How will end of QE2 affect interest rates?

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Joe Davis

The planned conclusion in June of the Federal Reserve's $600 billion bond-buying program—a second round of "quantitative easing" commonly referred to as QE2—may not result in the dramatically higher interest rates that some market watchers feared could potentially put the brakes on economic growth.

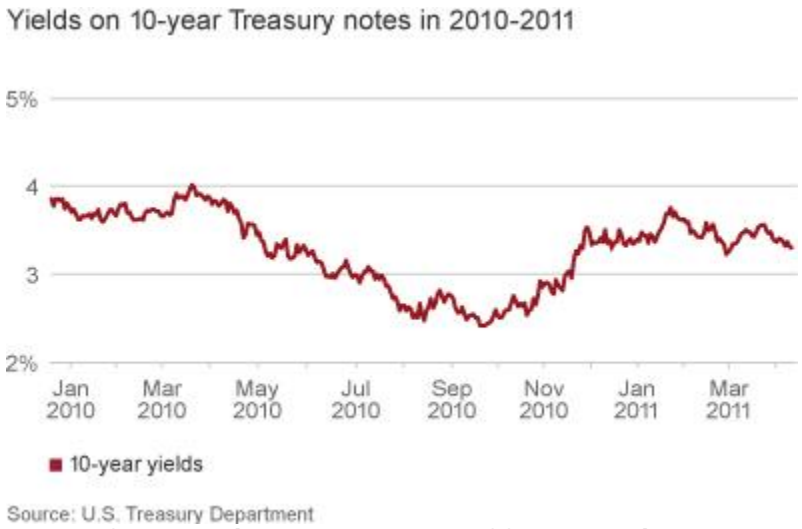
"Our view is that the economic fundamentals for growth and inflation over the next several months—and their influence on expectations for future short-term rates—should be a more important driver of long-term rates than should the official end of QE2," said Joe Davis, Vanguard's chief economist and head of its Investment Strategy Group.

Interest rates may "drift higher" in the months ahead based primarily on economic conditions, but that will most likely happen gradually, added David Glocke, who oversees Vanguard's taxable money market funds.

The reasons "why"

There are a number of reasons the end of QE2 may not impact long-term rates. Most notably, the bond markets are forward-looking and thus may have *already* priced in the expected effects of the program's end, Mr. Davis said, since the details and timing of QE2 are public knowledge and have already been announced. That may help explain why rates have already crept up. For example, the yield on the 10-year Treasury rested at 2.66% on August 27, 2010, when Fed Chairman Ben Bernanke first opened the door to more bond buying. It stood at 3.32% on April 29, 2011.

A similar "announcement effect"—in the opposite direction—was observed well before QE2 began. The Fed's bond-buying program was "an extra shot of stimulus that was designed to change inflation expectations in the marketplace by driving interest rates that much lower," Mr. Glocke said.



Past performance is not a guarantee of future results.

The program's relatively small size may also help keep its end from having too much of an effect on rates, Mr. Davis added. Fed purchases account for less than 1% of the average daily volume in the secondary market for Treasury securities, he said.

Finally, given that inflation expectations are one of the most important drivers of long-term rates, the ending of QE2—a program that was designed to be inflationary (or, more accurately, reduce the likelihood of deflationary psychology)—could actually have a stabilizing effect on rates by anchoring inflation expectations around the federal funds target rate, Mr. Davis said.

Inflation expectations

"The most likely outcome, in our view, is a CPI inflation rate centered near 3% over the next five to ten years," Mr. Davis said, noting that this view is similar to that of the bond market, and that considerable dispersion exists in such projections. "It is fair to say that the potential risk to this forecast has moved somewhat toward the direction of higher- rather than lower-than-expected inflation. Until recently, the risk has been more on the side of deflation, rather than higher inflation. Arguably one goal of QE2 was to reduce this deflation bias in the broader economy." Despite these risks, Mr. Davis stressed that "it's still a low probability that we would see a return to the double-digit inflation rates that we saw during the 1970s and early 1980s."

Implications for bond investors

Mr. Davis concluded that the constant uncertainty surrounding the many drivers of interest rates—including the future direction of economic growth, the deficit, inflation, the stock market, and Federal Reserve policy—would seem to support greater fixed income diversification in the years ahead, rather than less.

Notes:

All investing is subject to risk. An investment in a money market fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although a money market fund seeks to preserve the value of your investment at $1 per share, it is possible to lose money by investing in such a fund.