WEEKLY MARKET THOUGHTS

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Europe Goes QE

This past week, Mario Draghi, the President of the European Central Bank (ECB) announced that the ECB was going to launch Quantitative Easing (QE) strategies, in which European central banks will purchase $65 billion of bonds from the open market every month. There wasn't a "formal" time frame announced during which these purchase actions would occur. It appears total purchases will be approximately $1 trillion, closely resembling the U.S. Federal Reserve's QE3 action in size and scope.

Why is the ECB launching this action? What do they hope to accomplish? ***Europe's GDP growth rate has stagnated. Deflationary pressures are high and inflation is largely absent from the European scene. In addition, European unemployment rates are higher than 10 percent. The continent has experienced two recessions since 2008. In other words, European economic growth has evaporated. The ECB hopes a massive $1 trillion cash infusion into their economy will revive spirits. Will their new QE action work? We are skeptical.***

Quantitative Easing – What Is It and How Does It Work?

Quantitative Easing (QE) is central bank activity where bonds (usually high-quality government bonds) are purchased by the central bank and held as a liability on their balance sheet. The money paid for the bonds is primarily used by those selling the bonds (banks/insurance companies and other large institutional investors) to purchase riskier assets (lower quality bonds or stocks). Where does the central bank get the money to purchase the high quality bonds? They essentially "print" the money. Again, the goal of these actions is to increase overall economic vitality and growth.

As banks, insurance companies and other investors sell their government-backed bonds to the central bank. The proceeds from these sales will primarily be used to purchase other "riskier" assets. As these purchases take place, the asset values of their "riskier" assets normally rise, creating financial benefit. How does a rise in asset values (stocks and riskier bonds) effect economic activity? As asset values rise, people feel wealthier – and consumption increases tend to follow after a period of time. This transmission mechanism is known as the "wealth effect." Central bank QE actions are undertaken to spur higher economic growth through the "wealth effect," or rising asset values, which spurs economic activity and consumption.

The ECB will take these actions over the next several months to the tune of $65 billion in asset purchases per month.

Historical Precedent

Will economic activity increase in Europe due to QE? Are there precedents as to the effectiveness of this type of QE? The U.S. Federal Reserve has launched three different QE actions since 2008. Have these actions been effective? It depends on what is considered "effective."

Following are capital market results which occurred in the U.S. markets during the last three QE actions taken by the Federal Reserve over the last number of years.

Date of QE Activity	Change in U.S. Treasury Bond Yields	Change in Value of Dollar to Euro	Change in Value of S&P 500 Index
12/2008 – 3/2010	+1.12%	-4.5%	+42.9%
11/2010 – 6/2011	+0.52%	-3.5%	+10.7%
9/2012 – 10/2014	+0.76%	+1.2%	+38.3%
Average	**+0.80%**	**-2.3%**	**+30.6%**

As can be seen from the above, the capital markets certainly reacted strongly when QE actions were undertaken by the Fed. On average, interest rates (10-year U.S. Treasury Bonds) rose by 0.80 percent, the value of the dollar fell by 2.3 percent to the Euro and the S&P 500 rose by a massive 30.8 percent in value. Did these capital market reactions provide the "wealth effect" with rising GDP growth the Fed was seeking? Did "follow on" positive economic activity occur after the end of QE activities?

The following data details the GDP growth in the United States both during and following each of the last three periods when QE actions were undertaken.

Date of QE Activity	Concurrent GDP Growth	Resulting 12-Month GDP Growth
12/2008 – 3/2010	0.2%	1.9%
11/2010 – 6/2011	1.3%	2.3%
9/2012 – 10/2014	2.5%	???
Average	**1.3%**	**2.1%**

The data above shows the "real" GDP growth rate of the U.S. economy during the time the Fed was conducting QE actions in the United States, and the average 12-month growth rate following the end of each round of QE activity. On balance, GDP growth accelerated after the first two QE actions by an average of about 1.5 percent. However, as a point of reference, the long-term (50-year) average GDP growth rate in the United States has been 3.2 percent. Out of the 23 calendar quarters of GDP activity from 12/08 to 10/14 (period covered above when QE activity was ongoing) U.S. GDP grew by more than 3.2 percent in only seven quarters – or a mere 30 percent of the time. So, the true effectiveness to the overall economy of QE actions is, at best, questionable.

QE actions taken by the Fed over the last six years have provided significant lift to asset values, while the resulting positive impact on the "real" economy has been questionable. Some take the "counter factual" argument that if the Fed hadn't taken QE actions over the last six years our economic growth rate would have been lower than we experienced. As with any "counter factual" argument, these claims can't be proven or denied.

Europe's QE Actions and Our Expectations

Will the ECB's QE activity "work?" Let's take a look at one last piece of data. Let's compare U.S. economic growth to Europe's economic growth (annual "real" GDP growth) over the period when QE actions were occurring in the United States.

	2009	2010	2011	2012	2013	2014	Total Economic Growth
U.S. Growth	-0.2%	2.7%	1.7%	1.6%	3.1%	2.5%	11.2%
Europe Growth	-4.5%	1.9%	1.7%	-0.7%	-0.4%	0.8%	-1.4%

Over the last six years the U.S. economy has grown by 11.2 percent (un-annualized) while the European economy has actually shrunk by 1.4 percent. Obviously, something needs to change in Europe. Will QE do the trick and return Europe to a more sustainable overall growth rate?

I Am Skeptical

I am skeptical that QE, by itself, will lift European economic growth on a sustained basis. It's important for investors to understand that Europe's economy is plagued with issues that the United States doesn't face. Demographically, the population in a number European countries are older than the United States. In addition, they have smaller, less productive work forces. Additionally and importantly, the Euro currency is the national currency for 19 sovereign countries that all have independent tax and spending policies. In other words***, there is one monetary policy affecting 19 separate countries with different fiscal policies. I have long held the view that the current state of monetary/fiscal policy determination in Europe is not sustainable.***

Given Europe's systemic problems*, **I don't expect Draghi's announced QE actions to provide an upward push in sustainable overall economic growth.*** Will Europe's capital markets rally to higher values? ***I suspect Europe's stock markets may indeed rally while QE actions are occurring. Certainly, we have precedent in the United States that stock values tend to rise during QE actions. What about the other ramifications which Draghi and the ECB want to effect? Their desire is to lower the value of the Euro to the dollar, spurring overall export growth. On balance, this didn't happen in the United States when the Fed was conducting QE operations over the last six years as the dollar tended to contract in value to the Euro during our domestic QE periods. Also, interest rates rose in the United States while QE actions were ongoing.***

Bottom Line

We are skeptical, due to deep non-monetary problems, of the current QE activities actually increasing economic vitality in Europe. The Greek election this weekend adds to the uncertainty, as a left-leaning government has moved into power in Athens. This isn't good news for the stability of the Euro currency.   Worker productivity has been weakened while capital investment in the private sector has lagged.

All of this being said, we may indeed see European equity assets appreciate in value over

the next year while QE actions are ongoing. This was certainly the experience of U.S. stock market investors while the Fed was conducting QE actions. That being said, there are numerous fundamental frailties of the European economic system. If investors increase exposure to the European markets over the next year in hopes of participating in a rise in equity markets, we advise taking a short-term view of the positive aspects of European equity ownership.

We will be back next week.

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