INVESTIME Insight

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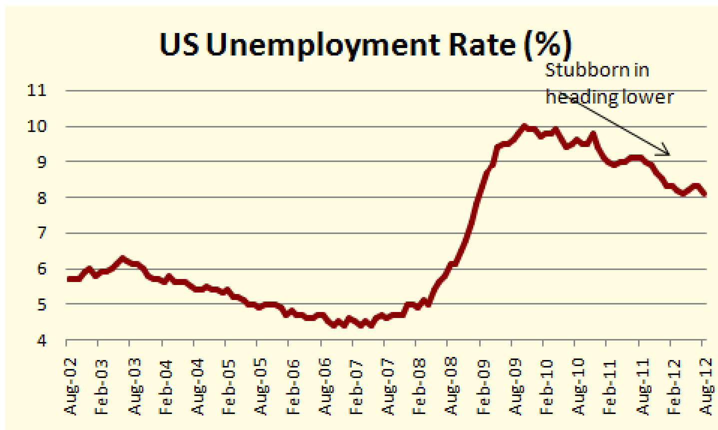
QE3 – Yet another Financial Steroid

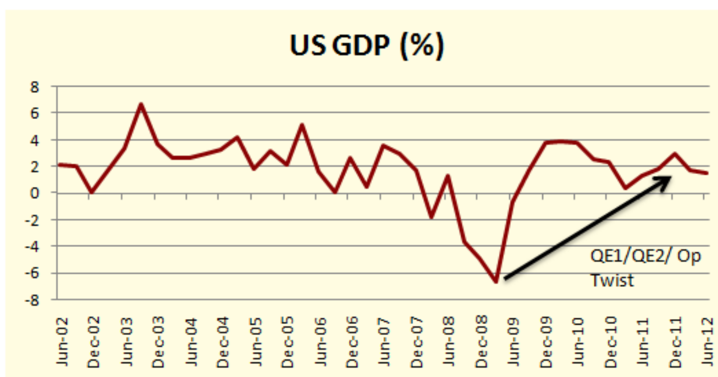
US Fed has finally launched QE3 (quantitative easing) yesterday after resisting for the past few quarters as economic data continues to be weak and was forced to take action after ECB came out with its Operation OMT (Outright Monetary Transaction). This QE3 is different from QE1 and QE2 as the previous programmes were one shot large purchases of mortgage backed securities, while QE3 is an open ended one. Under QE3, Fed will buy USD 40bn of mortgage backed securities per month and while maintaining Operation Twist 2 , will lead to a total USD 85bn of purchases every month but Operation Twist 2 will end by December 2012. Fed also has stated that it will maintain low or zero interest rates till mid 2015, compared to mid 2014 stated before.

Fed has stated that if the labor market does not show improvement **" additional asset purchases and other policy tools"** may be employed as appropriate until improvement is seen. It means that it is more concerned about labor markets rather than inflation and inflation has taken a backseat for the moment. August unemployment rate at 8.1% is still very high compared to pre recession levels of 6%, as lower unemployment means more spending by the consumers, industries being positive and increasing their investments and boost to the GDP.



Source: Reuters

Q2 GDP came in at 1.50% and was much lower than expectations as slowdown in the global economy has hit growth and updated economic projections are also pointing towards lower growth in 2012, but has been increased slightly for 2013 and 14. Unemployment is expected to come below 8% to 7.2-7.4% in next two years, but it is still higher than the long term average of 5.5%.



The aim of QE1 & QE2 was to release liquidity into the system and remove the toxic sub prime mortgage bonds from the books of the banks and financial institutions. Operation Twist 1 & 2 was launched to bring down the long term interest rates by buying US treasuries of maturities between 6 to 30 years and sell an equal amount of treasuries of maturities less than 3 years. QE 1 & 2 and Operation Twist 1 & 2 have expanded the size of the fed balance sheet to almost USD 3.07trn. These measures ,though have managed to bring the economy out of its stupor, is not that effective in creating jobs as global economy is heading towards a slowdown and European sovereign debt crisis continue to haunt the markets and investors.

The major impact of QE 1& 2 was sucessful in increasing the prices of commodities and gold. At the end of QE1, most asset classes performed well and QE2 saw commodities continuing to rally and equities starting to slowdown due crisis building up in Europe. Gold has been one of the top performers due to weakening of the USD and also due to bouts of risk aversion that the markets have seen in the past few years. Gold may continue to rally higher due to the weak monetary policy stance by several central bankers around the world.

Further increase in commodity prices especially crude oil are negative for countries suffering from high inflation and slowing growth (India, Brazil & China).

QE market reaction

Asset performance following previous U.S. quantitative easing announcements — Percent change

QE1 announced	1 week after	1 month after	3 months after	6 months after	1 year after
Developed equities	-1.9	3.2	-10.9	11	40
Emerging equities	0.2	10.5	1.5	51	101
CRB commodities	-1.5	0.3	0.9	15	36
Brent crude oil	-9.8	-27.3	-12.0	20	56
Gold	-4.8	2.8	15.6	17	45
Industrial metals	-5.7	-17.6	-15.4	6	56
Soft commodities	1.0	-0.1	5.8	23	43
QE1 expanded					
Developed equities	5.2	12.1	23.0	47	56
Emerging equities	8.0	18.6	38.1	72	89
CRB commodities	2.6	10.2	19.0	28	46
Brent crude oil	8.6	11.9	49.1	50	71
Gold	-0.7	-7.7	-0.8	7	20
Industrial metals	3.7	21.1	29.3	57	89
Soft commodities	1.2	3.4	11.2	37	30
QE2 hint Jackson Hole					
Developed equities	3.9	8.5	11.8	24	10
Emerging equities	3.5	9.7	11.9	14	3
CRB commodities	1.3	6.3	6.8	23	19
Brent crude oil	0.0	2.5	11.7	46	45
Gold	0.8	4.7	10.3	14	48
Industrial metals	3.0	8.1	9.3	28	16
Soft commodities	3.6	20.0	33.4	74	64
QE2 announced					
Developed equities	-1.1	-1.1	5.9	10	-2
Emerging equities	-1.1	-2.5	-1.5	3	-12
CRB commodities	0.5	-0.2	12.0	12	1
Brent crude oil	0.9	3.9	13.4	38	27
Gold	1.2	1.6	-3.1	9	26
Industrial metals	1.5	-2.7	10.5	6	-13
Soft commodities	-2.0	-4.0	12.9	2	-3

Source: Reuters

Markets have reacted positively to the announcement as most markets rallied around the world and Indian markets closing at a 7 month high. Crude and gold prices have also rallied and will continue to rally going ahead. Current high market levels gives investors an opportunity to churn their portfolios by getting rid of poor or weak stocks and funds.

More challenging times remain ahead as we enter into a "**new normal**" situation of low growth scenario as US is expected to grow by 1.5% for 2012, Eurozone GDP is expected to be -0.4%, Indian growth is estimated at 5-50% and China to be below 8%. A permanent solution to the Euro crisis is not yet found even though Operation OMT is a step in the right direction. US elections in November along with the issue of "**Fiscal Cliff**" will come into play and investors may exercise prudence while making some hay in the sunshine.

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