First Trust
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The Myth of QE: Why Rates Are Headed Higher

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It's a myth; an abused narrative. Those who disagree are called economic heretics. What are we talking about? The idea that Quantitative Easing (QE) drives interest rates down. This myth has a fervent following even though virtually no evidence supports it.

Yes, the Federal Reserve has done a massive amount of QE. And, yes, interest rates have been low. But, correlation does not equal causation. Just look at Europe, where the European Central Bank (ECB) has allowed its balance sheet to contract in recent years – Quantitative Tightening. Yet, interest rates are even lower than they are in the U.S. Not just German and French 10-year bond yields, but Italian and Spanish as well.

Federal Reserve Chair Janet Yellen understood this back in December 2008, when she said, "As Japan found during its quantitative easing program, increasing the size of the monetary base above levels needed to provide ample liquidity to the banking system had no discernible economic effects aside from those associated with communicating the Bank of Japan's commitment to the zero interest rate policy."

In other words, by ending QE, the Fed is implicitly ending its commitment to low rates. As a result, the 2-year Treasury yield has jumped from 0.31% in mid-October to 0.64%. Not because of tapering, but because rate hikes are now expected.

There is no mystery here. QE signals a low interest rate policy. In Europe, the ECB keeps threatening to start QE again, which is the same thing as saying don't expect rate hikes.

It's the promise to hold interest rates low that matters, not the actual bond buying. When the Fed (or any central bank) indicates it will hold overnight rates at zero for one year, then 1-year yields will be close to zero. The same holds true if the promise is for two years.

In other words, QE is just another version of "forward guidance." As that guidance shifts, interest rates will rise. That's happening in the U.S. right now.

Since mid-October, the Fed has *increased* its holdings of bonds with 1 to 5-year maturities by $58 billion. At the same time it has *decreased* its holdings of Treasury bonds with maturities five years and longer by $52 billion.

Nonetheless, the 2-year Treasury bond yield is soaring, while the 10-year Treasury bond yield has remained stubbornly stable. The yield curve is flattening – exactly the opposite result that supporters of QE have claimed would happen.

It's a magic elixir. In Europe, by not doing enough QE, the ECB is supposedly causing deflation, which, in turn, holds bond yields down. In the U.S., QE itself was supposedly holding interest rates down. In Japan, interest rates were already low, and QE was supposed to boost growth, but instead a renewed recession is underway. It's the Wizard of Oz. Please don't look behind the curtain.

What does all this mean? Well, first it means QE isn't magical. We do not believe QE boosted economic activity or equity values in the US, nor did it keep interest rates down. All it did was boost bank holdings of excess reserves.

This is why tapering has not hurt the U.S. economy or equities. Job growth has accelerated, GDP, too, and the stock market has reached record highs.

What's missing from just about every conversation about central banks is their inability to offset the damage done by excessive taxes, government spending, or regulation. Europe and Japan will continue to underperform the U.S. as long as their governments spend more as a share of GDP.

The bottom line: The U.S. has turned the corner. Government policy is headed in a better direction, growth is picking up and interest rates are now headed higher, probably for quite some time. But, it's not because QE is over, it's because the Fed can no longer justify a zero percent overnight interest rate. "Forward guidance" is kaput. That means higher interest rates are on their way.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
12-11 / 7:30 am	Initial Claims – Dec 6	297K	**298K**		297K
7:30 am	Retail Sales – Nov	+0.4%	**+0.4%**		+0.3%
7:30 am	Retail Sales Ex-Auto – Nov	+0.1%	**0.0%**		+0.3%
7:30 am	Import Prices – Nov	-1.8%	**-1.9%**		-1.3%
7:30 am	Export Prices – Nov	-0.4%	**-0.6%**		-1.0%
9:00 am	Business Inventories – Oct	+0.2%	**+0.3%**		+0.3%
12-12 / 7:30 am	PPI – Nov	-0.1%	**-0.1%**		+0.2%
7:30 am	"Core" PPI – Nov	+0.1%	**0.0%**		+0.4%
8:55 am	U. Mich Consumer Sentiment- Dec	89.6	**89.3**		88.8