Key Questions

QE or Not QE… Is That the Question?

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Unconventional monetary policies have seemingly been reactivated, and investors should be questioning their efficacy to combat the next recession and getting prepared for once it arrives.

In mid-September, we profiled various maneuvers being undertaken by the Federal Reserve (Fed) designed to ease market pressures occurring within short-term funding markets (see our September 19 Key Question article: "What is a Repo and Why Should Investors Care?"). We won't recount the esoteric details that were prevalent at that time here. But since then, policymakers have (in some cases vociferously) proclaimed that "Quantitative Easing" was not being reconstituted.

Quantitative Easing (QE) refers to a form of monetary policy utilized when conventional policy (i.e., cutting short-term interest rates) is thought to be ineffective because interest rates are already low. When enacting QE, central banks typically purchase longer-term government bonds and other financial assets from financial institutions to inject liquidity into the economy.

QE was employed on a large scale following the Global Financial Crisis (GFC) of 2007-08, and it mitigated financial pressures that were then present and led to a substantial reduction in systemic risk. In short, according to many, the GFC and ensuing recession might have been several degrees of magnitudes worse had QE not been implemented.

Nonetheless, there are many detractors of QE. Opponents cite the harmful impact QE has on savers (persistently low interest rates), widening wealth inequality (financial assets generally rise faster than real assets and incomes), and increased unpredictability (QE's long-term effects are not widely known).

Because of these concerns, when the Fed took steps to address the aforementioned stresses in the short-term funding markets this past fall, policymakers vehemently claimed that QE was not being reactivated. This sentiment was recently reiterated when the Fed lowered interest rates for the third time this year exclaiming that "the economy is in a good place" and the next move in interest rates will be motivated by a "material reassessment of the outlook."

In our view, a "material reassessment" would come in the form of a significant rise in jobless claims and a concurrent decline in company payrolls, a substantial sell-off in the stock market, or a meaningful increase in inflation -– something much above 2%.

But QE or not QE is not the question. Instead, we believe investors should be questioning whether unconventional monetary policies will prove efficacious in combatting the next recession, whenever it arises.

With short-term rates and long-term rates below/around 2%, when the next recession occurs, short-term rates would almost certainly be lowered to zero, and QE would likely ensue.

But given the limitations of QE, policymakers will probably be looking toward fiscal policy to stave off the next recession. This could come in the form of tax cuts and/or major infrastructure spending. This approach was contemplated during the GFC, but austerity was the preferred approach.

Today, however, budget deficits are generally accepted by both sides of the political aisle in the US and are also gaining acceptance in other parts of the world as well.

Longer term, the big risk of this policy shift is inflation. And should inflation surface, we believe investors would be well served to consider select real estate, infrastructure, and other real asset investments. Such investments, in general, are currently fully priced. But we have begun to canvas the investment landscape today in anticipation of potential opportunities in the future when the time comes.

To be clear, opportunities are currently not abundantly apparent. But we believe that investors should maintain adequate liquidity and remain diversified in the interim and be prepared to invest in these opportunities once they arise.

For more information, please contact your Key Private Bank Advisor.

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