First Trust
Monday Morning OUTLOOK
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# QE Is Not A Magic Elixir

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In the Wild West, traveling salesmen sold Magic Elixirs that cured anything that ailed you. These days, the elixir is Quantitative Easing (QE) – it supposedly saved the world from Armageddon, lifted stock prices, drove down bond yields, and, according to at least one analyst, created the fracking boom.

So now that the Fed has tapered and plans a second rate hike, many investors fret about an impending recession and a collapse in stocks. They think the US is one big "bubble."

But those Wild West Magic Elixirs didn't work and neither does QE. Before the Panic of 2008, the Federal Reserve had assets totaling $870 billion. Then the Fed started buying Treasury and mortgage bonds from banks with abandon in exchange for new deposits in the banking system – the equivalent of printing new money. Fed assets ballooned in three stages – QE1, QE2, and QE3 – topping out at nearly $4.5 trillion by late 2014, when QE ended. Banks ended up with trillions in cash.

Before the Panic, banks had about $10 billion in reserves at the Fed, almost all of which they were legally required to hold to back up their customers deposits. Now, banks are holding $2.2 trillion in "excess reserves," or reserves in excess of what the banks are legally required to hold. They hold these reserves at the Fed and today earn 0.5% per year, about $12 billion per year, for doing absolutely nothing.

But those reserves just sit there. Over history, banks have always lent out all the money the Fed printed and exchanged for bonds, but now banks just hold most of this cash. Because the Fed has almost always said QE is temporary, banks have little reason to lend out funds the Fed could withdraw at any time.

So, even though the Fed's balance sheet soared, M2 growth, until recently, was a very pedestrian 6% per year. That's why hyperinflation never materialized. That's why the dollar didn't collapse. That's why all that QE wasn't necessary.

Consumer prices are up only 0.8% in the past year. We think inflation is headed higher, but hyperinflation this is not. Meanwhile growth has stagnated. So, if all this money was really boosting the economy, if it really was a magic elixir, wouldn't growth and inflation be higher?

Some say whatever growth we've had is because of QE, but how can money that's not lent cause anything? Nominal GDP – real GDP growth plus inflation – has grown at a 3.7% annual rate since the economic recovery started seven years ago in mid-2009. With the exception of the immediate aftermath of the Panic, that's the slowest 7-year period since World War II. So much for easy money.

Others acknowledge that maybe QE hasn't created hyperinflation or helped the economy, but somehow attribute the bull market in stocks to the same policy. But stocks are up around 10% since QE ended. If QE is so powerful, shouldn't stocks have cratered (and bond yields gone up) when QE ended? Of course, these analysts say European and Japanese QE has taken the place of US QE. But if QE in the US didn't lift M2, how could foreign QE? It's a foreign Magic Elixir!

Some say that the bear market will start when QE is put in reverse. The theory is the Fed will eventually sell bonds and make banks' excess reserves disappear, pushing up interest rates and therefore making stocks look more expensive.

But, we believe that a very low federal funds rate and the Fed's unwillingness to normalize rates, not QE itself, is what is holding down bond yields. This is why we use higher interest rates in our stock market models. In fact, to assess fair value for stocks, as we noted last week, even using a 3.5% yield on the 10-year Treasury Note suggests equities are still undervalued. We expect bond yields to rise as the Fed lifts rates.

Moreover, all the discussion about QE ignores corporate profits. The S&P 500 is no higher today *relative to economy-wide corporate profits* than it was in the late 1950s. Was that an unsustainable bubble as well?

We get it. Many investors and analysts, who have consistently predicted doom and gloom for the past seven years needed to come up with a reason why they were wrong. So they developed a theory that everything is fake: the economic recovery and the bull market, all built on temporary factors, like QE, that were about to reverse.

But the theory makes no sense. QE has been a great big nothing. It hasn't boosted inflation, hasn't helped growth, and has been meaningless to the bull market in stocks, which has been driven by entrepreneurship.

There really is nothing special about the current bull market. If anything, it should have been *stronger*. And it would have been if policymakers did their job right. But that doesn't mean we shouldn't have had any bull market at all.

| Date/Time (CST) | U.S. Economic Data | Consensus | First Trust | Actual | Previous |
|---|---|---|---|---|---|
| 9-6 / 9:00 am | ISM Non Mfg Index – Aug | 54.9 | **55.5** | 51.4 | 55.5 |
| 9-7 / 7:30 am | Initial Claims – Sep 3 | 265K | **263K** | | 263K |
| 9-8 / 2:00 pm | Consumer Credit– Jul | $16.0 Bil | **$16.1 Bil** | | $12.3 Bil |

*Consensus forecasts come from Bloomberg. This report was prepared by First Trust Advisors L. P., and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.*