With QE2 Over, What's Next?

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- The second phase of quantitative easing, a monetary stimulus policy also known as QE2, recently ended.
- In this article we review what QE2 was meant to accomplish and what can be expected now.

On June 30, the Federal Reserve (the Fed) completed its historic Treasury bond purchase program, which was dubbed QE2, an abbreviation for the second round of quantitative easing that Chairman Bernanke announced in August 2010 and began implementing in November. Though the program is technically over, its ramifications have been far reaching and have influenced the performance of investment markets. In this article we review the concept of quantitative easing, what is likely to happen next, and investment implications.

What Is Quantitative Easing?

As defined by Wikipedia, quantitative easing is "an unconventional monetary policy tool used by some central banks to stimulate the national economy when conventional monetary policy has become ineffective." In November 2008, during the midst of the financial crisis, the Fed embarked on the first round of quantitative easing (QE1). At the time the Fed had already used its primary (and conventional) monetary tool, establishing short-term, interbank lending rates, by setting the Federal Funds rate at effectively 0%. However, due to the damage that the financial crisis had inflicted on the economy and the financial services sector, the Fed implemented QE1, as well as other programs, as part of a monetary stimulus program to enhance the liquidity of financial institutions and the functioning of financial markets.

Before the beginning of the Great Recession, the Fed's balance sheet held $700 - $800 billion of Treasuries, considered to be the safest government debt in the world. As part of QE1, the Fed expanded its balance sheet by purchasing $600 billion of lower quality debt, primarily mortgage-backed securities. By March 2009, the Fed's balance sheet had grown to $1.75 trillion.

Ultimately, the Fed decided in August 2010 to embark on QE2 because of the U.S. economy's sluggish growth and the Fed's concern that the U.S. could suffer from deflation, or a decline in the prices of goods and services, which would lead to an economic contraction. During the quantitative easing that ended last month, the Fed purchased $600 billion of longer term Treasuries. QE2 resulted in not only asset price inflation as seen in the stock market, but also higher commodity prices that can crimp economic growth. Since QE2 was announced, the U.S. stock market climbed 9%, while commodities gained 16% and gold increased 10%. Inflation is now evident, whereas nearly one year ago deflation had been the concern.

What Happens Next?

Since the beginning of the financial crisis the combination of fiscal and monetary stimulus, the responsibility of Congress and The Fed, respectively, has cumulatively reached levels never seen previously. Without new stimulus programs, some have grown concerned that the economy would suffer and perhaps "double dip" into a new recessionary period. Though QE2 supported the prices of riskier assets like stocks and commodities, as well as improved consumer confidence and employment levels, economic growth should continue, though at a subdued level.

What Is the Investment Impact?

With the Fed's elevated purchases of Treasuries past, bond markets may experience less liquidity and heightened volatility. Ultimately, since the Fed had been a major purchaser of Treasuries, prices of these securities may begin to slowly decline, leading to an increase in interest rates. Once the Fed is convinced the economy is growing at a reasonably stable level and unemployment is trending down, it is likely to increase the Federal Funds rate, but this is unlikely to occur until 2012. Continued economic growth will also pressure interest rates higher. On the other hand, any shock to the economy would lead to a flight-to-quality and lower interest rates for Treasuries, if only on a transitory basis.