Payden&Rygel

Economic Update

THOUGHTS FROM OUR ECONOMICS TEAM

OCTOBER 30, 2014

A TEST OF THE THEORY WE'VE HEARD MOST OVER THE LAST 6 YEARS

Yesterday inaugurated a test of the theory we've heard most over the last six years: Treasury bond yields are ONLY where they are (i.e, "artificially low") because of Fed money printing and bond buying. Treasuries are a "bubble" that will burst once the Fed stops buying. One famous bond manager asked rhetorically: "Who will step in when the Fed steps away?" Another wondered, "Who will finance the US budget deficit if the Fed is not buying bonds?"

On account of these fears, we welcomed the results of the FOMC's October meeting. Aside from reporting that "market-based measures of inflation compensation hav[ing] declined somewhat" (a key concern for central bankers as we highlighted last week) and re-iterating that a "considerable time" remains before the first rate hike, the Fed ended their QE3 asset purchase program as most investors expected. While technically the Fed will continue buying bonds to maintain the current size of its balance sheet ($4.4 trillion), this is the way QE ends, not with a bang but a whimper.

A whimpering end to the largest asset purchasing program in U.S. history? That's right, no hyper-inflation, no 5% Treasury yields, no cataclysmic equity market selloff, failed Treasury auction or US dollar debasement. The US economy hardly noticed the incremental slowing of asset purchases in 2014. As we learned in this morning's first read on Q3 US GDP, if you look through the noise in the quarterly reports, annual GDP growth remains on track for 2% this year and has averaged 2.2% year-over-year on quarterly basis since 2010. Payrolls, too, are growing at 2% year-over-year, and inflation has not budged from a steady 1.5% year-over-year rate.

As far as experiments go in the economics world, the end of QE is as close as we can come to a lab experiment. We think it shows that the theory we've heard about most in the last 6 years was flat out wrong. What we think investors will realize is that QE was not all it was chalked up to be. The US economy will grow without a central bank buying its own government's buying bonds. Virulent inflation is not just around the corner. Instead, inflation could be "sticky" below the Fed's target in the near-term. And US Treasuries, not to mention corporate bonds and equities, remain an attractive destination for investors all over the world. As a result, the dollar, instead of being debased, looks like it has found its footing and should continue to gain strength. Finally, for bond buyers, low interest rates reflect low inflation, moderate growth, and the growth in global savings more than they do just the machinations of central banks.