October 29, 2014 2:49 am

Fed's grand experiment draws to a close

Michael Mackenzie in New York Author alerts

A grand experiment in US monetary policy is coming to an end. When the Federal Reserve releases the statement from its October meeting on Wednesday afternoon, the moment is almost certain to mark the end of the liquidity and stimulus programme known as quantitative easing.

Investors are already prepared for the Fed's last $15bn of monthly bond purchases to cease. Now, they are betting that it will replace its extraordinary actions with soothing words to limit the volatility markets have seen earlier this month.

The hope is for language that suggests any tightening of monetary policy remains a story for the latter half of 2015, defusing any return of that kind of market turmoil. In mid-October the S&P 500 briefly erased all of its gains for 2014 and Treasury yields plunged. But since then the focus on the Fed's next statement has helped markets stabilise, with shares prices and junk bonds rebounding smartly.

The question facing investors after nearly six years of large scale bond purchases that have swollen the Fed's balance sheet to $4.45tn, is whether the US economy can prosper sufficiently to justify the large appreciation seen in asset prices.

As the curtain closes on the Fed's third instalment of quantitative easing – QE3 – this month's market turmoil provides a glimpse of what may lie ahead for investors with the central bank no longer pumping liquidity into the financial system. Some believe the end of QE will reveal which of those asset classes have been lifted by their own fundamental strength, and which of them have merely been floating on the tide of US dollar liquidity.

"We have never seen such an extraordinary experiment in monetary policy and markets and the Fed are both worried about the exit from QE," said Win Thin, global head of emerging markets strategy at Brown Brothers Harriman.

Such a backdrop supports the general view that the Fed will provide markets with a friendly or dovish statement on Wednesday and in effect wait to see how forthcoming data unfolds. The S&P 500 rose 1.2 per cent on Tuesday ahead of the Fed meeting, and the broad benchmark has recovered nearly 7 per cent from its low in mid-October.

Interactive

Tracking the US market benchmarks

Charting the historical divergence in the S&P 500, the world's largest equity market, and the 10-year Treasury note yield

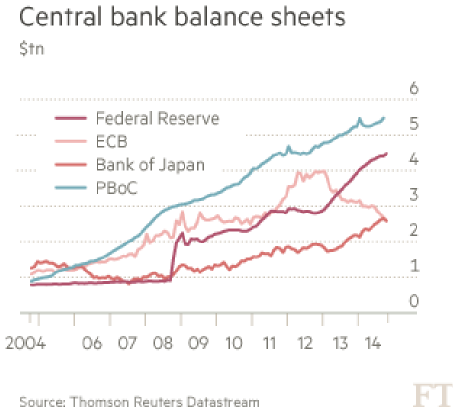
"With domestic economic growth momentum beginning to leak lower, and the medium term outlook for the recovery and inflation becoming less certain, we expect the statement to be tweaked sufficiently to reflect a more dovish bias towards the near term monetary policy stance," said Millan Mulraine, strategist at TD Securities.

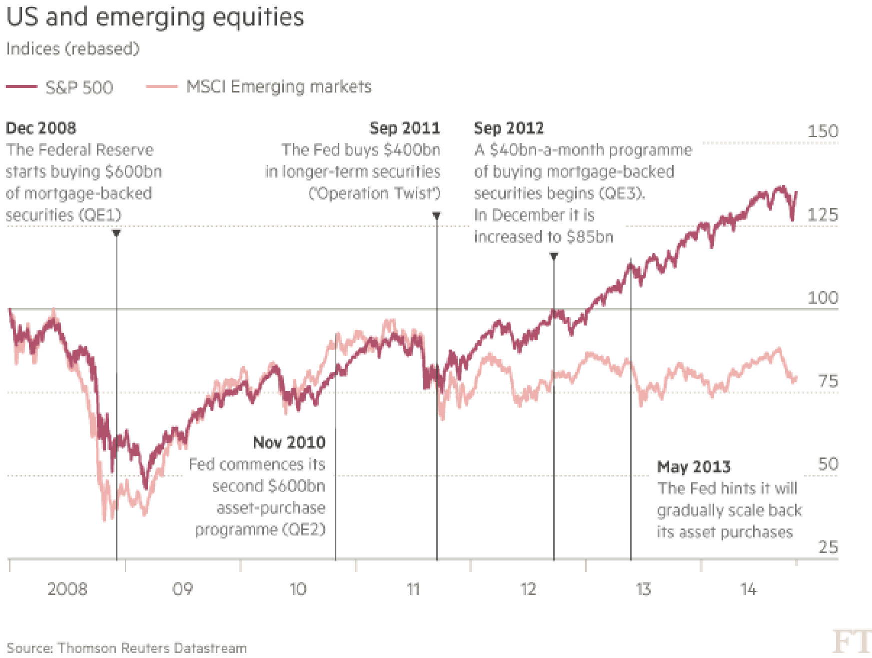
Within the Fed, however, there are policy officials who believe interest rates should start to rise relatively quickly once QE ends – and that could open the possibility of a less dovish statement.

"The risk, however, is that the statement fails to live up to the overly dovish tone that the market may be expecting," Mr Mulraine added.

Another factor supporting asset prices as the Fed ends QE comes from other central banks borrowing from the Fed's playbook. The Bank of Japan continues ramping up its bond-buying programme, as speculation rises that the European Central Bank will follow suit.

Moreover, the Fed's balance sheet will remain elevated for some time and economists say that another bout of market turmoil and weaker US data could well spark another QE programme.





Letter in response to this report:

The QE 'experiment', as you insouciantly call it, is nowhere near an end / From Jon Moynihan

RELATED TOPICS US Quantitative Easing, United States of America, Central Banks, European Central Bank, Federal Reserve USA