Outlook for November, 2010: "Setting Sail on the QE2…"

Financial markets – particularly equities and commodities – appear to be rejoicing at the advent of Quantitative Easing (QE2) by the Federal Reserve. Indeed, as the deluge of global excess liquidity continues to swamp markets, we worry about the longer term implications of QE2 and the uncharted nature of the waters that the Fed appears to be leading us into.

The US economy grew at a rate of 2.0% (seasonally adjusted annual rate) during the third quarter, compared to 1.7% for the second quarter: Personal Consumption Expenditures rose 2.6%, gross private domestic investment gained 12.8% while government expenditures posted a gain of 3.4% for the quarter. Final sales of domestic product rose a paltry 0.6% for the quarter suggesting that much of the vaunted growth was as a result of inventory accumulation.

The real question (pun intended) is whether the inventory accumulation (which accounted for 1.4% of the 2.0% growth in real GDP during the quarter) was voluntary (a good thing) or involuntary (not so good). Involuntary gains in inventory often lead to slowing in production and slower growth going forward, while the former might be a sign of increasing demand. With the Christmas retailing season fast approaching, we suspect – as is usual in these cases – that the inventory accumulation was a combination of both voluntary and involuntary forces.

The US economy also posted a greater than expected gain of 151,000 (seasonally adjusted) jobs during the month of October. Education and health services (+53k) and professional and business services (+46k) were the sectors that gained the most jobs, while government (-8k) and leisure and hospitality (-5k) were laggards for the month. The politically sensitive unemployment rate remained unchanged at 9.6% while the U-6 measure of under-employment posted a small decline of one-tenths to 17.0%.

Marked gains in average weekly hours (+0.1 to 34.3 hours) and average hourly earnings (+0.5c to $22.73) portend well for economic growth going forward. However, a two-tenths decline in the participation rate to a cyclical low of 64.5% suggests that the expiration of unemployment benefits after 99 weeks for the longer term unemployed is likely to have a non-salutary impact on the economy. Clear as mud, as they say!

Other economic data including the PMI index (56.9 in October versus 54.4 in September), the NMI Index (54.3 in October versus 53.2 in September) – both from the Institute of Supply Management and a small, but important improvement in consumer confidence (50.2 in September versus 48.6 in August) imply that the economy is slowly but surely regaining its sea legs after a pause this summer. While we feel that a small acceleration in the economy is entirely possible in the near term – we do not anticipate any change to the three steps forward two steps back pattern that has been in vogue for a few quarters.

The Federal Open Market Committee of the Federal Reserve announced that it was embarking on a new voyage of quantitative easing (QE2) at the conclusion of its two-day meeting in early November. While the announcement was one of the world's worst kept secrets – with many speeches and interviews by Fed Governors and regional Fed Presidents already intimating the move, the size of the announcement was still quite impressive: The Fed will buy debt securities to the tune of $600 billion – about $75 billion per month between now and the end of 2Q2011.

To put the $600 billion in perspective – it is equal to the amount of Treasuries, agency debt, high grade corporates and private label mortgages issued altogether every month for the next seven months. In other words, the fixed income markets now have a large and single buyer for many of the instruments that are issued every month in the normal course of business. The Fed did also indicate in its statement that the additional volume of $35 billion that it needs to buy every month in order to keep the size of its balance sheet constant – in terms of issues that are maturing and need to be replenished - will also continue – leading to a purchase program of the order of about $110 billion per month.

Regardless of whether one agrees with the Fed's views or not, it is very clear that the Fed is attempting to shock the economy into adding jobs in a hurry. The lower level of interest rates as a result of the Fed's actions will likely cause the yield curve to flatten somewhat – but the more pernicious effect will be on savers who will continue to see dwindling returns on their fixed income investments.

The Fed's move was met with stoic disbelief in many policy making circles abroad – particularly in those countries like China – whose currencies are likely to appreciate as a result of the Fed's actions. Indeed, the Reserve Bank of Australia and the Reserve Bank of India have raised rates as a result of increasing inflows into their respective countries – a direct result of too many Dollars floating around in the global financial system.

In subsequent speeches and in a much publicized op-ed piece in the Washington Post, Chairman Bernanke attempted to explain the rationale for the Fed's move. While the Fed would prefer to see improved employment conditions, it is also abundantly clear that the Fed sees very little in the way of future inflation as a result of their own actions. They appear to be very secure in the knowledge that at the first sign of trouble, they could very easily turn the spigots off.

Our main worry from a policy standpoint is that the Fed might indeed be creating the conditions for the next bubble - perhaps in equity or commodity prices. In addition, merely turning the spigots off will not do, particularly after inflation expectations become unmoored (yes, another nautical term!), despite the Fed's belief that inflation expectations are currently very quiescent and they have nothing to fear on this score. The US Dollar has resumed its decline in earnest – primarily against the Yen and the Euro, but also against its cousins the Canadian Dollar and the Australian Dollar.

Brazil has resorted to currency controls as a way to reduce the inflows of money into its markets and such moves are apparently being contemplated by other developing nations as well. Taken to an extreme, these sorts of policy moves could easily deal a death knell to the global system of trade and currency flows as we currently know and global growth could easily suffer as many of the linkages we now take for granted are broken.

The mid-term elections handed an ignominious defeat to Democrats in Congress. While they managed to hang onto their majority in the Senate, the change in the House of Representatives makes for interesting political theatre in the future. With Republicans gaining control of seven additional gubernatorial seats, the re-election prospects of President Obama were dealt a severe blow as well. It will be interesting to see whether he manages to tack to the center (yes, yet another nautical term) in response to the electoral losses.

Equity markets have rallied in the hope that the additional liquidity generated by QE2 will eventually find its way into the stock market and the wealth effect of such increases will lead to better economic prospects down the road. Meanwhile, earnings reports for the third quarter have in general been better than expected as well thus leading to many analysts raising their targets for the year ahead.

In summary, we view the outlook for financial markets as cautiously optimistic: While gains in equities and commodities appear to come at a frenetic pace, we do feel that the fundamentals are generally supportive of higher levels over the medium term. We do worry about the bi-polar nature of sentiment in the near term. However, our abiding faith in a fully diversified portfolio - that has a balanced approach to both risk and return - as the main way to attain favorable investment outcomes over the long haul remains resolute.

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