MARKET INSIGHTS

Market Bulletin

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Still pushing on a string? The implications of QE2

In a much anticipated action, at 2:15PM on Wednesday, November 3, the Federal Reserve (Fed) announced further measures designed to stimulate the economy. These measures, commonly referred to as QE2[1], consist of a plan to print an additional $600 billion between now and June 30, 2011, to buy a wide range of both short-term and long-term Treasury securities. In addition, the Fed expects to continue reinvesting principal payments from their vast mortgage security holdings into the Treasury market, a policy that is expected to add between $250 billion and $300 billion to the program's size. In their statement, the Fed noted that they could adjust both the pace of the purchases and the overall size of the program "in light of incoming information" in order to "best foster maximum employment and price stability."

QE2 has been a central topic for financial markets during the last few months, but what does it mean for investors? To begin to address this question, it's important to understand how monetary policy has evolved over the last few years, what quantitative easing is and what it's supposed to accomplish, while acknowledging some of the long-term risks for the economy and investors as this brave new world of unconventional monetary policy continues to unfold.

The road to QE2

In the summer of 2007, it became clear that the great housing boom of the 2000s was coming to an end, with potentially serious consequences for the broad economy. In response, in September of that year, the Federal Reserve took a first step toward monetary easing, reducing the federal funds rate from a relatively high 5.25% to 4.75%. Over the next 15 months, as the economy and financial markets gradually worsened, the federal funds rate was cut further, culminating in a final reduction on December 16, 2008, to a range of 0% to 0.25% as shown on the following page. However, this final cut left Ben Bernanke, the Chairman of the Federal Reserve, in an awkward position. The financial crisis continued to rage, the recession was deepening and the Fed was out of conventional monetary ammunition. With all of this happening, how could they help stabilize financial markets, restart the economy and ward off deflation?

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[1]QE2 refers to a second program of "Quantitative Easing"

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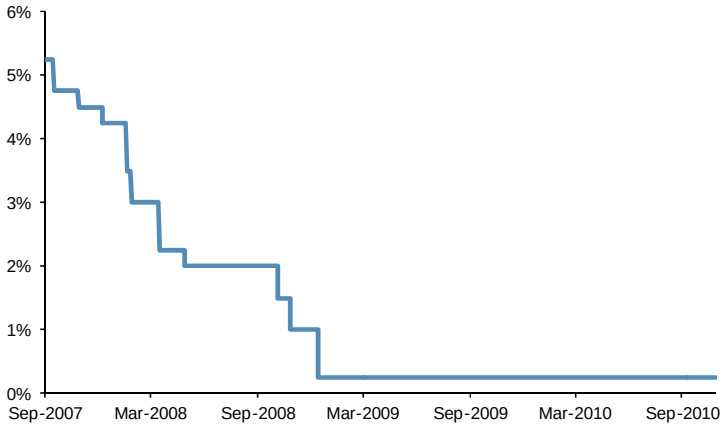
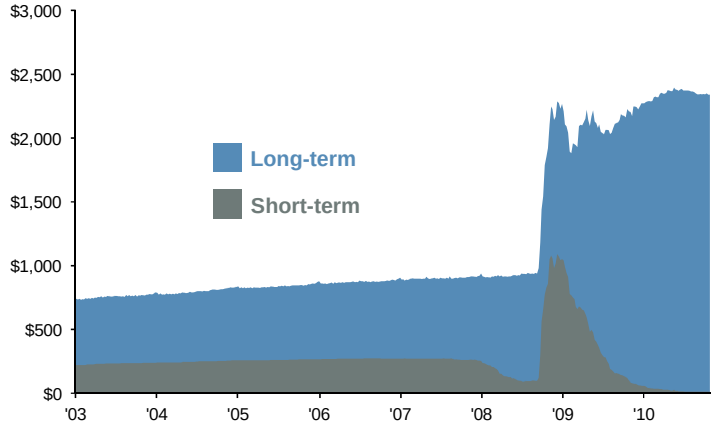
Fed Funds Target Rate
September 2007 - October 2009



Source: Federal Reserve, FactSet, J.P. Morgan Asset Management.

Federal Reserve Balance Sheet
Total reserve bank credit, billions USD



Source: Federal Reserve, FactSet, J.P. Morgan Asset Management.

At that time, the Fed was already engaged in a series of actions that constituted an answer to that question. These actions, which have been broadly described as "Quantitative Easing,[2]" resulted in a ballooning Federal Reserve balance sheet as shown on the chart to the right. In early September 2008, just before the collapse of Lehman Brothers, the Fed's assets (or total reserve bank credit) amounted to $943 billion. Two months later, they had grown to $2.289 trillion, as the Fed printed money to buy many types of securities including short-term commercial paper and longer-term mortgage-backed securities, primarily because private markets for these assets had dried up.

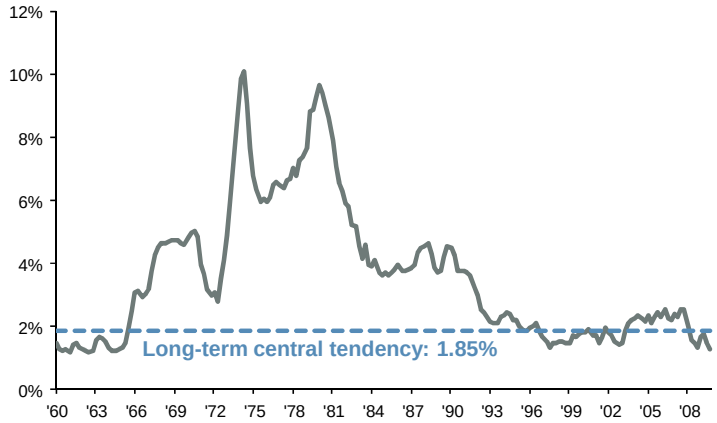
These and other policy moves to unfreeze financial markets were generally successful, and over the following few months, the Federal Reserve allowed its newly acquired holdings of commercial paper to mature and roll off its books. However, the Fed still felt a responsibility to strengthen the economy and ward off deflation. Consequently, in March 2009, they announced a program that included $850 billion in further purchases of mortgage-backed securities and $300 billion in purchases of longer-term Treasury debt. These actions were taken with the hope that low long-term interest rates would promote an economic recovery, particularly in the housing market.

Since then, this program has been implemented with maturing mortgage debt being replaced by additional Treasury securities. Moreover, the economy has clearly improved, with real GDP rising by 3.5% over the last 15 months. However, as Ben Bernanke noted in an October 15 speech in Boston, the economy is far from healthy based on the Federal Reserve's mandate to maintain stable prices and low unemployment. In particular, Bernanke noted that Federal Reserve governors interpreted that mandate as a goal of roughly 2% inflation and a 5% to 5.25% unemployment rate.

[2]Actually, the Fed's unconventional actions throughout the financial crisis could better be described as credit easing rather than quantitative easing, as is noted later in this paper.

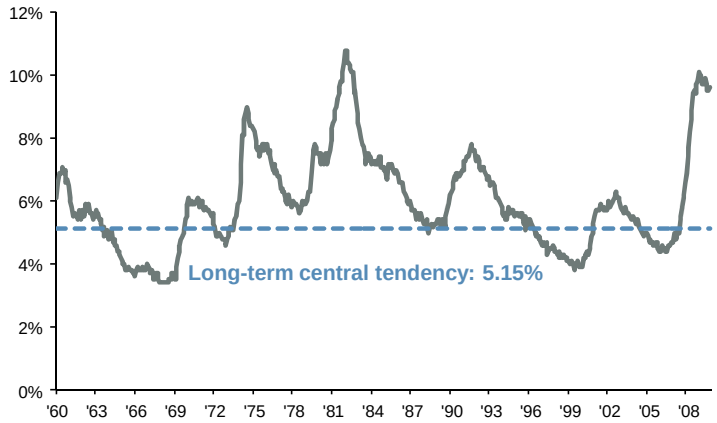
The charts below clearly show how far we are from those targets. In September, inflation, as measured by the personal consumption expenditures deflator, was just 1.4% year-over-year while the unemployment rate was a lofty 9.6%.

Personal Consumption Expenditures Deflator
Year-over-year % change, quarterly data



Source: BEA, Federal Reserve, FactSet, J.P. Morgan Asset Management.

Civilian Unemployment Rate
Year-over-year % change, seasonally adjusted



Source: BLS, Federal Reserve, FactSet, J.P. Morgan Asset Management.

Despite considerable internal and external reservations, because of these weaknesses, the Federal Reserve announced its new program of Treasury purchases on Wednesday.

Quantitative easing – In theory and practice

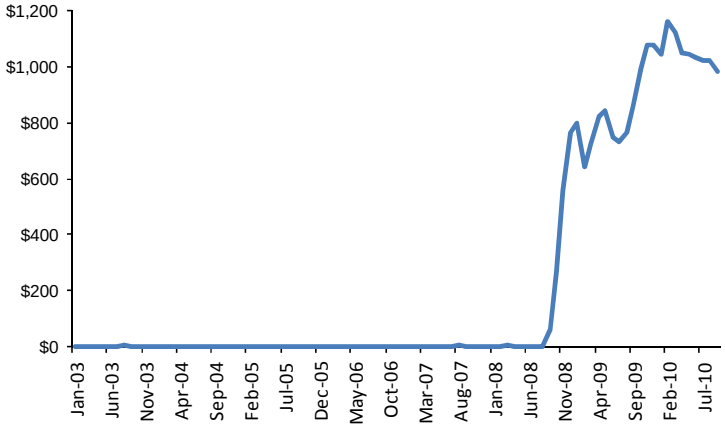
Before going any further, it's important to define exactly what is meant by "quantitative easing." The idea is this: suppose in a low inflation or deflationary environment, a central bank has pushed short-term interest rates down to zero and the economy continues to languish. For obvious reasons, the central bank can't push interest rates below zero – no one will lend for a guaranteed negative nominal return, since cash stored under the mattress would provide a better return. But if the central bank can't cut short-term interest rates anymore, is there anything else they can do? The answer, *in theory*, is yes.

The central bank can buy short-term bonds on the market, printing new dollar bills to pay for these bonds. This flood of cash will end up in the banking system, thereby boosting bank reserves; essentially, the Fed is buying these bonds to increase the quantity of reserves in the system, rather than lowering the interest rates on these specific bonds. This will leave banks with far more excess reserves than are necessary to back existing deposits, so rather than having these reserves sit idle and earn nothing, banks will put them to work, theoretically stimulating economic growth.

The most obvious way for banks to promote economic growth is to make new loans to businesses and home buyers. However, it should be noted that almost anything the banks do with these reserves, other that leave them sitting idle, should boost economic growth. They could buy long-term bonds, pushing down long-term interest rates in general and mortgage rates in particular, thereby boosting the housing industry. Or they could buy foreign securities, which would tend to push down the value of the dollar and result in stronger exports.

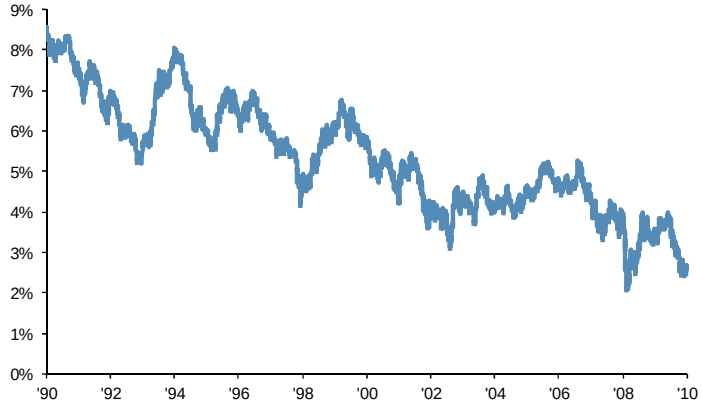
The first problem with this purest form of quantitative easing is that it does very little if banks hoard the excess reserves. This is clearly happening today. In fact, as is shown in the chart on the following page, at the start of September, banks had almost $1 trillion in excess reserves sitting on their books, doing nothing to boost the economy.

Excess Reserves of Depository Institutions
Billions of dollars, monthly, not seasonally adjusted



Sources: Federal Reserve Bank of St. Louis, J.P. Morgan Asset Management.

10-year U.S. Treasury Yield
Percent

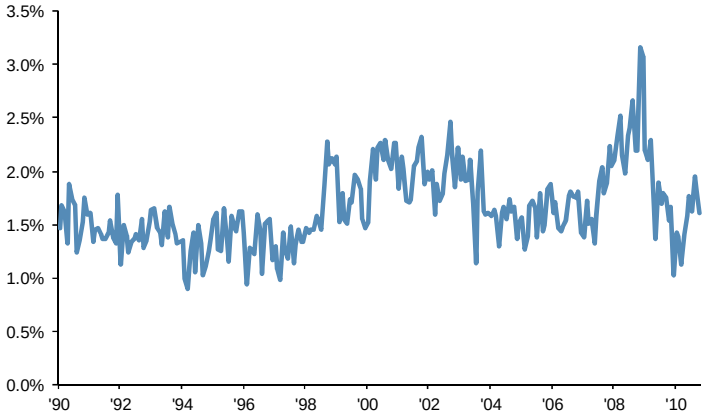


Sources: U.S. Treasury, FactSet, J.P. Morgan Asset Management.

In all fairness to the Federal Reserve, they have recognized this problem and responded to it by engaging in what could better be described as "credit easing." With credit easing, the Fed doesn't just buy short-term securities where they can't directly cut interest rates (because they are already essentially zero in a depressed low-inflation economy), but also buys other securities, such as long-term Treasuries and mortgage securities, in an effort to achieve a meaningful reduction in longer-term interest rates.

In this goal, the Fed *has* had some impact. As shown in the top chart in the adjacent column, the Fed has succeeded in keeping long-term Treasury rates at extremely low levels, despite some improvement in the economy and massive issuance of debt by the federal government. Equally important, as is shown in the second chart, their purchases of mortgage securities have succeeded in bringing mortgage rates down to a normal spread relative to Treasuries, despite severe disruption in the mortgage markets. This has provided potential home buyers with the lowest long-term mortgage rates in modern history.

30-year Mortgage Spread
Average 30-year mortgage rate less the 10-year Treasury yield



Sources: Freddie Mac, U.S. Treasury, FactSet, J.P. Morgan Asset Management.

However, while you can lead a horse to water, you can't make him drink. Despite enticingly low mortgage rates, home sales remain very depressed. More generally, despite a flood of liquidity, both businesses and consumers remain very reluctant to spend money. So, what's the problem?

One problem not often mentioned is that a policy of super-low interest rates can starve many conservative investors of cash flow. Older investors, in particular, who receive income from CDs and savings accounts, have had to cut back as they

watch the impact of low rates on their stream of income. In addition, it is very hard to pull the trigger on buying a house or hiring an employee if you are uncertain about the economic outlook, and each statement by the Federal Reserve announcing another dose of medicine can only help foster the idea that the economy remains dangerously sick. Finally, an open-ended commitment to maintain exceptionally low interest rates gives people a reason to "wait and see." The U.S. housing market, for example, would likely look a lot more lively today if home buyers and sellers were assured that mortgage rates would rise substantially next year rather than stay flat. Many years ago, John Maynard Keynes is alleged to have coined the phrase, "pushing on a string," when describing the impact of monetary policy actions in jump-starting an economy from recession. Over the past year, in particular, the Federal Reserve has had reason to ponder his words.

Potential impacts and implications of QE2

With all this as a backdrop, what does the Fed's announcement this week mean for the economy?

- First, QE2 it is likely to hold both long-term and short-term interest rates down, at least initially. However, if economic growth accelerates from its recent 2% real GDP growth rate to 3% or even 4% in 2011, long-term interest rates should drift up. Importantly, if we take the Fed at its word, it should be willing to let long-term interest rates rise in an improving economy, since it only committed itself to adjust the program to foster maximum employment and price stability, not to protect bond-holders or the federal government.

- Second, QE2 is dollar negative. Some central banks, particularly those in developing countries, have already begun to increase interest rates, fearing inflation. The Fed's stance is now among the most dovish in the world, and this, in combination with slow U.S. economic growth and a recently rising trade deficit, may push the dollar down.

- Third, QE2 raises the risk of future inflation and significantly higher long-term interest rates. Even with an extension of all the Bush tax cuts, we expect the total Federal budget deficit to amount to between $700 and $800 billion over the next 8 months. This means, in rough terms, that the Fed will be buying more than the total net issuance of government bonds over this period. If, at the end of eight months, the Fed closes down the program, leaving the purchases of Treasury bonds to private investors, it is hard to see how Treasury rates won't soar. If, on the other hand, QE2 is replaced by QE3, the Fed will be further monetizing the government debt, increasing the long-term risk of inflation. Either way, this is a story that will likely end badly for the bond market.

For the Federal Reserve, QE2 is a gamble. It is not clear, from recent experience, that QE2 will promote stronger economic growth. Moreover, the very flexibility that the Fed has afforded itself in implementing the program increases market uncertainty about the ultimate direction of monetary policy and the economy itself.

For investors, however, perhaps the most important point is that the economy does appear to be gradually strengthening and corporate profits continue to rise strongly, making stocks look attractive. Moreover, if QE2 *does* push the dollar down further, it could be a positive for both international stocks and commodities, which tend to rise as the dollar falls. Meanwhile, although the Fed's actions this week have helped bond investors, it is clear that they have taken an extreme stance. If the economy continues to improve, the Federal Reserve will likely resume a more balanced posture. Because of this, it still makes sense for investors to cautiously overweight stocks relative to fixed income, especially within the context of a balanced portfolio.

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