6 February 2012

Further Fed QE is Unlikely

Last Friday's US labour market figures cast significant doubt over expectations for further quantitative easing from the Fed. Whereas the QE to date looks to have been highly appropriate in the face of significant deflationary forces, conditions in the US economy now look to be evolving to the point where further monetary easing would not be required/justified.

"Taylor Rule" calculations provide a guide as to the extent to which a central bank should engage in unconventional easing. For technical reasons, central banks are unable to bring their official interest rates below zero. Whenever "Taylor Rule" calculations (based on current levels and trends in unemployment and inflation relative to desired levels) suggest that the official interest rate should in fact be negative, this is a signal that quantitative easing should be deployed to protect the economy from mounting deflationary forces. The chart overleaf suggests that the Fed's policy of holding its official interest rate close to zero while also engaging in aggressive QE has been very appropriate, given Taylor Rule calculations suggesting that the appropriate level for the Fed funds rate was as low as minus 2% for a prolonged period of time. However, deflationary forces look to have been fading over the past year in the US and **recent Taylor Rule readings are now approaching the point where, although the zero-based Fed funds rate is still appropriate, the need for further QE is becoming questionable.**

It should be remembered that as recently as early 2011 markets were beginning to discount the Fed's first tightening move of the current cycle. A series of deflationary shocks then quickly put these expectations for Fed tightening into reverse (an oil price spike aggravated by political upheavals in North Africa and the Middle East, the natural and nuclear disasters in Japan and a rapid escalation in the Eurozone debt crisis). However, the resilience of the US economy in the face of these deflationary shocks has been impressive and the US labour market is stronger now than in early 2011 when markets were first beginning to discount a less accommodative monetary environment.

So why is Bernanke still talking so dovishly? As recently as January 25th the Fed has extended the period over which it sees its official interest rate staying zero-based out to late 2014, while also saying that it remains on standby for further QE. It seems likely that the Fed is now in the business of making sure that it has seen off the threat of deflation, being all too aware of the potential for further deflationary shocks to the global economy (oil, politics, debt etc) over the medium term. It nonetheless seems increasingly likely that its incremental policy interventions are now more verbal than concrete and the likelihood of further QE is in fact receding. Although the Fed funds rate looks like staying zero-based for quite some time yet, nobody could confidently predict that this policy will remain appropriate until late 2014. However, the Fed has plenty of scope to stick with its promise in respect of the Fed funds rate for longer than might otherwise be appropriate by tightening its unconventional policy settings should the need arise.

Eurozone monetary policy will lag US policy. With unemployment historically high and rising again in a recession prone Eurozone economy, it still seems appropriate for the ECB to zero base its official interest rate while being prepared to engage in more aggressive and unsterilized QE if required to avert an unnecessarily deep recession. In any event, expectations for less accommodative monetary policy in the US relative to Eurozone could provide further support for the Eurozone economy by driving further weakness in the Euro relative to the US Dollar.

Implications for equity markets are positive on balance. An economic environment that justifies further Fed QE would be too deflationary for a healthy equity market. "Sweet spot" conditions for the equity market are more likely to exist when the economy is seen as secure enough to justify a gradual and slow reversal of super-loose monetary policy. With US and global unemployment still at high levels, monetary policy is likely to remain supportive of economies and equity markets over the medium term.

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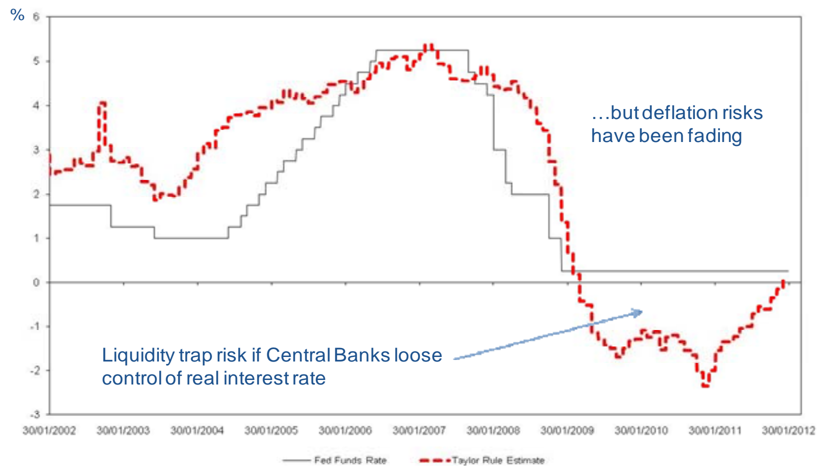
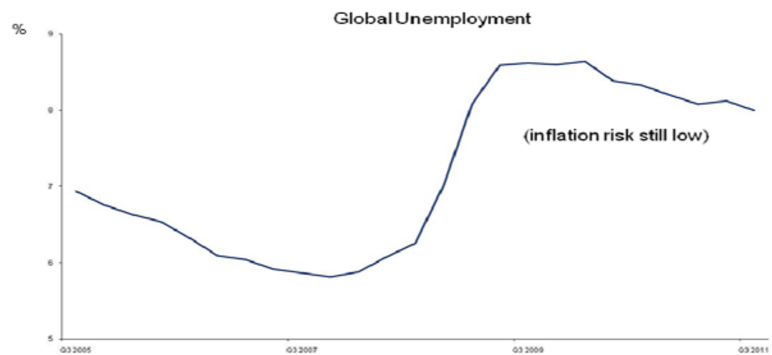
"Taylor Rule" Has Been Justifying Fed's QE



Source: Bloomberg

High Unemployment Allows Global Monetary Policy to Keep the World Growing



Source: NCB

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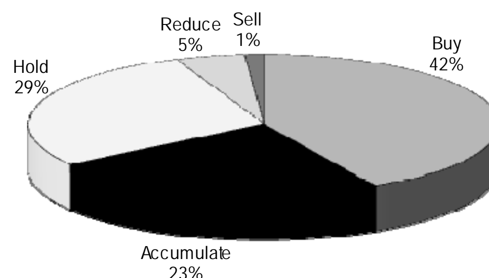

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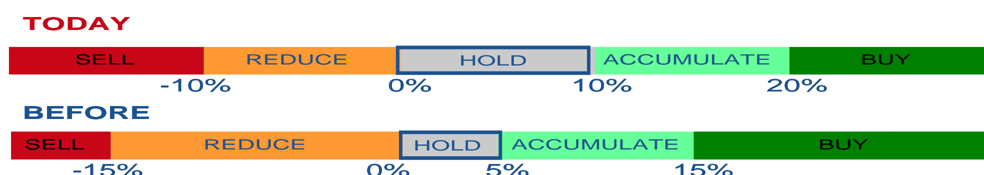

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