

May 12, 2011

## QE2 Ends Like Y2K

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Concerns about the end of QE2 have put downward pressure on equities and bond yields. We think this will ease.

- We expect the consensus outlook to improve as it did in the face of Y2K. Like the June 30 end of QE2, Y2K crash warnings had a date certain, January 1, 2000, to worry about, causing months of hand-wringing due to the uncertainty. Equities ended up rallying over 15% in the final three months of 1999 and went higher in following months. We expect a substantial flow from bonds to equities in coming months as the growth outlook improves, inflation rises and the uncertainty over the end of QE2 is finally resolved.
- Today's \$16 billion 30-year bond auction had the weakest number of bids per bond since November. We think this signals a decline in risk aversion and a weakening of the bond squeeze that has dominated bond yields in recent weeks (see Bond Squeeze Nearly Over on May 3.)

### 10 Year U.S. Treasury Yield (last obs. May 12, 2011)

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Source: Federal Reserve; Encima Global

- Short-term interest rates and Treasury bond yields were being squeezed down by what we think were temporary factors, giving a false impression of market-based pessimism and risk aversion and a disconnect between falling bond yields and rising equities.
- Several factors caused what we think was an artificial month-long decline in bond yields from April 11 through May 6: 1) the view that the end of QE2 was a tightening by the Fed – but QE2 isn't money printing and ending it isn't a tightening given the increasingly negative real Fed funds rate; 2) the April risk that the \$14.3 trillion debt limit might have suspended Treasury issuance while the Fed was still buying heavily – but due to strong April tax receipts and technical factors, Treasury now has headroom to continue regular deficit funding into August, lifting the squeeze; 3) a major bond fund's April announcement that it was short U.S. Treasuries; 4) the concern that the economy was slowing – we think it peaked with the very high May 5 initial jobless claims reading; 5) a change in bank capital adequacy standards that disrupted the repo market and short-term credit markets, depressing the front end of the yield curve.

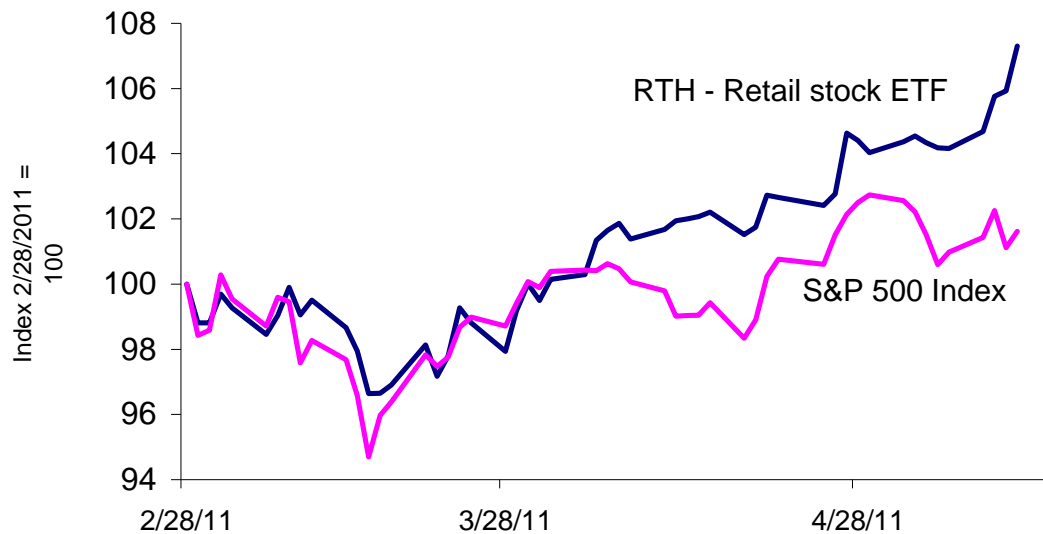
### **Past the Low Point**

The April low point in the consensus outlook had a long list of concerns beyond QE2 and falling bond yields. These included the oil price spike, the ECB's rate hike on April 7, Japan's severe crisis, China's aggressive monetary tightenings, the first quarter weather-related letdown in U.S. GDP and the deterioration in peripheral European debt markets. While each of this is a negative, we don't think they will derail the global expansion, leaving room for an improvement in the outlook (see Tall Wall of Worry; Good Second Half Outlook on April 15.)

### **We note several positive developments:**

- Retail stocks are rising. Consumer credit has increased six months in a row (through March) after 20 months of shrinkage. We disagree with the view that consumer debt will constrain consumption – the key variable in consumption is the employment climate which is gradually improving. Today's retail sales data was a bit weaker-than consensus, but there were upward revisions to previous months and the net result is consistent with our expectation of over 3% real growth in the second quarter. Retail sales are up 7.6% yoy. Excluding autos, gas and building materials (which is an input for GDP), sales are up 5.5% yoy.

## Retail Stocks Outperforming the overall Market (last obs. May 12, 2011)



Source: Bloomberg; Encima Global

- April tax receipts were strong. This suggests economic strength. More importantly, it helped Treasury delay the debt limit problem beyond the Fed's final QE2 bond purchases in June. **We think the timing change for the debt limit increase broke the bond squeeze and will reduce the sensitivity of financial markets to the debt limit increase.**
- April payroll data was strong, consistent with today's sizeable upward revisions in February and March retail sales data.
- Bearish sentiment and continuing confusion about QE2 provides upside – for example, some analysts are asserting that M2 growth will drop when QE2 ends because that Fed will stop increasing excess reserves (yet excess reserves aren't part of M2).

We expect the U.S. to continue very loose monetary and fiscal policy – meaning a near-zero Fed funds rate and over \$3.7 trillion per year in federal spending. We look for a moderate 3%-3.5% U.S. growth rate in coming quarters -- that's disappointing given the severity of the recession and won't create the surge in small-business jobs needed to pull the unemployment rate quickly below 8% but is fast enough to dispel the QE2 concerns and QE3 predictions.

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