Weekly Economic Commentary

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QE Ended, Now What?

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Highlights

The Fed ended its bond purchase program last week and the bar has been set fairly high for restarting more QE.

The economy is in far better shape today, compared with the start of QE in 2008 and the end of QE1 and QE2.

It is probably too soon to know if QE has "worked," and the better question may be, can the U.S. economy stand on its own without QE?

We believe the BOJ and ECB are likely to do more QE.

The economy is in far better shape today than it was at the end of QE1 in March 2010 and at the end of QE2 in June 2011.

The Federal Reserve's (Fed) policymaking arm, the Federal Open Market Committee (FOMC) met last week (October 27–31, 2014) and decided, as was widely expected, to end its bond purchase program known as quantitative easing, or QE. While the FOMC retained its promise to keep rates low for a "considerable time" after QE ends, it set the bar fairly high for restarting another round of QE. At the end of this week's commentary, we'll present some metrics to help answer the question many are asking in the wake of last week's announcement: Did QE work? Our view is that it is probably too soon make the final call as to whether QE "worked," and we'll leave it to the economic historians, pundits, and politicians to debate that in the years and decades to come. One thing we know for sure is that no one can ever know what would have happened to the United States and global economies had the Fed (and other central banks) not embarked on QE during the uncertainty generated by the collapse of Lehman Brothers and its aftermath in late 2008 and early 2009.

QE Is Still Needed in Japan and the Eurozone

QE was also in the news in Japan last week, as that nation's central bank, the Bank of Japan (BOJ), ramped up its QE program, surprising markets, which had mostly expected the BOJ to wait until early 2015 to dial up its QE program. Late this week, November 3–7, 2014, the Eurozone's central bank, the European Central Bank (ECB), will hold its monthly policy meeting. We continue to expect the Eurozone to expand its QE program, but in our view, that expansion is not likely to be announced this week. Although the results of the bank stress tests conducted by the ECB (which will take over this week, for the first time, as the bank regulator across the Eurozone) were released last week, the ECB is likely to wait to see some progress on the fiscal front (i.e., more government spending and tax cuts to help support the Eurozone economy) before it proceeds with the expansion of its QE program. We acknowledge, however, that the earlier than expected action from the BOJ to expand QE puts additional pressure on the ECB to do more—and sooner rather than later. As we noted in our recent (September 25, 2014) *Weekly Economic Commentary*, "Central Bankapalooza":

> *The data continue to suggest that even if the ECB does embark on more aggressive monetary policy (ABS purchases or outright QE), its impact on the real economy could be muted unless the fractured banking system can be repaired.*

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The policy divergence among the world's major central banks is likely to intensify, creating risks—but also opportunities—for global economies and financial markets.

The Bank of England (BOE) also meets this week, and until the recent bout of economic weakness in the Eurozone, was on track to be the first major central bank to raise rates in this cycle. Our view remains that the BOE will join the Fed in 2015 as the first major central banks among developed market economies to raise rates, while as noted above, the ECB and the BOJ are likely to do more QE. The policy divergence among the world's major central banks is likely to intensify in late 2014 and into 2015 (and perhaps beyond). This divergence will create risks to global economies and financial markets, but opportunities as well. We will continue to monitor what these banks do and say over the remainder of 2014 and into 2015.

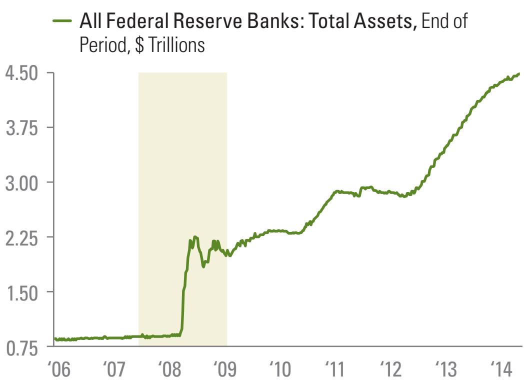
The U.S. Economy Has Improved As a Result of QE

The nearby figures present the size of the Fed's balance sheet [Figure 1] and the output gap in the U.S. economy [Figure 2] over the past decade or so. In Figure 3 we present some key economic indicators at the time that QE1 (November 2008 to March 2010), QE2 (November 2010 to June 2011), and QE3 (September 2012 to October 2014) began and ended. Our view is that the overall economy is in far better shape today than when the Fed started QE in 2008, including the areas of the economy within the purview of the Fed's dual mandate (as granted by Congress) to ensure low and stable inflation and full employment, as well as measures of the health of the consumer—the housing market and business spending. When QE started, the economy was contracting, the labor market was shedding over 500,000 jobs per month, the housing market was in free fall, and sales and production of vehicles and other business indicators were dropping sharply.

But the most important question for investors to ask today, as the Fed wraps up QE3, is not whether QE worked or didn't work. We'll leave that discussion to the economic historians, pundits, and politicians to debate in the coming years and decades. The better question to ask is, can the U.S. economy stand on its own without QE? It's important to point out that when QE3 was announced in 2012, the Fed left the program open ended. While the end point for both QE1 and QE2 were known in advance, the Fed essentially said that it would maintain QE3 until it worked; and as a result, the economy is in far better shape now than at the end of either QE1 or QE2.

As noted in Figure 3, the measures of economic activity (across the areas noted above) all indicate the economy is better today than at the end of QE1 or QE2, and much improved compared with when QE1 began in November 2008. For example, today, the output gap (the difference between actual gross domestic product [GDP] growth and growth of GDP if the economy were running at full employment) stands at -3.5%, still wide by historical standards but far above the -6.6% output gap in Q1 2010 or even the -5.7% gap in Q2 2011 when QE2 ended. Our Beige Book Barometer (see the *Weekly Economic Commentary* from October 20, 2014, for details) stands at +82 today, well above the -30 and +50 readings seen at the end of QE1 and QE2, respectively.

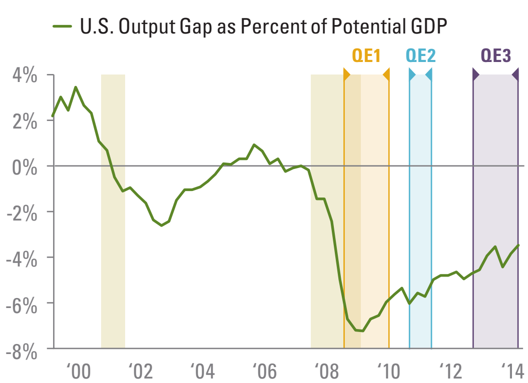
1 QE Has Nearly Quadrupled the Size of the Fed's Balance Sheet



Source: LPL Financial Research, Federal Reserve Board, Haver Analytics 10/31/14

Shaded areas indicate recession.

2 QE Has Helped to Narrow the Economy's Output Gap



Source: LPL Financial Research, Congressional Budget Office, Haver Analytics 10/31/14

Shaded areas not identified as periods of QE indicate recession.

3 The Data Suggest the U.S. Economy Is in Better Shape Today Than at the End of QE1 and QE2

		QE 1 Begins 11/08	QE1 Ends 03/10	QE2 Ends 06/11	QE3 Ends Today
Fed's Dual Mandate	Unemployment Rate	6.8%	9.9%	9.1%	5.9%
	Private Sector Job Gains (Thous, Avg. per Month, Prior 12 Months)	-251	-216	+165	+216
	Inflation Expectations (Next 5–10 Months)	+2.9%	+2.7%	+3.0%	+2.8%
	Core Inflation	+1.7%	+1.6%	+1.5%	+1.5%
	Output Gap	-5.0%	-6.6%	-5.7%	-3.5%
Overall Economy	Beige Book Barometer	-93	-30	+50	+82
Consumer	Consumer Sentiment	65	78	77	100
	Household Net Worth ($ Tril)	56.5	59.3	64.3	81.4
	Policy Uncertainty Index (Higher = More Uncertainty)	149	137	158	85
	Total Vehicle Sales (Annual Rate, Mil)	10.3	11.6	11.7	16.4
	Demand for Mortgage Loans (Net Percentage)	-61.2%	-14.5%	-31.1%	+33.6%
Housing	Housing Starts (Thous, Annualized Rate, Prior 12 Months)	650	485	427	634
	Home Prices (Year-over-Year Change)	-18.0	-1.0	-0.8	+7.6
	Mortgage Rates	6.15%	5.00%	4.62%	4.06%
Businesses	NFIB % Citing Weak Sales	25	34	24	14
	Demand for Business Loans (Net Percentage)	-16.7%	-25.5%	+27.3%	+30.7%
	Car and Truck Production (Mil, Prior 12 Months)	13.1	10.0	12.8	17.4

Source: LPL Financial Research, Bloomberg, Haver 10/31/14

QE and Inflation

Runaway inflation as a result of the Fed's QE program was a common fear among investors and the public alike as the Fed embarked on — and subsequently added to — QE. Although the final chapter on QE's impact on inflation has yet to be written, the rate of inflation today (+1.5% year over year) is in-line with where it was at the end of QE1 and QE2. Notably, core inflation has actually decelerated from the 1.7% rate seen in November 2008, when the Fed began QE1.

Today, the unemployment rate (5.9%) is much improved from the end of QE1 (9.9%) and QE2 (9.1%), while a key measure of the other half of the Fed's dual mandate — inflation expectations — is virtually unchanged compared with the end of QE1 and QE2. A key measure of the consumer — household net worth — now tops $81 trillion, well above where it was at the end of QE1 and QE2. Other measures of the health of the consumer, the housing market and business spending, tell the same story: The economy is in far better shape today than it was at the end of QE1 in March 2010 and at the end of QE2 in June 2011.

On balance, the final chapter has yet to be written on the efficacy of QE as a policy tool here and abroad over the past six years. We will continue to monitor the Fed and the other major central banks over the remainder of this year and into next as those banks exit from — or pursue more — quantitative easing. ■

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. All performance reference is historical and is no guarantee of future results. All indexes are unmanaged and cannot be invested into directly.

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