No One Respects A Quantitative Easer

What applies to human relations applies to monetary policy as well: Sometimes saying, "No" in the short run saves a lot of grief in the long run. The question, "When did the financial panic of 2007-2009 end?" surely will be debated by economic historians for decades to come, but the round of quantitative easings on March 5, 12 and 18, 2009, by the U.K., Switzerland and the U.S., respectively, must be given consideration.

A fourth quantitative easing had occurred earlier and unannounced, on December 16, 2008, by Japan. This easing occurred on the very day when the Federal Reserve's Open Market Committee cut the target federal funds rate to 0-0.25% and hinted their next step would be quantitative easing.

Quantitative easing is the central bank adding excess reserves to the banking system when short-term interest rates nominally have been pushed toward zero percent. An alternative, negative interest rates, or the charging of a penalty rate on savings is both difficult to administer and punitive toward risk-averse savers. The objective of quantitative easing is to forestall deflation by debasing the currency. You may arrive at your own conclusion whether this constitutes prima facie evidence of idiocy by considering Japan first engaged in quantitative easing in March 2001 and has yet to arrest deflationary forces.

The Carry Trade

The reason quantitative easing does not work is central banks cannot control who borrows those excess reserves. For years, Japan fueled speculative asset bubbles in the rest of the world via the yen carry trade, the borrowing of yen to lend elsewhere at a presumably higher return. Once the U.S. started to follow the Japanese path, (see "A Tale of Two Tragedies," September 2008) a dollar carry trade opened. A Swiss franc carry trade opened between Switzerland and Eastern Europe as mortgage borrowers in Poland, Hungary and elsewhere discovered the joys of financing a mortgage in a different currency. The U.K., which cut rates in response to the devastation in its financial sector, has not financed a pound carry trade…yet.

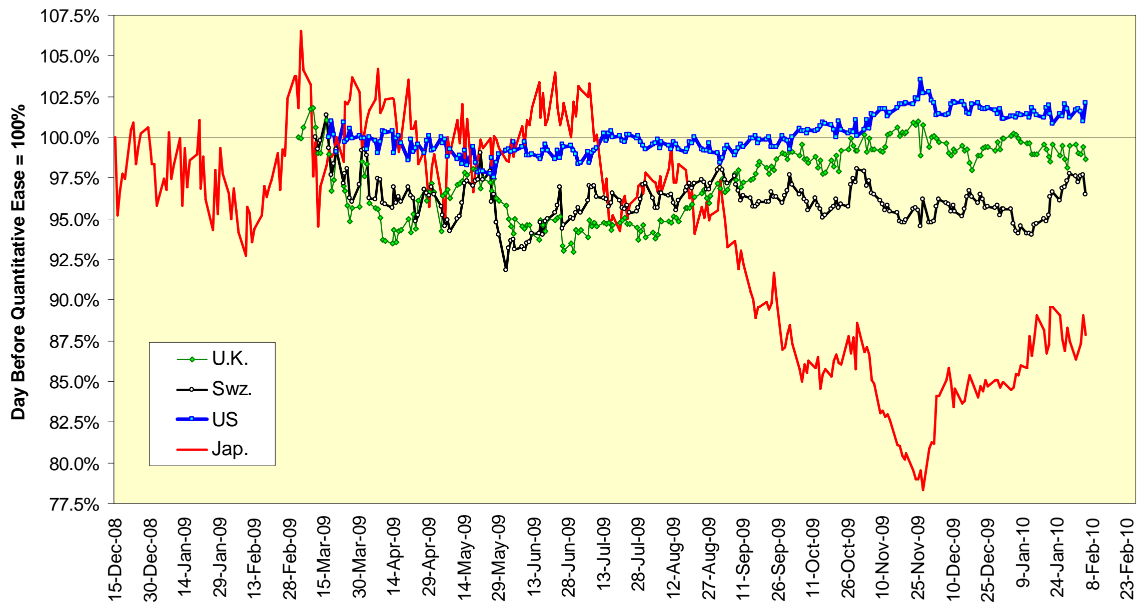
Sometimes market relationships are far more logical and direct than they may seem. If a country engages in quantitative easing, it presumably is doing so in response to some measure of economic or financial market stress. If the funds created from thin air are borrowed to lend or invest elsewhere, we should expect the returns in the non-easing world to exceed those of the easing country. This is easy to test.

The Comparison

Let's use the Morgan Stanley Capital International total return indices as the raw material for stock market comparison and the Bank of America/Merrill Lynch 7-10 year government debt indices for the bond market comparison. We can do this on both on a local currency and a U.S. dollar basis; U.S. investors most likely should use the USD basis for their personal comparison. In all cases national stock and bond performance will be presented as an incremental return to a global index, and all resulting indices will be set to 100% the day before the central banks' quantitative easing action.

First, let's use the local currency case for stocks even though this is not the one a U.S. investor would be interested in for a typical mutual fund or ETF holding. The results in Chart 1 are very telling. Each and every national index underperformed the global index after its central bank eased quantitatively.

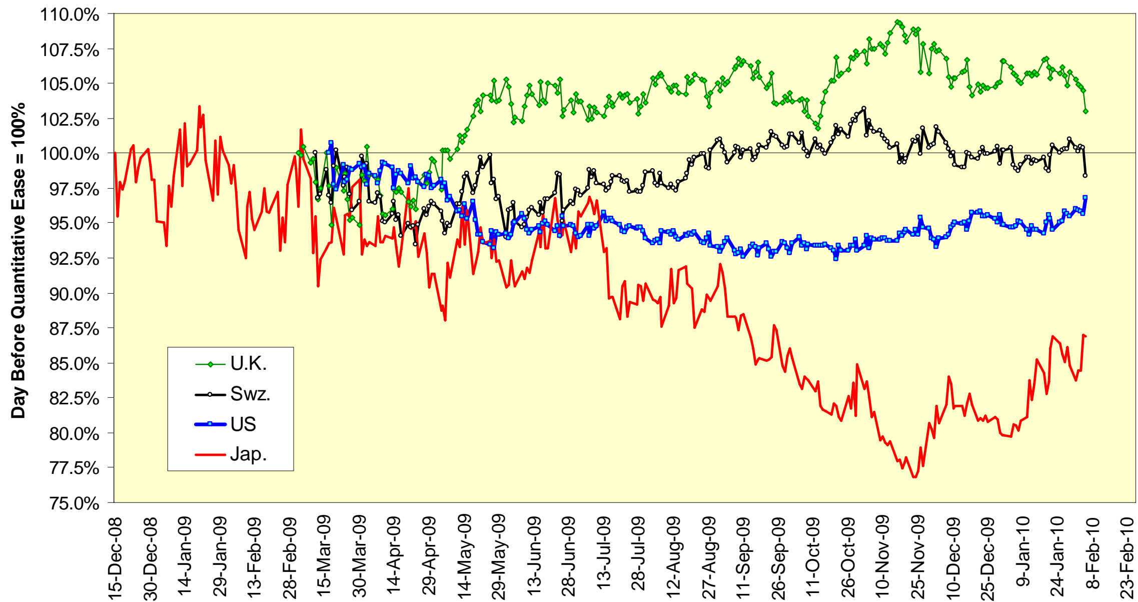
Chart 1: Incremental Stock Market Performance After Quantitative Easing
Local Currency



As of the time of this writing, the U.S. is the best-performing member of the quartet, followed by the U.K., Switzerland and Japan. Neither the British nor the Swiss markets showed much life after their central bank's actions, and Japan struggled mightily after August 24, 2009. This is the date when dollars became cheaper to borrow than yen; yen carry trades were unwound, pushing the currency higher and pressuring Japanese exports.

If we switch to the comparison in USD terms, the results become quite different. Now the U.K. market outperforms the global index handily as the result of the pound's relative strength. However, the Swiss, American and Japanese markets all underperformed, with the long-suffering Japanese market bringing up the rear.

Chart 2: Incremental Stock Market Performance After Quantitative Easing
USD

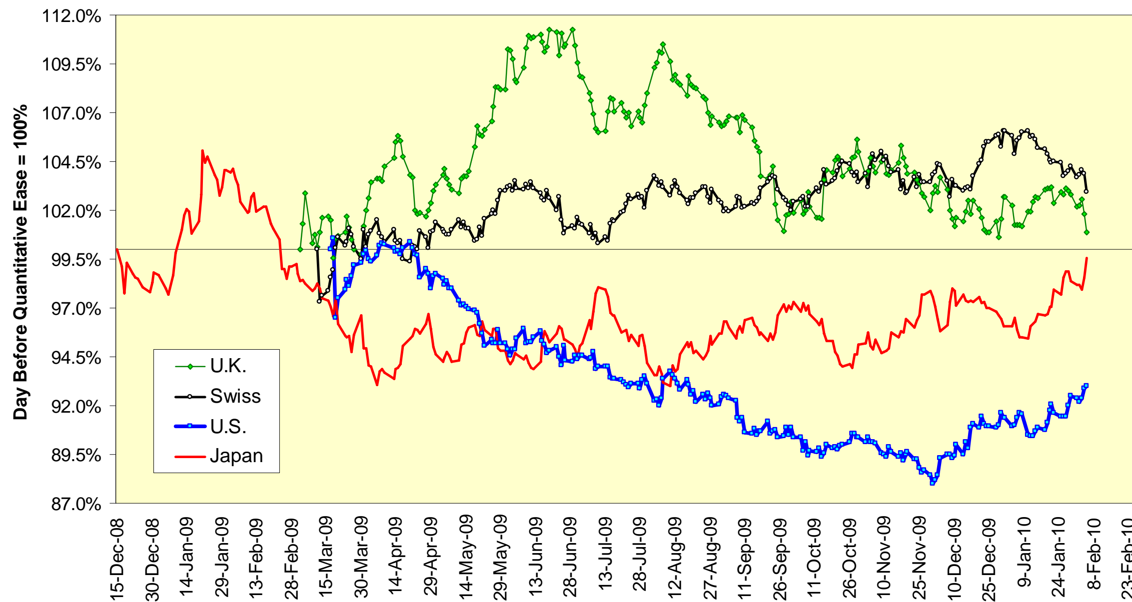


Bond Market Comparison

The results split out differently for the bond market comparison. We should expect the results in USD terms to look like a currency trade, and they do. The Swiss and British markets turn out to be the strongest, with the Japanese and American markets the weakest. The results for the American market are rather striking; the 7-10 year bond index'

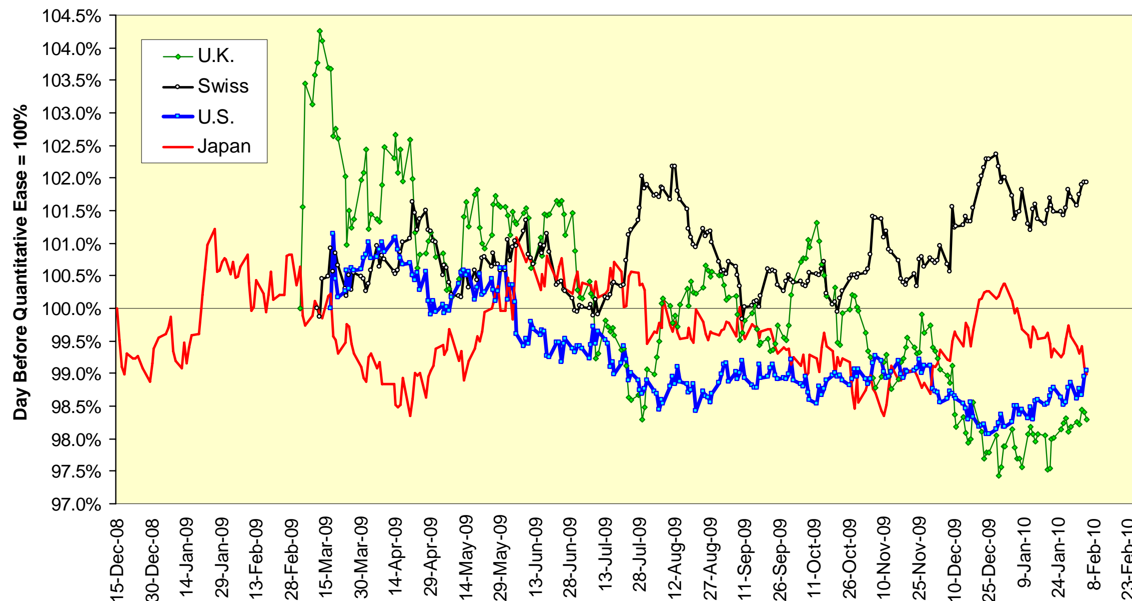
relative performance seldom was positive. This means U.S. yields rose and the dollar weakened after quantitative easing. If anyone considers this to be a lose-lose proposition, we shall not quibble.

Chart 3: Incremental 7-10 Year Sovereign Market Performance After Quantitative Easing
USD



In local currency terms, as seen in Chart 4, the real effects of quantitative easing are readily visible. Only the Swiss market outperforms the global benchmark.

Chart 4: Incremental 7-10 Year Sovereign Market Performance After Quantitative Easing
Local Currency



Cheating Never Works

Let's return to the American program in isolation. On March 18, 2009, the FOMC announced it would buy up to $300 billion of Treasury securities and more than $1 trillion in mortgage securities. Long-term interest rates rose shortly thereafter and anyone who bought into the panic of that announcement lived to regret it. Consider the following factoid: The selloff in long bond futures from that day's high to that day's close would have been the third largest down day in bond futures' history, and that *within* the context of the largest single gain in bond futures history. Even during the panic, some saw a reason to sell the market.

Only the U.S. government could buy $300 billion of something, pay for it with an IOU and watch its price go down. This is the sort of "talent" the investment banks think they are paying for with their massive bonuses.

Be it stocks or government bonds, the conclusion is clear: Those who try to avoid long-term solutions by the wanton printing of money both condemn their home countries to underperformance and finance asset bubbles elsewhere. The policy of quantitative easing is a massive failure and indeed a fraud upon the citizenry. If any of the countries involved are a democracy worthy of the name, they should think long and hard as to whether quantitative easing ever should be permitted again.