TD Asset Management

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currentPERSPECTIVES

# Quantitative Easing Update: Good News Is Now Bad News?

As the U.S. economy fought to recover in the wake of the financial crisis, the U.S. Federal Reserve (the Fed) adopted policies to help stimulate it, including dropping the federal funds rate to a dramatically low level and establishing a quantitative easing (QE) program. Through its most recent QE program, the Fed purchases $85 billion of government securities per month ($1 trillion per year), which provides plenty of liquidity to the system and has led to increasing asset prices, decreased market volatility and economic improvements, particularly in the U.S. Given that the purpose of QE was to stimulate economic growth, it is entirely reasonable to expect that improved economic growth will ultimately lead to the end of QE. In addition, since market volatility had reached incredibly low levels on the back of the QE program, it is also reasonable to expect that the tapering (slowing) of the program will lead to some increase in volatility. We believe that this will be a healthy level of volatility that creates opportunities, not a return of the unhealthy and extreme volatility that occurred during the financial crisis.

In recent weeks, speculation around the timing of the Fed's tapering of asset purchases has led to what is being called a "taper tantrum," with bond, equity and commodity prices falling. While this undoubtedly causes concern for investors, it is important to remember that the market action is being driven by speculation of what might happen, not by what is happening. It is also important to understand that it is precisely because economic growth is improving that there is speculation that the Fed will taper asset purchases. And so, we may have entered a period where market sentiment materially shifts from a position where markets respond positively to any sign that the economy is improving to a new position, one that views positive economic news in a negative light because every positive data point brings the end of QE a little closer.

During the press conference that followed the Fed's June 19, 2013 policy announcement, Fed Chairman Ben Bernanke confirmed that with employment improving and the economy growing at a moderate pace in spite of significant fiscal headwinds, it may become appropriate to reduce the pace of QE. He also confirmed that if the data continue to meet the Fed's forecast, the slowdown in asset purchases could potentially begin this year. A key point, which he did not specifically make, is that the U.S. economic recovery is having the very positive effect of materially reducing the U.S. fiscal deficit. As such, if the Fed reduces asset purchases in line with the reduction in the deficit, it may be considered to be providing the same level of liquidity even though the level of asset purchases is lower – i.e. $1 trillion in asset purchases when the federal deficit is $1 trillion provides the same amount of market liquidity as $500 billion in purchases when the federal deficit is $500 billion.

We believe it is also worth noting that tapering QE doesn't mean the Fed will be reducing its balance sheet. It has no plans to sell the securities it already owns. Rather, as the economy continues to improve and, therefore, require less stimulus, the Fed plans to reduce the number of new purchases it makes. The reduction in purchases will take place gradually while the Fed continues to monitor economic growth to ensure it is meeting expectations, even with the lower level of stimulus. In addition, the Fed has made it clear that it intends to keep the federal funds rate at its current 0-0.25% range even after the QE program has ended. It does not plan to consider raising the rate until the unemployment rate is at or below 6.5%.

With the Fed pledging to maintain the current federal funds rate for some time to come and global central banks also remaining highly accommodative, we anticipate that yields will stay low for some time to come. The gradually improving economic activity that the Fed seems to be confirming is taking place supports the TD Wealth Asset Allocation Committee's preference for high-quality dividend-growth stocks over bonds as the better risk-adjusted means of protecting the real (after inflation) value of savings.

At TD Asset Management, we continue to stay true to our philosophy of focusing on quality, with a commitment to seeking the best risk-adjusted returns for our clients. We continue to monitor and evaluate this, and other events, and to assess conditions with the objectives and best interests of our clients in mind.■

**Bruce Cooper, CFA**

Vice-Chair, Active Equities & Fund of Funds,
TD Asset Management

**Ken Miner, CFA**

Vice-Chair, Fixed Income, Derivatives &Currency
TD Asset Management