The Capital Market Effects of QE
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Within the next month we will see the Fed's second round of quantitative easing come to end. The question is what will happen then? How will markets react? The unwind of quantitative easing is historic as its rarely a tool wielded by central bankers in the first place. We've seen QE only once before…in Japan, but there are plenty of reasons why Japan shouldn't be our model on QE. We are in 'uncharted' territory sort of speak.

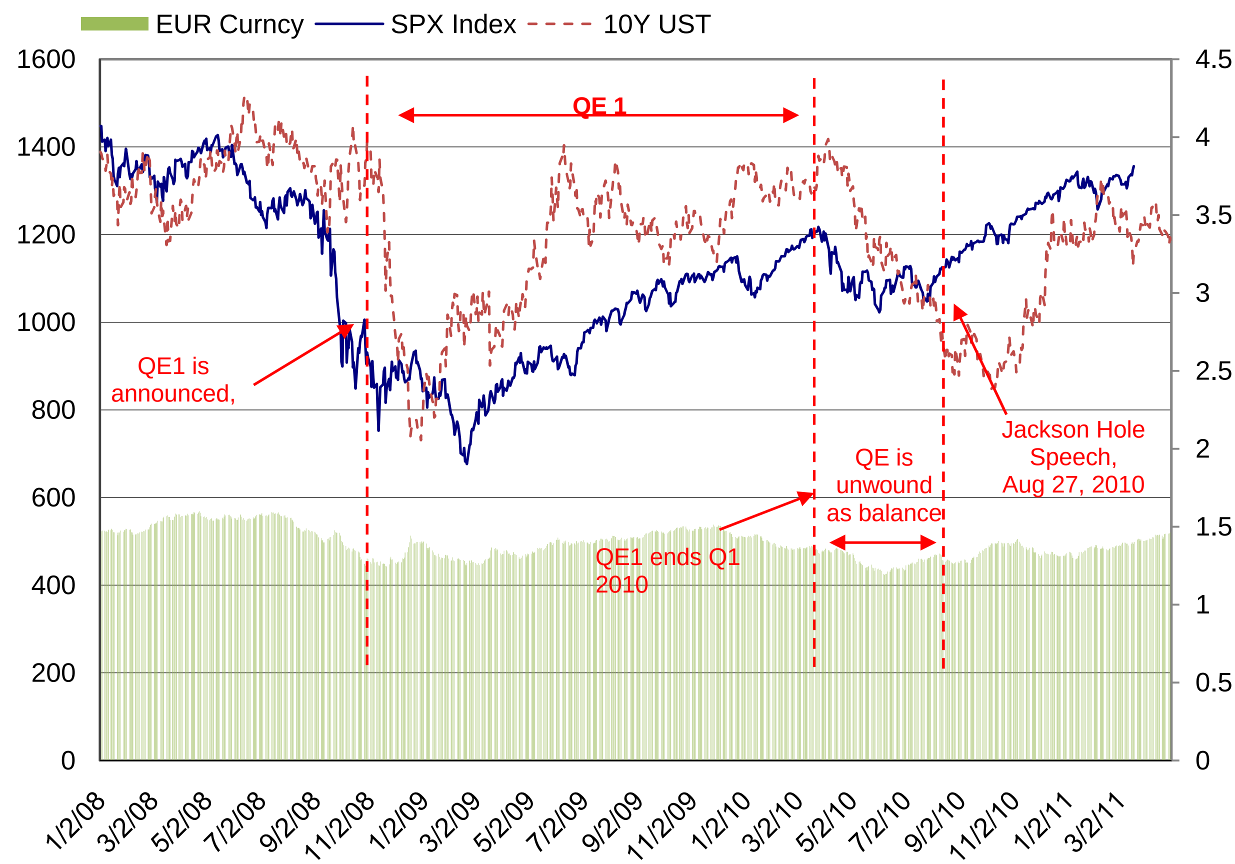
Not only is QE to be unwound but rates need and must be raised. The tremendous rally in oil, agriculture and all things commodity-based is a function of demand, supply, and Bernanke & Co. It's rumored that the FOMC will remove the words: "...for an extended period of time" from their communications. That means the time to make hay is quickly coming to a close.

But where will markets settle when the Fed starts to tighten its policy?

The important thing to remember is the Fed moves at a glacial pace and they do so not out of political deadlocks or inertia, they do so very intentionally. They want to give markets time to adjust so the tightening will likely come over several quarters as their balance sheet rolls off naturally.

Nevertheless, the potential for a large market move is more than probable, it's likely. Fortunately, we do have a brief data set to draw some conclusions from. If you think back to the period right after QE-1 ended and before the Fed had announced its second round of, we had a window into a world without monetary easing.

It was this period between March 31, 2010 and the Jackson Hole speech on August 27, 2010 where Bernanke hinted at additional 'support'.



Source: Bloomberg

Above you will see several of the most important Fed announcements against a time series of the S&P 500, USD/EUR, and the 10Y Treasury rate.

You will notice something of an anomaly in the 10Y rate. Quantitative easing after all involves the printing of money, so you would expect that to depress interest rates, but it didn't. In fact rates rose during the 'money making' period and fell shortly after it ended.

For this reason many questioned the effectiveness of QE. The best explanation I've heard on this anomaly postured that QE removed the specter of deflation and further economic downturn. If QE removed the chance of deflation, they theorized that rates below 2% was simply too low. Continuing on this thesis, the printing of money is inherently inflationary so why wouldn't investors demand higher interest rates to compensate for the loss of real purchasing power?

For equity, the relationship between QE and stock prices is much more intuitive and well behaved. The markets rallied on news of QE1 & QE2. Hay was made as the cheap dollar became the currency of choice for carry trading putting additional pressure on an already weak dollar.

This had another indirect benefit for equity markets as globalization has transformed the income statements of many corporations. Today, nearly 50% of revenue for the S&P500 come from overseas sales which means that earnings become supercharged as they were translated back into a weaker USD. This naturally argued for higher equity prices even as you held the earnings multiplier constant.

But again the important area to focus on is the period between the end of QE-1 and the beginning of QE-2. During this period the Fed allowed their balance sheet to roll off effectively tightening the money supply. The S&P 500 lost close to 9% of its value and the dollar gained 5.8% against the EUR over this five month period.

In my mind, I have no doubt that a healthy amount of Fed dollars is sitting in equity markets, being used to own the likes of Johnson & Johnson, Microsoft, and double levered S&P ETF's. But what happens when the Fed starts to call back those printed dollars? I'd say it manifests itself through weaker equity prices whether it's driven by the unwind of carry trades or the reversal of favorable translation effects for non-USD earnings.

The only certainty we know is that quantitative easing moved markets, so a reasonable assumption would be that the end of QE will likely move them again. We have already seen treasury rates rallying and a softening in equity and EUR prices ahead of the end of QE. In light of the current situation in Europe, troubling housing data, and uncertainty surrounding QE 2.0, this would definitely be one of my 'risk-off' trades.

Appendix 1:

QE Effects on Capital Markets

		S&P 500	Equity Chg From QE1 Announcement	-	10Y Treasury	USD/EUR
November 25, 2008	QE1 Begins: $100 Billion GSE direct obligations, $500 billion in MBS	857	0%		3.11	1.31
December 16, 2008	Fed evaluating benefits of purchasing longer-term Treasury Securities	913	7%		2.26	1.40
January 28, 2009	Fed Stands Ready to expand program	874	2%		2.67	1.32
March 18, 2009	Fed expands MBS program to $1.25 trillion, buy up to $300 billion of longer-term Treasury securities	794	-7%		2.54	1.35
March 31, 2010	QE1 comes to a close Q1'10. Fed balance sheet begins to roll off.	1,169	36%		3.83	1.35
August 27, 2010	Jackson Hole Speech and QE2	1,065	24%		2.65	1.28
4/27/2011	**Yesterday.**	**1,356**	**58%**		**3.36**	**1.48**