

# Market Insight

## On your marks, get set, print

Quantitative easing (QE), otherwise known as credit easing or money supply expansion has become *the* dominant issue in FX markets; it has circumvented almost every other theme that was in play before or during the current financial crisis. Both long-term and short-term market participants have been affected by the fallout of QE policy announcements, their implementation and speculation surrounding future QE developments.

In our lifetimes very few people have ever heard of these trailblazing policies because the economic circumstances have never been so daunting. Demand has fallen exponentially in several asset classes simultaneously thus inducing anxiety over deflation. Deflation is a scenario whereby most participants of an economy decide to save their incomes, make very few purchases and most importantly, take very few risks. Such a reaction following all the hype about the heady days of too much lending, too much borrowing and too much spending seems logical. The rationale is that if households, businesses and governments have all over-borrowed and over-spent on assets that have either fallen in value or are simply not traded anymore, why should anyone want to borrow and spend now? Especially when the risk of doing business today is proportionately higher than before the crisis started.

Here is where quantitative easing comes in. Essentially, it is way of 'creating' money at least in the short-term but quite possibly over the long-term also. The money supply is expanded to enable economic activity to take place because of the hope/expectation that liquidity will be utilised by banks and consequently by other companies.

### QE in theory:

#### Stage 1:

The central bank creates money through the press of a button. £150bn has been announced in the UK, ¥13 trillion in Japan and \$300bn-\$1 trillion in the US. The new money is used to buy assets such as government bonds, corporate bonds or low-rate assets that are unlikely to recoup their purchase price. This particular component has been dubbed 'toxic debt' or 'distressed' assets. Banks are holding assets on their balance sheets that are simply not worth very much because no one else is willing to buy them. If losses are admitted and written-off this places a requirement on the bank to have a specific amount of supporting capital that will support the firm in consideration of the loss made. A negative spiral occurs because banks being scared to conduct banking activities in an attempt to preserve scarce capital reduces trust and confidence amongst other banks leading to widespread capital preservation. A bank that does not lend money is unlikely to prosper which is why money must be created and effectively 'given' to financial institutions to allow confidence, trust and business activity to return.



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### *Stage 2:*

Step 1 lowers the risk-free cost of borrowing because of an increase in the supply of money. The banks receive the newly created money in exchange for assets they either do not want (assets linked to mortgages for example) or assets that are readily available at any time (government bonds).

### *Stage 3:*

The banks place the funds on deposit with the central bank thus improving capitalisation ratios and in theory, incentivising banks to lend capital because of its abundance.

### *Stage 4:*

Banks choose to either lend capital to private individuals, companies, governments etc or to keep it on deposit with the central bank.

Ultimately, quantitative easing can only be successful if market participants make appropriate decisions. If capital is simply hoarded or if an insufficient amount of market participants respond to the easing in monetary conditions, we are likely to see a negligible improvement in economic activity alongside elevated inflation. In addition, confidence and sentiment are likely to fluctuate subject to developments in the rate of inflation, growth, employment, sales etc so even if QE policies have an effect and banks resume their pre-2008 levels of activity, it is still not a certainty that other sectors of the economy would prosper.

### **QE in practise**

Switzerland, Japan, the US and the UK have been primary adopters of QE policies. In nominal terms, the US and the UK are conducting the most stimuli (\$1 trillion and £150bn respectively) but in real terms, when considering the size of each economy it is actually the UK and Switzerland who have the largest QE policies when taking GDP size into account; the UK balance sheet will equal 23% of GDP and 40% in Switzerland.

Our research suggests that the Bank of England's actions will accelerate UK monetary base growth from 28% currently to over 205% by Q4 2009. The UK's QE policy is by far the most aggressive and could either lead the UK economy to recovery before any other country but at the same time it could generate substantial inflation and capital flight from the UK. It is possible that the cure may turn out to be worse than the disease if things do not go to plan.

The first auction of Gilts totalling £2bn was done on March 11<sup>th</sup> with larger than expected demand. However, the most recent auction on March 25<sup>th</sup> was severely undersubscribed. As a side note, a US bond auction on the same day also had sanguine demand. There are fears that if weak bond auctions become a regular occurrence, countries like the US and the UK will struggle to finance mushrooming fiscal spending and be forced to pay higher yields in order to entice sufficient demand.

Further US bond auctions will take place on March 27<sup>th</sup>, March 30<sup>th</sup>, April 1<sup>st</sup> and April 2<sup>nd</sup>. The gap between issuance (supply) and actual bids (demand) will be of interest to investors. UK bond auctions are taking place twice a week and should also be paid some attention.

## QE within a broader horizon

Quantitative easing is much more difficult to pull off unless other countries are doing the same. If only one nation participates that increases the risk of investors fleeing and waiting to see what happens. This would be damaging for equities, the domestic currency, bonds, property and would put a firm cap on economic growth. If several nations conduct QE policies in unison we could see a change in investor psychology in that unprecedented money supply expansion would be regarded as a given thus preventing the shunning of one particular economy.

The US, UK, Switzerland and Japan have embarked on a path of creating capital which will be held on reserve thus freeing up banks to make use of existing capital. The pattern emerging so far is that only very strong nations (essentially, a select few from the G10) could ever hope to pull off sudden money supply expansion without severely negative consequences. Net creditor countries such as Japan, Switzerland stand a better chance of accomplishing the potential benefits of QE compared to net debtor countries such as US and the UK. Logically this makes sense; a country with a healthy fiscal balance has a higher probability of successfully digesting a rapid expansion in the money supply whereas a debtor country is burdened by having to finance its deficit on top of expanding the money supply.

Considering this we would speculate that the EUR, USD and even JPY have a safe-haven allure which could counter-act reasonable money supply expansion whereas Sterling is far less well regarded considering rapidly increasing government debt, very high correlation between UK prosperity and financial services, the likelihood that increased fiscal expenditure will take decades to repay, the overly optimistic recovery forecasts by the Bank of England and the UK government (growth to resume in late 2009/first half of 2010). All this is in addition to the unknown short/medium/long-term impacts that quantitative easing policy is likely to have. Also, countries such as Sweden and Canada are reportedly close to announcing their own QE plans with a likely negative impact on SEK and CAD. However, very conservative programmes could be seen as a positive because of how they contrast with QE policies elsewhere.

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