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The Week

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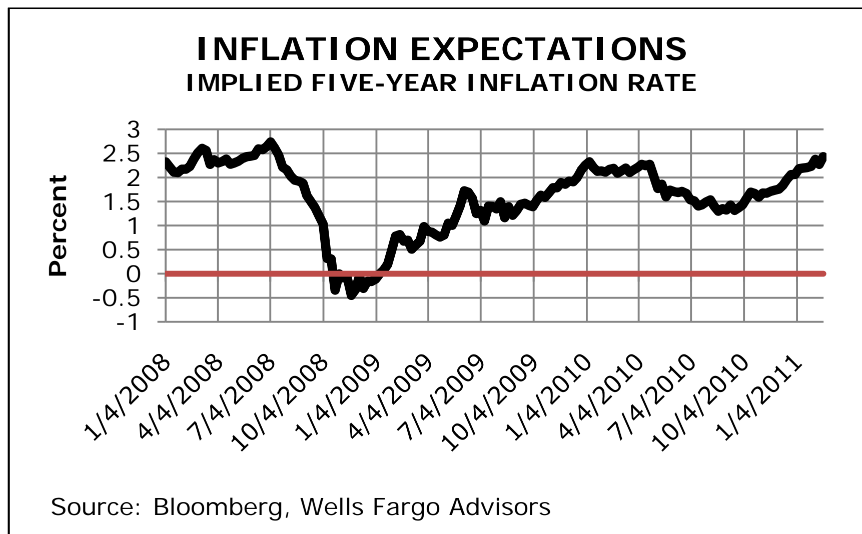
Do we need QEIII?

In early November, the Federal Reserve started to add additional liquidity to the financial system through its second round of quantitative easing (QEII). This program is scheduled to last until June of this year. We are now about half way through QEII, and many investors are probably wondering whether the Fed will do a third round of quantitative easing (QEIII) when it is finished with its current stimulus. Our work suggests the Fed does not need to do more, but it is still too early to say that the Fed won't.

The Fed's first round of quantitative easing was in early 2009 when the economy was in the depths of the financial crisis. At that time, investors were worried about depression and deflation. The Fed had already pushed interest rates down to nearly zero and still needed to do more to boost the economy. Therefore, the Fed added liquidity to the financial system through purchasing government securities. This worked. The economy stopped spiraling downward, and the financial markets rebounded. However, within a few months, investors began to worry that the Fed had provided too much stimulus. Consequently, inflation expectations increased.

By late 2009 and early 2010, the Fed was talking about its exit strategy for reversing its quantitative easing program. However, the economy started to weaken again last summer, and investors began to worry about deflation rather than inflation. This downturn in inflation expectations can be seen on this week's chart, showing the five-year breakeven or implied inflation rate in the market for Treasury inflation protected securities (TIPS). As inflation expectations decreased, policymakers decided that a second round of quantitative easing was warranted to ensure that the economy did not fall back into recession.



Source: Bloomberg, Wells Fargo Advisors

Please see page 3 of this report for Important Information, Risk Factors and Disclaimers

This second round of quantitative has also worked. Economic growth accelerated in the fourth quarter of last year, increasing at the fastest pace in three quarters. As a result, investors became more optimistic about economic prospects, causing commodity prices to increase and the equity market to rally. Unfortunately, inflation expectations increased and are now near the highest level since 2008. This has been bad for the bond market.

In recent statements, Fed officials have defended their decision to undertake QEII. But the Fed has not signaled what it intends to do after the current program is finished in June. Policymakers appear to be keeping all their options open and may even be planning further quantitative easing in case it is needed.

When defending its current QEII policy, monetary officials note that the Fed has dual mandates, full employment and price stability. In particular, the Fed has noted that inflation is below its 2.0% preferred rate while the unemployment rate is still significantly above its pre-recession level. Using these two measures as a guide, the Fed could decide that it needs to do a third round of quantitative easing later this year.

However, using inflation expectations as a guide, the Fed probably does not need to do a third round of quantitative easing. Furthermore, we feel the recent gains in the strong stock market indicate that the economy is continuing to improve and may not need additional stimulus. After all, the economy is now producing more output (gross domestic product-GDP) than it did at its pre-recession peak in late 2007.

The economy still faces many challenges. Housing remains weak, state and local governments continue to curtail spending because of weak revenues and employment continues to grow more slowly than before the recession. Therefore, another round of stimulus cannot be ruled out. However, if the Fed decides to do QEIII when the economy is already well on the road to expansion, it could cause inflation to increase beyond the 2.0% level targeted by the Federal Reserve.

In summary, investors will need to carefully monitor what the Federal Reserve says about its policy as the June 2011 QEII end date approaches. If the Fed decides that it has done enough, it will likely stop providing extra funds to the financial system at the end of the second quarter. This could take some of the support from the stock market, increasing market volatility as the June end date approaches.

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