MFC Global Investment Management®

Spiking the Punch Bowl

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North American equity markets roared ahead last week on good news from many fronts. The week started out on the positive side with a strong Purchasing Manager's Index out of China that indicated its economy continues to advance rather nicely, putting aside fears of a hard landing. The China PMI released by the China Federation of Logistics and Purchasing rose to 54.7 from 53.8 (a measure greater than 50 indicates expansion). Of more relevance to the sustainability of the U.S. economic recovery was the US ISM Index which also showed continued expansion rising to 56.9 from 54.4. As well, at week's end the US Nonfarm Payrolls report showed the economy created 151,000 jobs in October, far surpassing expectations and providing a nice boost to stocks that saw the S&P 500 Index hit a new high for the year.

Perhaps the most anticipated news of the week was the announcement by the Federal Reserve with respect to another round of quantitative easing. To this end Bernanke and company did not disappoint. The Fed will buy US$600 billion in securities between now and June, approximately US$75 million a month. When added with the reinvestment of MBS proceeds to treasury securities announced in August, the total amount of QE2 looks to be approximately US$800 billion. But will it do anything for the economy? I spoke to Don Rich, Vice President, Tactical Asset Allocation and Senior Portfolio Manager for the Manulife Leaders Portfolios to dig into the potential outcomes for QE2.

There will be three broad implications for QE2: 1. it will inject liquidity, 2. it will lower borrowing costs, and 3. it will weaken the USD. Firstly, QE2 will inject liquidity into the system. QE1 was arguably successful because at that time, the global economy (although concentrated in the developed markets) was in the midst of a liquidity crisis. Libor rates back in 2008 spiked leading up to and following the collapse of Lehman Brothers; liquidity was scarce. There is no liquidity crisis today. Adding more liquidity will have little effect on a market that is already flush with cash, both on corporate balance sheets and with banks which have over a trillion dollars at the Federal Reserve. In other words, the Fed is adding water to an already saturated sponge - nothing happens to the sponge, and the spillover may actually cause a bigger mess.

On the second point, with the Fed buying treasuries they will lower rates and as such, QE2 would be considered a success if it encourages consumer borrowing and bank lending. However, mortgage rates have fallen to their lowest level in 25 years (the 30-year fixed rate in the United States at time of writing was 4.30%) and the consumer has reacted with fewer mortgage applications in recent weeks. Further, consumer credit has fallen as rates have fallen; revolving credit has fallen consecutively for 25 months and total credit outstanding has fallen for 21 out of the last 24 months. If low borrowing costs haven't worked so far, what will another half-point do?

Lastly, QE2 is a form of monetary easing, and monetary easing should weaken the currency. This is perhaps the most interesting aspect to QE2 as there hasn't been an explicit call in the U.S. to weaken the dollar. Manufacturers would argue for a weaker USD as it should reduce the cost of exports. At the same time it makes imports more expensive and perhaps boosting demand for American made goods.

Upon a closer look however is the fact that exports account for approximately 15% of U.S. GDP while consumption, which is largely made up of imports, accounts for approximately 65% of U.S. GDP. Thus, QE2 will only prove effective if consumption remains static and exports grow.

There is a fourth implication with respect to QE2 as described by Ben Bernanke in the Washington Post on November 4. "What the Fed did and why: supporting the recovery and sustaining price stability - The FOMC agreed to deliver that support by purchasing additional longer-term securities, as it did in 2008 and 2009...This approach eased financial conditions in the past and, so far, looks to be effective again. Stock prices rose and long-term interest rates fell...And higher stock prices will boost consumer wealth and help increase confidence, which can also spur spending." We have written in the past that a positive wealth effect may help to support the U.S. economy in absence of significant job growth, the latest move by the Fed and by their own words, seem to be heading in that direction.

The bottom line is that in our view QE2 will not provide a direct lifeline to the U.S. economy. It will inject liquidity into a system that probably doesn't need it. The excess liquidity will most likely drive equities and commodity prices up locally and abroad. As such, if QE2 does nothing for the U.S. economy, it should at least provide a boost to equity markets. Here's to QE2!

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WIP1-MC-1110

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