First Trust
Monday Morning OUTLOOK
630-517-7756 • www.ftportfolios.com
February 20, 2018

QE and Its Apologists

Brian S. Wesbury – *Chief Economist*
Robert Stein, CFA – Dep. Chief *Economist*
Strider Elass – *Economist*

On March 9, 2018, the bull market in U.S. stocks will celebrate its ninth anniversary. And, what we find most amazing is how few people truly understand it. To this day, in spite of massive increases in corporate earnings, many still think the market is one big "sugar high" – a bubble built on a sea of Quantitative Easing and government spending.

While passing mention is given to earnings (because they are impossible to ignore), conventional wisdom has clung to the mistaken story that QE, TARP, and government spending saved the economy from the abyss back in 2008-09.

A review of the facts shows the narrative that "Wall Street" – meaning capitalism and free markets – failed and government came to the rescue is simply not true.

Wall Street was not the driving force behind subprime mortgages. In his fabulous book, *Hidden in Plain Sight*, Peter Wallison showed that by 2008 Fannie Mae, Freddie Mac and other government programs had sponsored 76% of all subprime debt – not "Wall Street." Everyone was playing with rattlesnakes and government was telling them it was OK to do so. But, when the snakes started biting, government blamed the private sector, capitalism and free markets.

At the same time, Wall Street did not cause the market and economy to collapse; it was overly strict mark-to-market accounting. Yes, leverage in the financial system was high, but mark-to-market accounting forced banks to write down many performing assets to illiquid market prices that had zero relationship to true value. Mark-to-market destroyed capital.

QE started in September 2008, TARP in October 2008, but the market didn't bottom until March 9, 2009, five months later. On that day in March, former U.S. Representative Barney Frank, of all people, promised to hold a hearing with the accounting board and SEC to force a change to the ill-advised accounting rule. The rule was changed and the stock market reversed course, with a return to economic growth not far behind.

Yes, the Fed did QE and, yes, the stock market went up while bond yields fell, but correlation is not causation. Stock markets fell after QE started, and rose after QE ended. Bond yields often rose during QE, fell when the Fed wasn't buying, and have increased since the Fed tapered and ended QE.

A preponderance of QE ended up as "excess reserves" in the banking system, which means it never turned into real money growth. That's why inflation never took off. Long-term bond yields fell, but this wasn't because the Fed was buying. Bond yields fell because the Fed promised to hold short-term rates down for a very long time. And as long-term rates are just a series of short-term rates, long term rates were pushed lower as well.

We know this is a very short explanation of what happened, but we bring it up because there are many who are now trying to use the stock market "correction" to revisit the wrongly-held narrative that the economy is one big QE-driven bubble. Or, they use the correction to cover their past support of QE and TARP. If the unwinding of QE actually hurts, then they can argue that QE helped in the first place.

So, they argue that rising bond yields are due to the Fed now selling bonds. But the Fed began its QE-unwind strategy months ago, and sticking to its plans hasn't changed a thing.

The key inflection point for bond yields wasn't when the Fed announced the unwinding of QE; it was Election Day 2016, when the 10-year yield ended the day at 1.9% while assuming the status quo, which meant more years of Plow Horse growth ahead. Since then, we've seen a series of policy changes, including tax cuts and deregulation, which have raised expectations for economic growth and inflation. As a result, yields have moved up.

Corporate earnings are rising rapidly, too, and the S&P 500 is now trading at roughly 17.5 times 2018 expected earnings. This is not a bubble, not even close. Earnings are up because technology is booming in a more politically-friendly environment for capitalism. And while it is hard to see productivity rising in the overall macro data, it is clear that profits and margins are up because productivity is rising rapidly in the private sector.

The sad thing about the story that QE saved the economy is that it undermines faith in free markets. Those who argue that unwinding QE is hurting the economy are, in unwitting fashion, supporting the view that capitalism is fragile, prone to bubbles and mistakes, and in need of government's guiding hand. This argument is now being made by both those who believe in big government and those who supposedly believe in free markets. No wonder investors are confused and fearful.

The good news is that QE did not lift the economy. Markets, technology and innovation did. And this realization is the key to understanding why unwinding QE is not a threat to the bull market.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
2-21 / 9:00 am	Existing Home Sales – Jan	5.600 Mil	**5.480 Mil**		5.570 Mil
2-22 / 7:30 am	Initial Claims – Feb 17	230K	**229K**		230K

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.