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Is QE Coming To An End? Abolutely!

by Guest Columnist....Peter Jarvis, Executive Director, CFA Society Toronto

One of the most asked questions this summer has been whether quantitative easing, or QE as it is commonly referred to, is coming to an end. My answer is 'of course it is, and hopefully, sooner rather than later.' If this does occur, it means the tremendous expansion of the monetary base and the Fed balance sheet will stop. But that doesn't mean financial repression will end. I still expect short term rates to be held lower than is otherwise justified. But nevertheless short-term rates will rise.

Why must this be so? Instead of quoting a host of statistics or explaining matters from a sense of morality, let me provide the principle reasons QE must end. But before we begin, let me quote Stein's Law (named after the former Chairman of the Council of Economic Advisers): "If something cannot go on forever, it will stop."

To start, one must immediately recognise that recent extreme low interest rates and negative real short-term rates, as policy tool, is decided short term in nature. Logically speaking, long term policy cannot maintain a price of capital below some sort of longer term fair value without introducing misallocations and imbalances that are destructive in nature. Monetary authorities are recognising their short term policies related to financial easing are becoming marginal in terms of impact. Also, any policy that misallocates capital can become difficult to exit.

All other things being equal, economic policy posits that low and falling short-term rates encourage economic growth, capital formation and business expansion. Unfortunately, in the medium and longer term nothing remains equal. By their very nature, economies and markets learn and when capital become

essentially free, very strange things happen. Those with capital tend to hoard it and those without capital (such as governments) consume infinite amounts of it. In the process, normal behaviours change and the capital allocation process falls into disarray.

So what is the appropriate mix of capital allocation when capital is free? Moreover, in a capitalist economy, how are prices set when capital has no cost? And with capital being essentially free, how much leverage is appropriate? What types of booms, busts or bubbles are spawned as monies increasingly flow all over the place as the pricing system becomes corrupted? You may well answer that in the very short term, nothing really changes. But once government debt hits unprecedented levels, will participants alter their behavior to protect their own economic interest?

While no one can guess what will happen when money becomes too cheap, usually excessive leverage builds and enormous debts are created. A famous industrialist once was asked incredulously "How did you go bankrupt". Paraphrasing his response, he said "slowly at first, but then quite quickly at the end." This applies as much to countries as to corporations.

So while the transfer of wealth form savers to debtors has been successful to date, and low yields have increasingly fueled certain asset prices, the days of QE and related low interest rate policies is coming to an end. I would be nervous if you own medium and longer term bonds, and interest sensitive or highly leveraged investments. If you don't believe me, I have a quote from Stuart Chas, a US economist "For those that believe, no proof is necessary. For those that don't believe, no proof is possible". ◻

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....Cheers, GMK

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