First Trust
Monday Morning OUTLOOK

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QE Didn't Work

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Last week the Federal Reserve hiked the federal funds rate by ¼ of a percentage point for the fourth time since December 2015. The funds rate is still below the rate of inflation, which means the Fed is still a long way from becoming tight.

The Fed also presented a relatively detailed plan to begin unwinding its balance sheet. However, this plan means that fully ending QE will take at least a few years, probably more. In a policy environment where banking rules are (hopefully) moving away from the irrational toughness of the last several years, these reserves have the potential of spurring more economic growth and more inflation even as the Fed raises rates. In other words, it's hard to see the Fed making monetary policy "tight" anytime soon.

While these slow-motion maneuvers grab all the headlines, the real news is that QE didn't work. It was very hard to convince anyone of that between 2008 and 2015, but maybe now more people will listen to the evidence.

Yes, the Fed bought bonds. Lots of them. $3.5 trillion of them. And, yes, the Fed created new money – bank reserves – to pay for them. Most of those reserves, about 90%, ended up being stored as Excess Reserves – money that exists but is not circulating in the economy.

Those reserves did not boost the money supply. Those reserves did not boost stock prices. Those reserves did not boost bond prices. QE did not work. How do we know? Because the Fed stopped Quantitative Easing and the stock market continued to move higher – to record highs. Because the Fed stopped buying bonds and interest rates have not moved higher. Because the Fed has now announced that it will reduce its bond holdings and the stock and bond markets yawned.

More specifically, we know QE didn't work because M2 never accelerated when the Fed bought $3.5 trillion in bonds. Between January 1995 and September 2008, the M2 measure of money – all deposits in all banks – grew 6% at an annual rate. From September 2008 (the month the Fed started QE) to today, the M2 measure of money has grown at a 6% rate.

Milton Friedman said, "watch M2!" And the growth rate of M2 has not changed. What's more important is that economic growth actually slowed. Between January 1995 and September 2008 (which includes the 2001 recession), real GDP expanded at a 2.9% annual rate. During the current recovery, in spite of QE, real GDP has grown just 2.1% at an annual rate.

If QE was effective, then real GDP would have accelerated. Don't be fooled when political economists say the reason real GDP hasn't accelerated is because businesses aren't investing.

C'mon, think about it. First, if there wasn't enough investment, there would be shortages of something. Second, if zero percent interest rates and all the free money in the world can't make people invest more, what can? And, third, excluding the energy sector, US corporations are earning record profits. They must be investing, and that investment must be profitable. But, it's not low interest rates that make them do it, it's the return on high-tech inventions, which get cheaper every day.

The decline in prices of high-tech goods are masking an investment boom. Over the past three years, real (inflation-adjusted) business investment as a percent of overall real GDP is the highest it has ever been. The benefits of those investments have caused profits to boom.

That's why stocks are up. Because profits are up. Not because of QE. QE didn't work.

There are those who say foreign QE took over when the Fed stopped. But if this were the case, then US QE would have driven foreign stock markets higher. It didn't.

So many analysts have been blinded by an obsession with QE that they have missed the forces that are truly driving the underlying economy. More to the point, by ignoring the great things going on with new technology, and crediting the Fed with causing stock prices to rise, many conservative economists are undermining their own beliefs.

By saying QE, not entrepreneurial success, lifted stocks, they are setting the stage for the Fed to do it all over again in the next recession. This would be a mistake. Government interference in the economy causes slow growth and slow recoveries. Giving credit to the Fed encourages more of it.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
6-21 / 9:00 am	Existing Home Sales – May	5.550 Mil	**5.600 Mil**		5.570 Mil
6-22 / 7:30 am	Initial Claims – Jun 17	240K	**241K**		237K
6-23 / 9:00 am	New Home Sales – May	0.590 Mil	**0.587 Mil**		0.569 Mil