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CAPITAL MARKETS RESEARCH

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Special Report: Do Record-Low Treasury Yields Make QE3 Pointless?

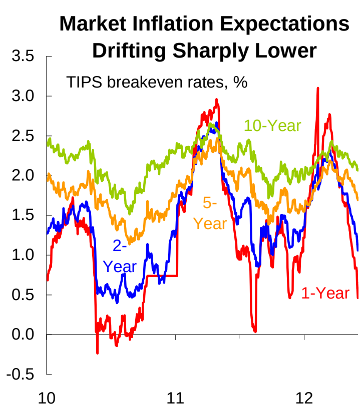
- **No, and the key lies in recalling how Chairman Ben Bernanke justified QE2's impact.**

A line of reasoning against additional Fed stimulus has posited that there is no point to offering additional bond purchases since it's next to impossible for the Fed to drive borrowing costs lower with Treasury yields sitting at their lowest levels ever. There is a fair point to be made here, but it gives short shrift to how Federal Reserve Chairman Ben Bernanke explained why, in his opinion, QE2 and QE1 worked. Recall the following remarks from his speech on February 3, 2011 titled "The Economic Outlook And Macroeconomic Policy":

> "A wide range of market indicators supports the view that the Federal Reserve's securities purchases have been effective at easing financial conditions. For example, since August, when we announced our policy of reinvesting maturing securities and signaled we were considering more purchases, equity prices have risen significantly, volatility in the equity market has fallen, corporate bond spreads have narrowed, and inflation compensation as measured in the market for inflation-indexed securities has risen from low to more normal levels. Yields on 5- to 10-year Treasury securities initially declined markedly as markets priced in prospective Fed purchases; these yields subsequently rose, however, as investors became more optimistic about economic growth and as traders scaled back their expectations of future securities purchases. All of these developments are what one would expect to see when monetary policy becomes more accommodative, whether through conventional or less conventional means. Interestingly, these developments are also remarkably similar to those that occurred during the earlier episode of policy easing, notably in the months following our March 2009 announcement of a significant expansion in securities purchases. The fact that financial markets responded in very similar ways to each of these policy actions lends credence to the view that these actions had the expected effects on markets and are thereby providing significant support to job creation and the economy."

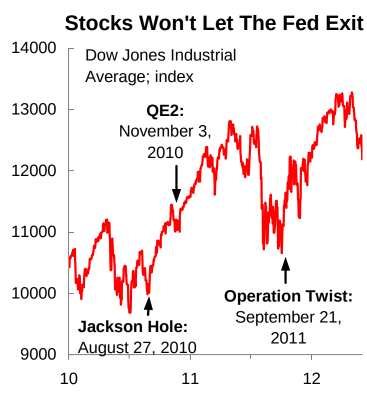
Judged through this context, it's clear that the Fed would not view the motivation for additional asset purchases solely in terms of pushing Treasury yields lower. Indeed, the Fed judged higher Treasury yields following QE efforts as a policy success that reflected averted deflation risk. Further, charts 1-3 showcase some of the factors that the Fed

Chart 1



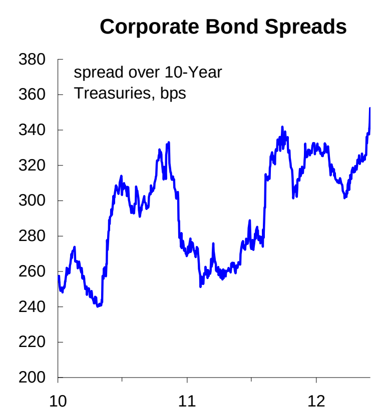
Source: Bloomberg, Scotia Economics.

Chart 2



Source: U.S. Federal Reserve, Bloomberg, Scotia Economics.

Chart 3



Source: Bloomberg, Scotia Economics.

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could point to this time around as justification for providing additional stimulus. As chart 1 demonstrates, market inflation expectations have drifted markedly lower since March. Thus, particularly if these trends push even further as we think they will, the Fed could argue that additional stimulus would be designed to ward off fatter tail downside risks to inflation either in the form of a too-sharp pace of disinflation or a return to outright deflation risk itself. Also, as chart 2 demonstrates, the recent equity correction would lend itself toward parallels in the lead-up to past rounds of Fed stimulus; the Fed leaned against corrections in order to attempt to improve market appetite. Third, corporate bond spreads have become very wide again such that corporations are not witnessing the flow-through effects of very low base yields. While strong safe haven flows into nominal Treasuries are distorting many ratios including TIPS breakevens, corporate bond spreads and equity indices, that's precisely the point that the Fed could make in justifying additional stimulus in favour of risk seeking and for reasons beyond the ones we laid out in our pieces "Reasons Why Additional Fed Stimulus Remains On The Table," pp.4-6, *Global Views*, April 27th 2012; "Fed's Published Rate Forecasts Could Be A Warm-Up To QE3," January 20th 2012; and "Would The Fed Be Captive To The Electoral Cycle?" pp.5-6, *Global Views*, May 11th 2012.