



## An unconventional plan – what the Fed’s actions mean for the markets

In this Point of View, AXA’s Chief Investment Officer Mark Dutton looks at the US Federal Reserve’s unconventional plan to stimulate the economy and considers what this policy measure means for the markets.

### An unconventional plan

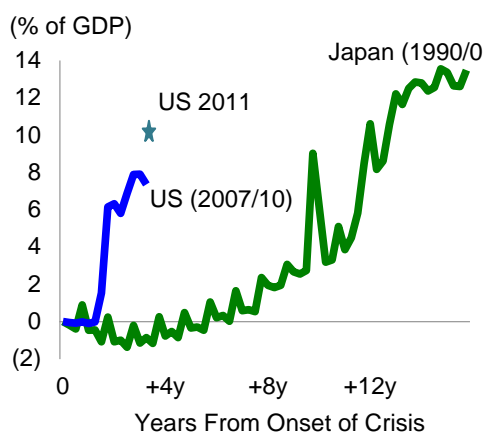
After weeks of speculation, the US Federal Reserve officially announced its ‘new’ asset purchasing program, which is being referred to as quantitative easing 2 (QE2).

Put more simply, this policy measure is often referred to as ‘printing money’, as the Federal Reserve deliberately increases the money supply to stimulate the economy.

This time, the Federal Reserve’s intention is to increase inflation and combat the persistently high unemployment problem. (For further details see October Point of View).

This second round of quantitative easing will involve the purchase of an additional \$600 billion of longer-term treasuries by the middle of 2011, thereby increasing the money supply by a massive 10 per cent of GDP, as shown in figure 1 below.

**Figure 1: Change in the Monetary Base as a percentage of GDP**



Source: AllianceBernstein, Haver Analytics. Data as of 30 September 2010.

This unconventional policy measure has been criticised for targeting inflation, since it’s not clear that the US even has a deflation problem.

Most inflation measures have come off their low point and are now on the low positive side, especially when rent is taken out.

In contrast to Australia, the Federal Reserve does not specify an inflation target range, which makes it difficult to assess its objectives.

It’s also not obvious what type of inflation will follow, or how this policy measure will be wound back if it has adverse consequences.

Given the sensitivity of the announcement, the Federal Reserve has left its commitment open-ended to give it room to move further.

QE2 is really the last major trigger US policy makers can pull to stimulate the economy. The official cash rate is already at zero and an unprecedented amount of fiscal policy has already been deployed.

Current high levels of public debt mean the Government can’t readily stimulate the economy further via more traditional methods.

### Is the US like Japan?

The situation in the US is not readily comparable to that of Japan in the early 2000s, especially given the timing and scale of their respective policy responses.

Japan’s credit growth cycle was twice as large as the US’s, and the Bank of Japan actually raised interest rates during the early stages of its bubble bursting.

In contrast, the Federal Reserve cut rates aggressively and implemented its first round of quantitative easing at the onset of the GFC to get liquidity moving through the system and prevent the economy from sliding into depression.



The Bank of Japan only started easing monetary policy more than a decade after its crisis started, and at a substantially slower pace than the Fed's actions over the past two to three years, as shown in figure 1.

## What does this mean for the markets?

On a positive note, the new round of purchases should help to keep interest rates low, allowing households and businesses to refinance existing debt obligations.

Of course, there is a risk that interest rates will be held low for too long, leading to distortions in risk taking and the allocation of capital. In other words, 'new' asset bubbles may form.

This policy measure will also remove a massive number of US Treasuries and other securities from the market, which will encourage investors to buy other financial assets, such as equities and bonds, potentially driving up their value.

It's also likely that the US dollar will weaken further, which in turn should help fuel export growth. In practice, though, it's not this simple given the wide-ranging impact a further depreciation in the US dollar will have on global rebalancing.

Overall, QE2 is a risky potential solution given the sensitivity of the US economic recovery.

Providing the Federal Reserve can manage the risk of overshooting, it may well provide a path to recovery.

## 10 November 2010

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