



## Investment Alerts Archive

### What's next after QE2?

#### With the end of QE2 scheduled in June, what will that do to the world's economy and your portfolio?

On 3<sup>rd</sup> November 2010, the Federal Reserve announced its second quantitative easing (QE2) plan to inject US\$600 billion into the ailing US economy in an attempt to accelerate growth and spur recovery from the deepest recession since the Great Depression.

Seven months have since passed and now with the Fed's bond-buying binge drawing to a close on 30<sup>th</sup> June, what could be the likely impact? Would it spell trouble and mirror the impact seen last spring when stocks and bonds tumbled with the end of the first round of quantitative easing? Or would it set US economy on route towards recovery and send cheers as inflationary threats exacerbated by QE2 diminish?

#### What is Quantitative easing (QE)?

Quantitative easing (QE) is an unconventional monetary policy adopted by central banks to increase money supply in the market by buying up government and other securities in the market with money created ex nihilo. By flooding financial institutions who sold such securities with capital, the central bank hopes to promote increased lending and liquidity.

QE is usually used when interest rates are already at near-zero levels but failed to stimulate the economy. In the early 2000s, Bank of Japan adopted QE in an unsuccessful effort to combat deflation. Subsequently, QE was also adopted by UK, US and the Eurozone in the recent 2007-2010 financial crisis.

#### Impact on US

- Higher bond yields.** By the time QE2 ends, the Fed would have bought an average of \$75 billion of bonds every month. This represents a substantial proportion of all bond issuance since November 2010 and come 30th June 2011, bonds yields would be expected to rise without the demand created from QE2 credit. Moreover, bond yields have been rising since the beginning of QE2 on the back of an improving US economy. This has set the path for yield appreciation which would be further catalyzed with the withdrawal of the Fed as a significant buyer. Bill Gross, the portfolio manager of the world's biggest bond fund – PIMCO Total Return Fund, has already sold off all US government debt in anticipation of a spike in Treasury yields. However, we do not expect the federal funds rate to increase quickly in a short period of time and a more gradual appreciation of the treasury yield could be seen. **For the investor:** Investors should consider bonds with shorter duration to benefit from the expected increase in bond yields. One of the funds to consider is **Allianz US High Yield Fund** which has a duration of 4 years and provides exposure into the high yield spectrum.
- Opportunities in equities.** Upon the withdrawal of further liquidity, US equity markets could experience a pull back as witnessed when the Fed wrapped up QE1 in 2010. However, stocks are expected to be more resilient than bonds given stronger fundamentals in the US, cheap valuation and rising sales and profits for many S&P500 companies. **For the investor:** This represents buy-on-dip opportunities for US equities. Investors can look into **Equity-linked Convertible Investments** to seek to enhance their yield while waiting for the opportunity to enter. The investor should opt for more defensive plays in the current market like healthcare and consumer staples sectors.
- Appreciation in US Dollar.** The Fed's conclusion of its effort to flood the market with liquidity will inevitably reduce supply of the dollar and hence raise the greenback's value. This is further supported by the recent uncertainty surrounding the end of QE2, which may spur the unwinding of risk currencies, in turn helping the US dollar appreciate. **For the investor:** For the US dollar to show sustained appreciation on the back of possible tightening monetary policy in 2012, it would require stronger economic fundamentals to be seen in the US. Thus, for clients who are holding on to predominantly US based assets, they may wish to consider diversifying into other currencies, like Asian currencies, by converting directly, or by having exposure through **Dual Currency Returns** investment.

#### Impact on Asia and Emerging Markets

When the liquidity tap runs dry at the end of June, we could expect an outflow of funds from Asia and Emerging Markets (EM) back into developed markets like the US on the back of more attractive valuations. This shift of funds, coupled with uncertainty surrounding the end of QE2 may result in a slowdown in Asian and EM equities in the coming months.

Nonetheless, the broad-based assessment is still positive on Asian and EM equities for 2011 over the longer term as current stock valuations are inexpensive and bets are on EM to continue delivering higher returns. Despite current concerns on rising inflationary pressures, we are witnessing continual global economic and profit recovery that are expected to extend the Asian bull-market run which began in Mar 2009. **For the investor:** One strategy to yield benefits out of Asian equities is to diversify broadly into the Asian ex-Japan arena by buying into funds like **Aberdeen Pacific Equity Fund**. A more defensive approach can also be achieved by buying into funds that focus on high dividend-yielding counters, like the **First State Dividend Advantage Fund**.

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