

# VAKIFBANK GLOBAL ECONOMY WEEKLY

## What Will Happen After QE2 End?

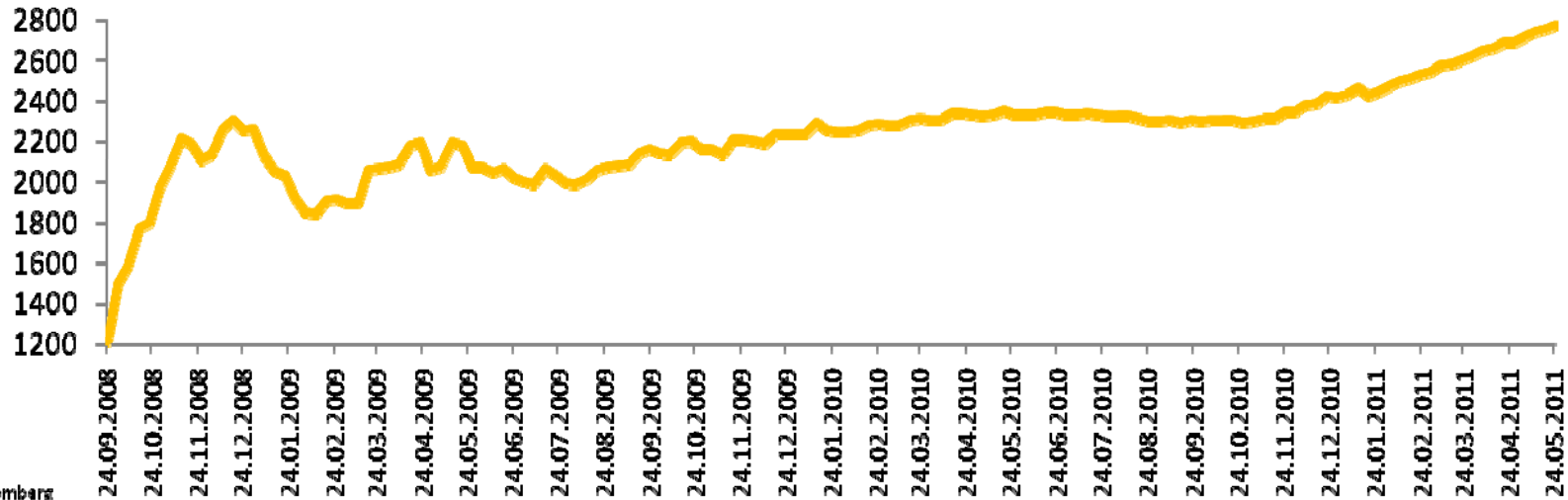


T. Vakıflar Bankası T.A.O



## QE2 ends in June 2011...


FED Balance Sheet (billion \$)



Source: Bloomberg

- When conventional monetary policy becomes ineffective, central banks can use **Quantitative easing (QE)** as another monetary policy tool to stimulate the economy.
- QE that is the expansion of the central bank's balance sheet introduced by FED during 2008-2009 financial crisis. FED used QE as an additional monetary policy in order to prevent the financial crisis.
- Through QE policies, the Fed started buying \$600 billion Mortgage-Backed Securities (MBS). By March 2009, it held \$1.75 trillion of bank debt, MBS, and Treasury notes and the total amount reached a peak of \$2.1 trillion in June 2010. In August 2010 the Fed decided to renew QE and in November 2010, the Fed announced it would buy \$600 billion of Treasury securities by the end of the second quarter of 2011.

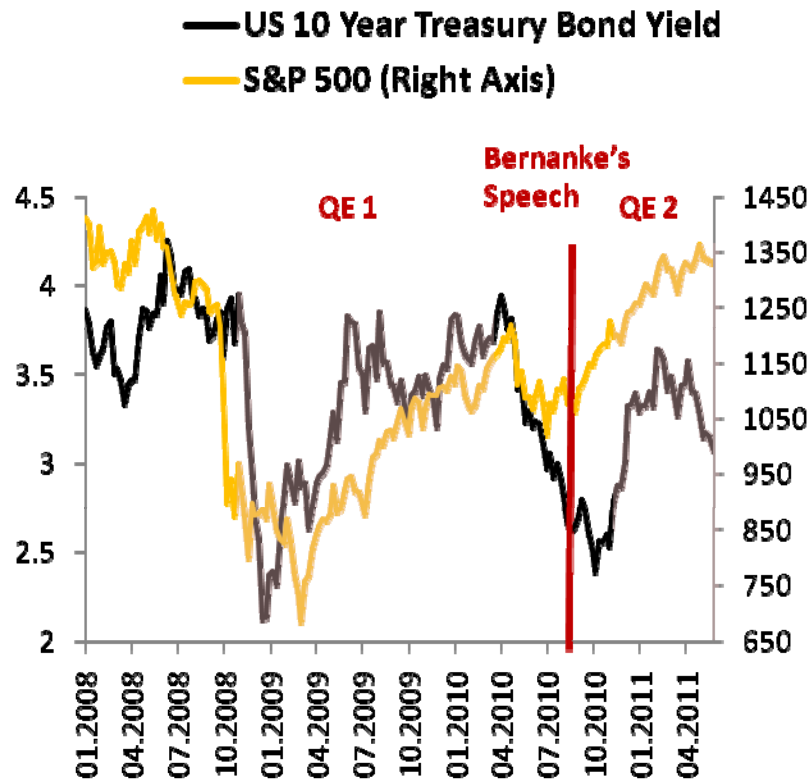
## Outline:

 The Federal Reserve's QE2 programme ends in June. In this report what QE2 ending means to the markets is analyzed under 3 headlines such as;

- Stock and bond markets
- FX
- Commodity

 Then, whether the Fed will continue QE or not is discussed through analyzing the recent US data.

➤ **Impact on stock and bond markets...**



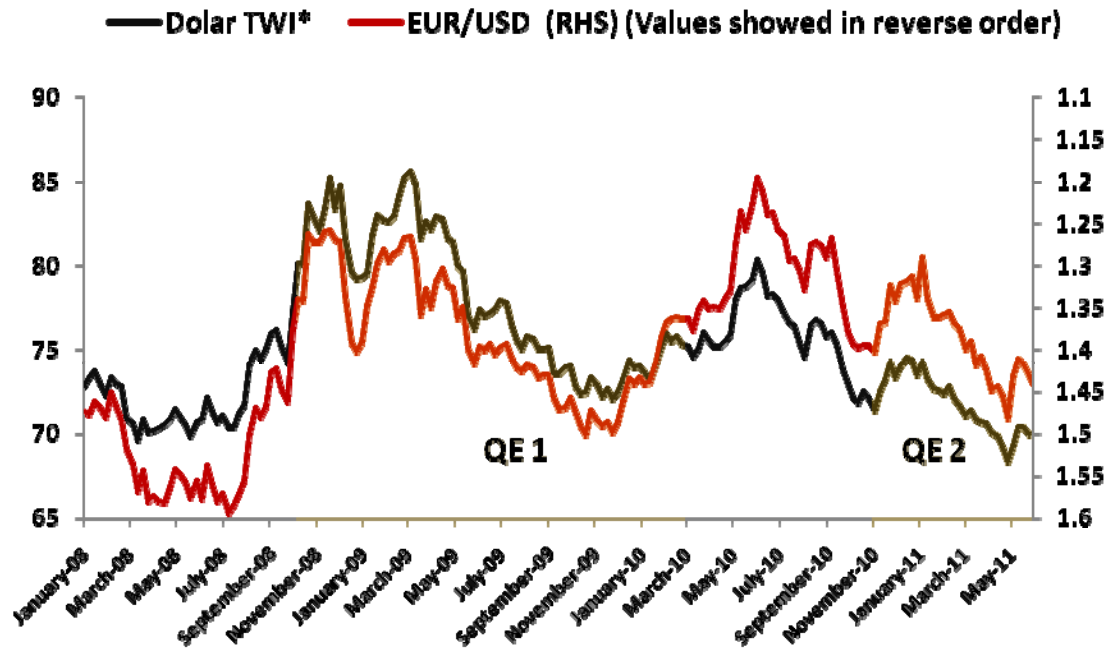
Source: Bloomberg

- After the FED announced QE programmes, bond yields were expected to decrease due to excess liquidity.
- However, after the launch of the QE1 and QE2, bond yields trended upward.
- The main reasons behind the raise in bond yields were positive growth expectations and increasing inflationary pressures in US.
- Afterwards the bond yields started to decrease as investors thought that QE programmes were insufficient. Moreover the concerns about Eurozone debt crisis surged and confusion in Middle East accelerated the fall in yields. In other words investors rushed into safe-haven US bonds and bond yields decreased in this period.

➤ On the other hand, due to excess liquidity S&P 500 increased in the same period.

➤ In conclusion, because of economic recovery and increasing risk appetite equities are bought and long term bonds are sold in the markets.

## ➤ Impact on FX markets...



Source: Bloomberg

\*The Trade Weighted US dollar Index: The broad index which is a measure of the value of the US dollar relative to other world currencies.

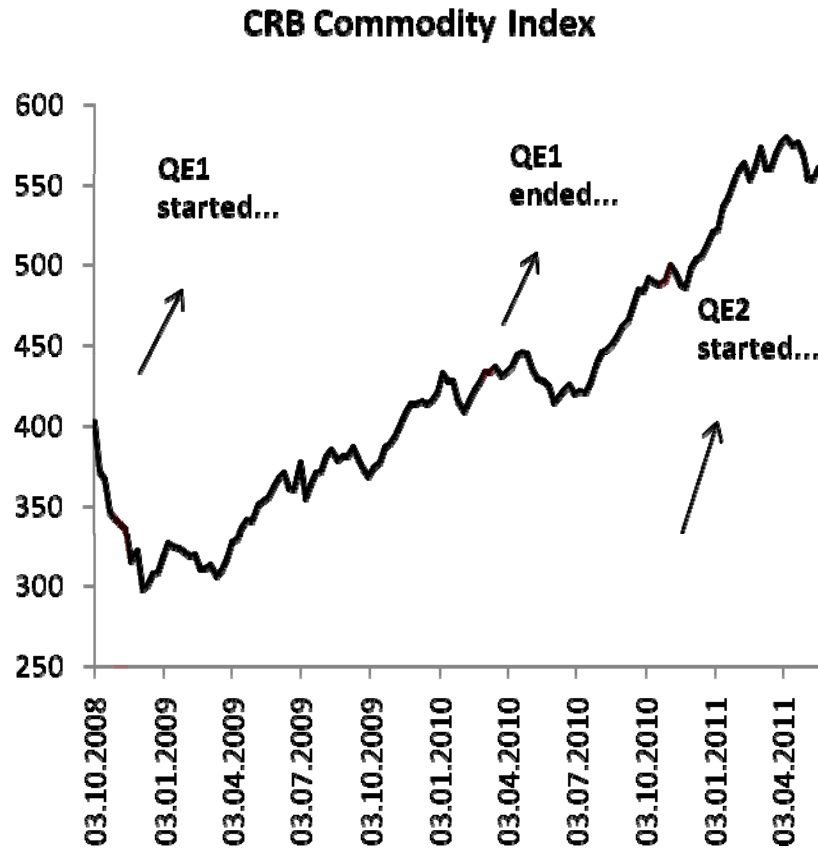
When dollar value against other currencies in QE1 period (November 2008-31 March 2010) and QE2 period (3 November 2010 - 30 July 2011) are analyzed, it is observed that dollar lost value in both QE periods with excess dollar liquidity.

QE policies are not the only fact that affecting dollar value. When QE1 ended in March 2010, dollar gained limited value. The main reason behind EUR/USD fall to 1.19 was the debt crisis in Eurozone and loss in euro value. Moreover the politic instability in Gulf countries raised safe haven demand for dollar so this could be defined as another factor behind EUR/USD fall.

EUR/USD has started to raise with the talks of QE in August 2010 and continued to increase as ECB started rate hikes before FED. Based on inflationary pressures in Eurozone, ECB is expected to continue rate hikes whereas FED does not seem to hike rates before 2012.

## ➤ Impact on commodities...

Both QE1 and QE2 programs result in rising commodity prices.



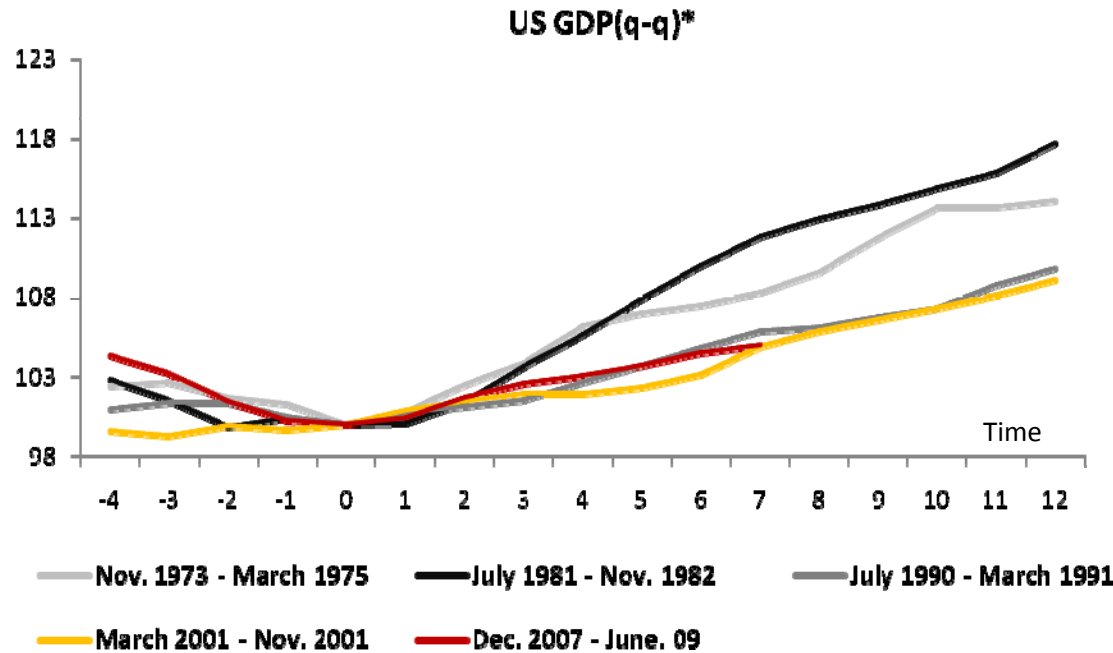
Source: Bloomberg

### ➤ Why did the commodity prices increase during QE?

- Depreciation in dollar increased the commodity prices as commodities are dollar denominated.
- Expectations that QE policies will positively affect the economic growth and this will increase the commodity demand from the emerging markets is another reason behind the rise in commodity prices.
- The depreciation in dollar, as a reserve money, caused investors to search for new reserve alternatives. Hence, the demand for commodities such as gold as a wealth saving tool increased during QE.
- In the QE2 period, commodity prices increased more than the QE1 period.
- In the QE2 period, rebellions in the Middle East increased supply concerns of some commodities such as oil and crops.
- While in the QE1 period the rise in commodity prices had been driven by demand side, in QE2 period the rise had been driven by both demand and supply side.

**After analyzing the impact of QE policies on markets, in this part whether the FED will continue QE or not is discussed through analyzing the recent US data.**

# US economy is loosing its momentum...



\* The end crisis period GDP is taken as 100 .

Source: Bloomberg

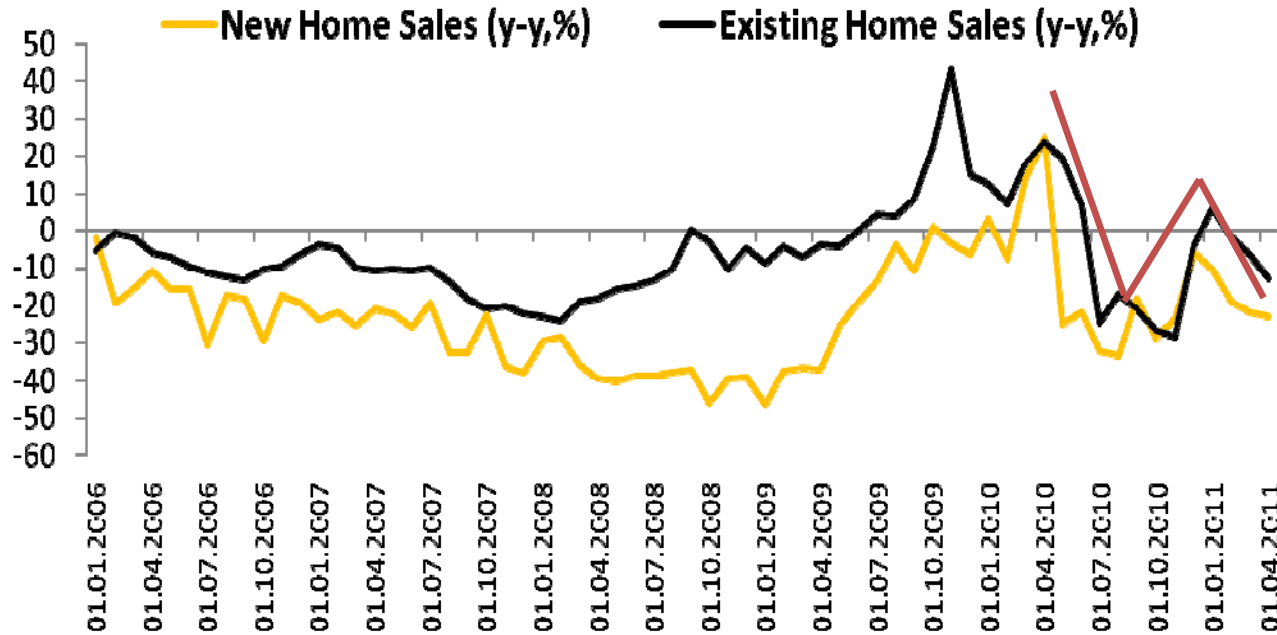
In order to analyze US growth, an index is composed for each recession period. In each index the end of recession date is accepted as zero and US growth performance in the 4 quarters before and in the 12 quarters after the end of each recession period are compared (seen in LHS graph).

It is observed that after the last global crisis in 2008 the economic recovery was similar to previous ones but relatively lower than the 1973 and 1981.

Although FED's QE programmes positively affected economic recovery , the growth was realized below the expectations.



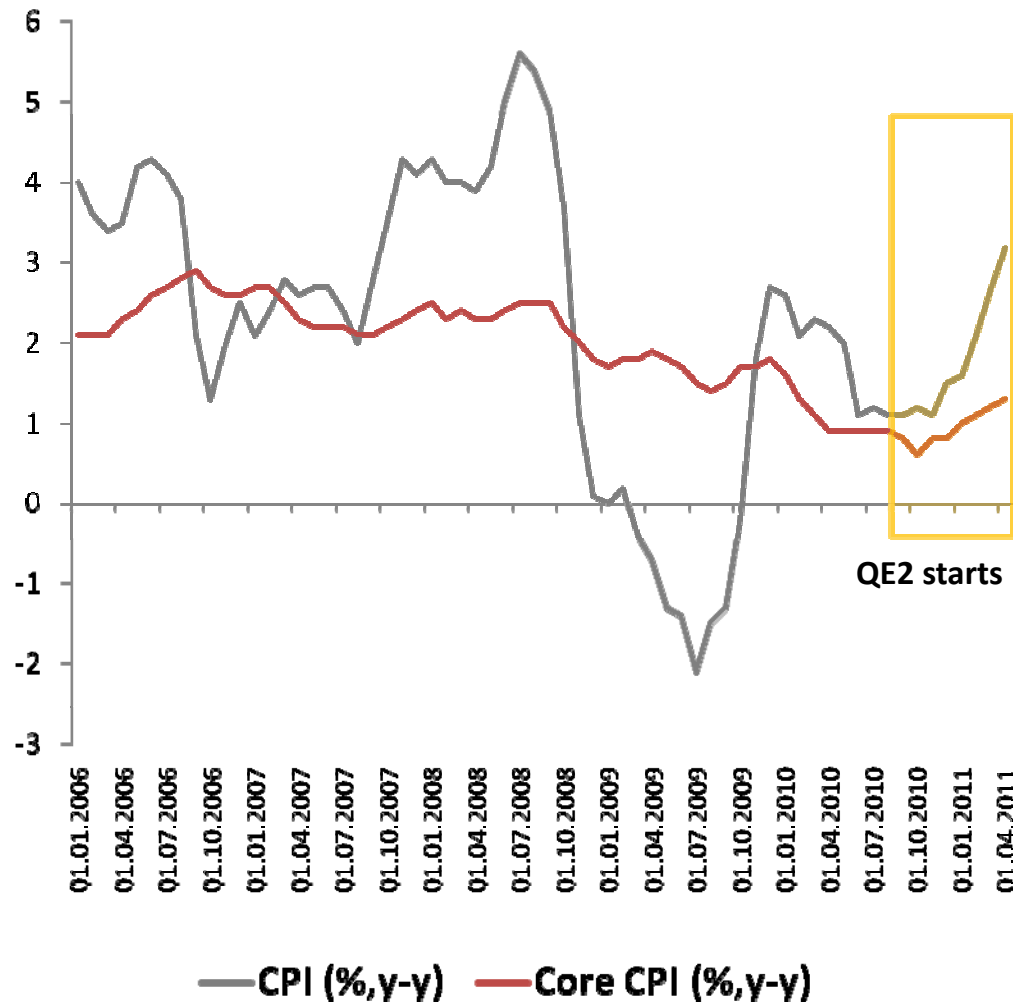
## Risks in the housing sector continue...






Source: Bloomberg

- Recent housing sector data increased the concerns about double dip in the sector.
- Slowing down in sales and decreasing house prices to the lowest levels reveal that the risks for the sector continue.
- Although the FED aimed to support the housing sector with QE, ongoing risks in the sector would continue to exist after the end of QE2.

## Inflation continued to trend upward after the QE2...



Source: Bloomberg

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 After QE2, headline inflation in US has increased sharply to its highest level in 2.5 years. Core inflation has also been increasing since QE2. In other words, the more QE will add more inflation.
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 Although core inflation is still low in US, the inflationary pressure is higher than at the beginning of the QE2.
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 This situation indicates that FED will not continue QE measures in the next term.

## To sum up,

- ✓ The QE2 will end in June 2011 and there are several risks towards the new QE3 programme.
- ✓ Especially, previously implemented QE policies which were supported by relatively loose fiscal policies were not sufficient enough to stimulate the economy. The recovery in US economy is losing its momentum that can be seen in leading indicators like PMI and ISM. Moreover, recent housing sector data has increased the concerns about double dip in the sector.
- ✓ Although the leading indicators signal that the economic growth in US has been slowing down, they are still above the 50 level which is the critical level for economic stability.
- ✓ In this case, QE3 in the US could only come up if the economy went into a recession. But from now on, there do not exist any risks about another recession in US in the near term.
- ✓ This is parallel to the speech of Bernanke who said that the QE2 will not continue after the end of June 2011.

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