First Trust
Monday Morning OUTLOOK
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# QE and Currency Wars
# A Theory With No Evidence

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Some analysts think that central bank policy (specifically, quantitative easing) is the only thing that matters.

They overlook innovation, investment, and just plain old hard work and argue that stock prices, interest rates and economic performance are driven by central bank stimulus. These analysts say the world has returned to a Depression-era game of competitive devaluation (some call it "currency wars").

But if expanding central bank balance sheets were the key factor driving equities and economic performance, wouldn't there be consistent evidence?

Let's look at global bond yields first. Yes, they have risen in recent weeks, but bond yields in advanced countries are still very low. Even after a six-year recovery, the 10-year Treasury yield is still just 2.04%. The UK's 10-year is yielding 1.71%; Germany's is yielding only 0.36%, slightly below Japan, at 0.39%. No one beats Switzerland, where the yield is 0.05%.

But just because interest rates are low right now, doesn't mean it's because of QE. In fact, you can make just as strong an argument in the opposite direction.

The Fed's QE3 started in late 2012 and ran full throttle through 2013. During that time yields didn't go down, they went up! But once tapering started, rates dropped and continued to drop after the Fed was no longer doing QE. In other words, US yields moved opposite of the QE argument.

The theory works a little better with the European Central Bank, but not much. Most European yields have dropped since they announced their recent round of QE. But yields were roughly unchanged from mid-2012 through mid-2014 even as the ECB did "quantitative tightening" – it actually reduced its balance sheet by one-third during that time.

Meanwhile, the Bank of England has kept a stiff upper lip since doing QE back in 2009-2012. It has kept its balance sheet essentially unchanged for the past two years and yields rose in 2013, fell in 2014, and are down slightly so far this year.

There is no consistent relationship between QE, currency values and interest rates. Low interest rates in Europe make more sense given low nominal GDP growth (real GDP growth plus inflation). But with nominal GDP growth trending 4% in the US, record low yields simply don't reflect economic fundamentals. Moreover, QE is over and yields are still low.

The same is true with QE and growth. US growth was more anemic during QE than it has been in the past year since tapering happened. And like it happened in the US, we expect European QE will just stuff banks chock full of excess reserves.

If QE affected economic growth it would do so by accelerating the growth rate of the broad M2 measure of the money supply (cash, checking and saving deposits, money market funds, and time deposits). But US-M2 increased 5.4% during full-throttle QE in 2013 and a faster 5.8% during 2014, when the Federal Reserve was tapering.

In Europe, the M2 growth rate accelerated from mid-2012 thru mid-2013 while the ECB cut its balance sheet, then decelerated thru mid-2014. Since mid-2014, M2 growth in the Eurozone has accelerated, but that started well before the ECB started expanding its balance sheet again. In other words, the assertion that European interest rates and money supply growth depend on QE and the ECB's balance sheet doesn't hold water.

We get it. Many bearish analysts have to come up with some reason to explain why they have been wrong. Extraordinary central banks actions are a convenient excuse.

Yes, QE has happened. But M2 growth, what Milton Friedman told us to watch, just hasn't followed suit. Therefore, it's impossible to say that QE boosted money, which then boosted growth and stock prices. And interest rates have fallen more in Europe, but stock markets have lagged the US, so it's not all about interest rates either.

The "currency war" story makes good copy and finds supporters, but it lacks any consistent set of facts to back it up.

| Date/Time (CST) | U.S. Economic Data | Consensus | First Trust | Actual | Previous |
|---|---|---|---|---|---|
| 2-17 / 7:30 am | Empire State Mfg Survey – Feb | 8.0 | **11.5** | 7.8 | 10.0 |
| 2-18 / 7:30 am | Housing Starts – Jan | 1.070 Mil | **1.066 Mil** | | 1.089 Mil |
| 7:30 am | PPI – Jan | -0.4% | **-0.5%** | | -0.3% |
| 7:30 am | "Core" PPI – Jan | +0.1% | **0.0%** | | +0.3% |
| 8:15 am | Industrial Production – Jan | +0.3% | **+0.4%** | | -0.1% |
| 8:15 am | Capacity Utilization – Jan | 79.9% | **79.9%** | | 79.7% |
| 2-19 / 7:30 am | Initial Claims – Feb 14 | 290K | **292K** | | 304K |
| 9:00 am | Philly Fed Survey – Feb | 9.0 | **8.4** | | 6.3 |
| 9:00 am | Leading Indicators – Jan | +0.3% | **+0.2%** | | +0.5% |