



The Week

Gary Thayer, Chief Macro Strategist

Credibility is hard to earn and easy to lose

This week the Federal Reserve is expected to announce another round of monetary stimulus called quantitative easing. Policymakers need to be careful and not pump too much money into the financial system or they could lose the credibility they earned restraining inflation over many years.

During the financial crisis in 2008 and early 2009, the Fed pumped a lot of money into the economy. Of course, the economy needed the money back then because lending had dried up. Now the Fed is considering a second round of quantitative easing. This raises many questions.

If the economy is currently in its sixth quarter of economic growth since the recession ended in June 2009, why is the Fed considering additional stimulus? The Federal Reserve has two mandates, full employment and low inflation. Unfortunately, unemployment is not coming down as the economy recovers slowly from recession. The Fed appears to be considering providing more monetary liquidity in order to boost economic activity and increase the rate of job creation.

If interest rates are near zero percent, doesn't that mean that there is already a lot of money in the financial system? Yes.

So why add more? We believe the Fed needs to encourage people to spend the money rather than just sit on it.

Why would people not spend the money the Fed put into the system? If people believe that the economy is going into deflation where prices drop, then they may be inclined to wait for lower prices before buying. We are already seeing this problem in the housing market. The Fed wants to make sure that these deflation concerns do not spread to other parts of the economy.

How does the Fed get people to spend the money that is already in the system? People are more inclined to spend when they think that prices are going up and they would have to pay more if they wait to buy something later. In other words,

increasing inflation expectations may be a way to get people to shop.

How are investors to know what the Fed is trying to do? The minutes of the last Federal Reserve policy-making meeting said that the minutes are the best place to get a clear message of what the Fed is doing.

What do the minutes reveal? In the paragraph just ahead of the statement about the direction of policy, the Fed discusses the role that inflation expectations play when interest rates are near zero. This suggests that the Fed may be following a new policy of managing inflation expectations as a way to guide the economy along a path between deflation and inflation.

Has the Fed done this before? A little bit. For example, a year ago the Fed was trying to dampen inflation expectations and policymakers were talking about how the Fed would exit from the first round of quantitative easing. This summer, investors started to worry about deflation rather than inflation. Consequently, the Fed is now talking about doing more quantitative easing, rather than reversing the first round of stimulus.

What has happened to inflation expectation since the Fed began discussing more quantitative easing a couple of months ago? Inflation expectations have increased and have almost returned to the level that prompted the Fed to talk about reversing stimulus a year ago.

What is the risk of doing more quantitative easing? If the Fed does too much, investors could lose confidence that the Fed will be able to keep inflation contained in the future.

How will the Fed know if it is doing too much? By looking at the difference between the interest rates on regular Treasury notes and inflation-protected Treasury notes, the Fed can see what investors expect inflation to be in the future. Policymakers probably would not be concerned if investors think that inflation could increase in the short-run. Instead, the Fed is likely to focus much more on keeping long-term inflation expectations steady. If long-term expectations were to rise, investors might begin to question the Fed's credibility in keeping inflation low.

What is happening now? Unfortunately, long-term inflation expectations are higher than short-term inflation expectations. This means that the Fed needs to be careful and not pump too much liquidity. In fact, it might be better if the Fed provides only a little extra stimulus rather than massive stimulus.

What is likely to happen to interest rates if the Fed purchases more Treasury securities as part of more quantitative easing? The Fed hopes that this policy will reduce long-term interest rates. However, if the policy backfires and the Fed loses credibility, long-term interest rates could go up rather than down.

So what should investors do? The markets are already expecting substantial quantitative easing. That is partially why the stock market has rallied during the past few weeks while the bond market has softened. If the Fed only does a modest amount of extra stimulus, and not as much as the markets expect, then the stock market could weaken while the credit markets strengthen. Alternatively, if the Fed goes ahead with another large measure of quantitative easing, the stock market could do better while the bond market could suffer.

What do we expect? We believe the Fed is trying to manage inflation expectations as they indicated in the minutes of their last meeting. Since inflation expectations have already increased, we feel the Fed does not need to do a large amount of extra quantitative easing. We look for the Fed to hold back, and do less than the markets are expecting, but promise to do more if needed. That way policymakers may be able to keep their credibility rather than lose it by providing more stimulus than necessary.

Important Information, Risk Factors and Disclaimers:

- Past performance is not a guarantee of future results.
- Investing in fixed income securities involves certain risks such as market risk if sold prior to maturity and credit risk, especially if investing in high yield bonds, which have lower ratings and are subject to greater volatility. All fixed income investments may be worth less than the original cost upon redemption or maturity. Bond prices fluctuate inversely to changes in interest-rates. Therefore, a general rise in interest rates can result in the decline of the value of your investment.
- Although Treasuries are considered free from credit risk they are subject to other types of risks. These risks include interest rate risk, which may cause the underlying value of the bond to fluctuate.
- Stocks offer long-term growth potential, but may fluctuate more and provide less current income than other investments. An investment in the stock market should be made with an understanding of the risks associated with common stocks, including market fluctuations.
- Wells Fargo Advisors is one broker/dealer affiliate of Wells Fargo & Company; other broker/dealer affiliates of Wells Fargo & Company may have differing opinions than those expressed in this report. Contact your financial advisor if you would like copies of additional reports.

Investment and Insurance Products: ▶NOT FDIC Insured ▶NO Bank Guarantee ▶MAY Lose Value

Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice. The investment or strategy discussed may not be suitable for all investors. Investors must make their own decisions based on their specific investment objectives and financial circumstances.

Wells Fargo Advisors is the trade name used by two separate registered broker-dealers: Wells Fargo Advisors, LLC, and Wells Fargo Advisors Financial Network, LLC, Members SIPC, non-bank affiliates of Wells Fargo & Company.

H.D. Vest Investment ServicesSM, Member SIPC, a non-bank subsidiary of Wells Fargo & Company, and an affiliate of Wells Fargo Advisors.