped to stave off complete collapse in the US and global financial system, while QE2 played a part in preventing a loss of confidence in the recovery during late 2010.

However, there is the possibility that any further easing has only a limited impact – the law of diminishing returns. Central banks around the world are running out of policy tools, and a more creative approach on the part of governments could be a more promising avenue to take. If markets were to suffer a similar crisis to 2008, then active central bank support could be justified, but short of a full-blown crisis, they may instead choose to 'hold fire', allowing markets to wean themselves off the 'easy money' provided by QE1 and QE2.

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Contributors: Anthony Grech, Head of Research; Chris Beauchamp, Research Analyst; Jana Pristovsek, Research Analyst