First Trust
Monday Morning OUTLOOK
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QE: Not That Big of a Deal

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The most frequent question we get lately is "what happens to long-term interest rates when quantitative easing ends?" Many analysts argue that the Federal Reserve is buying and holding a huge share of Treasury debt and once QE ends other buyers will suddenly have to absorb more. This will cause interest rates to soar, bust the housing market, undermine stocks, and possibly cause a recession.

We disagree with this analysis in major ways. To respond, we crafted some charts which you will be able to find on our blog, here. In addition, a friend and one of our favorite economists, Scott Grannis at Calafia Beach Pundit, tackled the same topic last week. We urge you to read his take as well.

Much of what people believe about QE is mistaken. It has boosted the monetary base, but not M2. Interest rates are low because of the zero fed funds rate policy, not QE. And most importantly, despite trillions in purchases, the share of Treasury debt held by the Fed is not out of line with history.

Don't get us wrong. We expect interest rates to move higher in the years ahead, but not because QE ends and not as quickly as the QE-bears say. Until the Fed raises short-term rates, it's unlikely the 10-year Treasury yield will rise above 4%. QE is a signal of the Fed's commitment to hold short-term rates near zero, not a direct driver of rates. The longer investors expect the Fed to keep rates near zero, the lower longer-term yields will be. QE itself is not as important as many think.

The Fed has not cornered the Treasury market. The Fed now owns 18% of marketable Treasury debt. This is not an unusually large share; the recent peak was 20% in 2002 and the Fed still held 17% in 2008. Borrowing exploded upward in the Panic, the Fed's share of debt fell to 8%, but, with QE, it's back up to 18%. If the Fed still bought $45B/month of Treasuries for the next twelve months – which is very unlikely – we estimate the Fed's share of Treasury debt would rise to just 21%, slightly above the peak in 2002.

Interest rates have moved in the same direction as the Fed's share of Treasury debt. Those who see QE as the driver of interest rates have a huge problem – the facts. From late 2007 through early 2009 the Fed's share of the debt plummeted while interest rates fell. From late 2009 through early 2011, the Fed used QE to push its share back up, but interest rates trended up slightly. From early 2011 through the end of 2012, the Fed's share of the debt gradually fell. In theory, interest rates should have risen; instead, they fell. So far this year, the Fed's share of Treasury debt has risen while interest rates have gone up.

Don't worry; private markets can absorb debt normally. Since 1975, the amount of marketable Treasury debt held outside the Federal Reserve (known as privately-held debt) has increased $9.3 trillion, or $242 billion per year. During this time, annual GDP averaged $8.1 trillion per year. So, on average, the private markets have absorbed Treasury debt equal to 3% of GDP, sometimes more and sometimes less.

If the Fed goes "cold turkey" on QE, but rolls over the debt it already owns, private purchasers of Treasury debt would have to absorb an amount roughly equivalent to the budget deficit, which we forecast to be about 3% of GDP in fiscal year 2014. That's no different than the long-term average.

More likely, the Fed will taper purchases in 2014 rather than going cold turkey. Assuming the Fed bought $250 billion (about $20 billion per month), private markets would be left to absorb debt equal to about 1.5% of GDP. Easy peasy.

We don't believe deficits drive interest rates, but for those who do, the idea that QE itself is the driving force behind long-term rates is seriously flawed. The Fed owns no greater share of the debt than normal, and, deficits are shrinking.

While we expect interest rates to head higher, the bottom line is that QE was never that important and ending it is not the Armageddon event that the Bearish clan wants to believe.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
11-26 / 9:00 am	Consumer Confidence – Nov	73.0	**73.8**		71.2
11-27 / 7:30 am	Initial Claims – Nov 23	330K	**329K**		323K
7:30 am	Durable Goods – Oct	-2.0%	**-2.4%**		+3.8%
7:30 am	Durable Goods (Ex-Trans) – Oct	+0.4%	**+0.2%**		-0.2%
8:45 am	Chicago PMI - Nov	61.0	**63.1**		65.9
8:55 am	U. Mich Consumer Sentiment- Nov	73.1	**73.0**		72.0
9:00 am	Leading Indicators – Oct	+0.1%	**0.0%**		+0.7%