



# Weekly Market Commentary

May 31, 2011



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### Highlights

As the grand ocean liner the QE2 embarked on her final voyage, she ran aground on a sandbank near the Isle of Wight.

Might the markets run aground on unseen risks as the Fed's flagship QE2 program comes to its finish at the end of June?

We do not think so, the economy is much better equipped to handle unseen risks than after the end of QE1.

The real issue for the post-QE2 environment may be the financial position of the United States and the outlook for fiscal, rather than monetary, policy.

## The Final Voyage of QE2

The Queen Elizabeth 2 ocean liner, often referred to simply as the "QE2," was the flagship of the fleet. As her cruising days drew to a close and she embarked on her final voyage she ran aground on a sandbank near the Isle of Wight.

As of June 30, the Federal Reserve (Fed) will have completed its flagship stimulus program of \$600 billion in purchases of Treasuries that began in November 2010. As we approach the end of this program, known as Quantitative Easing 2 (QE2), we seek to answer the questions:

- Did QE2 keep the economy afloat?
- Might the markets run aground on unseen risks as QE2 draws to a close?
- Will it be smooth sailing for the markets after the end of QE2?

QE2 was intended to put downward pressure on interest rates. In turn, this would keep mortgage rates low to make housing more affordable and keep corporate borrowing costs down to encourage hiring and investment. These easier financing conditions were intended to boost the economy, stock market, and consumer confidence leading to a transition from policy-aided recovery to independently sustainable economic growth.

As the final voyage of QE2 is completed by the Fed this month, the evidence is mixed when it comes to judging its achievements:

- Interest rates did not fall, but may be lower than they would be if the Fed had not acted. The yield on the 10-year Treasury note was at 2.64% on August 27 when Fed chairman Ben Bernanke first opened the door to another round of bond buying. By the time the program set sail in November the yield began to move up eventually reaching 3.74% before settling back to around 3.05%.
- Despite historically low mortgage rates, mortgage purchase applications have been weak. Even worse, housing activity deteriorated with existing home sales and prices renewing their declines.
- Corporate bond yields fell, supporting growth initiatives. This was true even for the riskiest companies as the yield on high-yield bonds, often called junk bonds, slid to the lowest yields in history. Corporate hiring finally reached and maintained the key threshold of 200,000 new jobs per month in February, shortly after QE2 began.
- Although not a stated objective of QE2, the most notable outcome we had anticipated was a weaker dollar. The rise in commodity prices reduced the



risk of deflation, a major concern of the Fed. The dollar decline helped to lift commodity prices and make U.S. exports more attractive.

- Stock prices rose as corporate earnings growth remained robust and appeared increasingly sustainable as companies began to reinvest in capital and labor.

As QE2 ends, many fear a repeat of the environment that unfolded after the end of QE1 back in the spring of 2010 when the markets pulled back and the economy slowed. However, there is a big difference in backdrop between now and when QE1 ended. The big event for the markets and economy in the spring of 2010 was not the end of QE1, but the unrelated eruption of the European debt market. The economic data softened and markets pulled back sharply as the fear grew that a debt meltdown in Europe would reignite a global banking crisis. While European debt problems have once again intensified as QE2 is drawing to a close, economic conditions are more robust in the United States than a year ago and better able to withstand any pressures. As we highlighted in last week's commentary:

- A year ago as QE1 ended, the economy had shed jobs during 10 of the prior 12 months, whereas this year new jobs have been added in every one of the past twelve months totaling 1.7 million.
- Deflation was a major concern of policy makers a year ago as QE1 ended with the year-over-year change in the Consumer Price Index (CPI) sliding to 1.1% by June, in sharp contrast CPI is now in line with the 30-year average of 3.2%.
- In the spring of last year as QE1 was winding down, business lending was falling at a 20% year-over-year pace as businesses were unwilling to borrow and bank credit standards were tight. Now commercial and industrial loan demand has turned positive as businesses seek to fund growth and banks have eased standards.

The widely anticipated end of QE2 is unlikely to be a major turning point for the markets.

The most important conditions are much better now than a year ago and better able to sustain growth, and shocks from the emergence of unseen risks, in the absence of further QE2 support from the Fed. The widely anticipated end of QE2 is unlikely to be a major turning point for the markets. Only after the Fed actually begins to unwind the program by selling the bonds it has purchased, draining the economy of the stimulus it has provided, and eventually begins to raise interest rates will the drags on growth begin to test the economy. While the exact timing will be dependent upon a number of factors, including the budget battles in Washington, that test is unlikely to come until 2012.

#### Our Take on the Potential Process for Unwinding QE

<b>Step 1</b>	June 2011	End of QE2: Fed stops buying Treasuries to expand its balance sheet
<b>Step 2</b>	Second Half 2011	Fed maintains size of balance sheet by reinvesting interest payments and maturing debt
<b>Step 3</b>	2012 and Beyond	Fed begins to not reinvest allowing the balance sheet to start to contract



In the minutes from the April FOMC meeting released on May 18, 2011, the Fed gave some discussion of its plan to decommission QE2 and how it may offload the heavy cargo of bonds it has accumulated. They also noted that this “normalization strategy” was subject to economic conditions and unlikely to begin any time soon. In fact, they committed to continue reinvesting interest and principal repayments to maintain a constant \$2.6 trillion in bonds on their balance sheet on an ongoing basis after QE2 ends at the end of this month.

The final voyage of QE2 does not prompt us to change our outlook. While interest rates are likely to rise modestly, we do not anticipate a spike resulting from the lack of Fed buying that would put the economy at risk. In the months ahead, we continue to forecast slightly below average economic growth, range bound performance for stocks and bonds, a slightly weaker dollar and modest gains for commodity prices. However, the other policy transition taking place this summer may have more of an impact. The budget and debt ceiling debate may be of more importance since fiscal policy could tighten sharply or a failure to control the deficit could spike interest rates, in either case putting the economy at risk.

The QE2, decommissioned in 2008 and now retired from sailing, sits with her future in doubt over the poor financial position of her owner. The real issue for the post-QE2 environment may be the financial position of the U.S. and the outlook for fiscal, rather than monetary, policy.



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The Federal Reserve is the central bank of the United States. Its unique structure includes a federal government agency, the Board of Governors, in Washington, D.C., and 12 regional Reserve Banks (Atlanta, Boston, Chicago, Cleveland, Dallas, Kansas City, Minneapolis, New York, Philadelphia, Richmond, San Francisco, and St. Louis).

High yield/junk bonds (grade BB or below) are not investment grade securities, and are subject to higher interest rate, credit, and liquidity risks than those graded BBB and above. They generally should be part of a diversified portfolio for sophisticated investors.

The market value of corporate bonds will fluctuate, and if the bond is sold prior to maturity, the investors' yield may differ from the advertised yield.

A commodity is a basic good used in commerce that is interchangeable with other commodities of the same type. Commodities are most often used as inputs in the production of other goods or services. The quality of a given commodity may differ slightly, but it is essentially uniform across producers.

Quantitative Easing is a government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity.

The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

Stock investing may involve risk including loss of principal.

The fast price swings in commodities and currencies will result in significant volatility in an investor's holdings.

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