

A fundamental look at the end of Quantitative Easing 2

Summary

In September 2010, Fed Chairman Ben Bernanke indicated his intentions to deploy a second round of Quantitative Easing ("QE2"), triggering sustained equity market rallies (S&P500 has moved up about 30% since his comments), and improved economic outlook.

Last week, Mr Bernanke confirmed that the QE2 programme will end in June 2011 and a third round of quantitative easing is off the table for now.

We think that the end of QE2 does pose clear risks to bond and equity markets. However, in and of itself, it will not stall the US recovery.

In this environment, we continue to recommend overweight in equities and commodities as the base case outlook remains favourable. But we highlight that the risks are increasing and we will likely adopt a slightly more cautious approach to the investment portfolios in the coming months.

The Fed announces QE2 programme to end in June 2011

In September 2010, Fed Chairman Ben Bernanke indicated his intentions to deploy a second round of Quantitative Easing ("QE2"), triggering sustained equity market rallies (S&P500 has moved up about 30% since his comments), and improved economic outlook.

Last week, Mr Bernanke confirmed that the QE2 programme will end in June 2011 and a third round of quantitative easing is off the table for now. The Fed also raised its inflation forecasts, and shaved the full-year GDP growth forecast this year to below 3.3 percent from 3.9 percent previously. However, the Fed did confirm that it would continue to reinvest the proceeds from the maturing mortgage-backed and Treasury securities to avoid a sudden plunge in liquidity.

Concerns over the end of the second quantitative easing programme in June this year are understandable given that the massive liquidity boost has been a lifeline for both the economy and financial markets. The fear is that without the liquidity, US rates may instantly jump, thereby causing a drop in consumer and business confidence along with a spike in business costs.

We think that the end of QE2 does pose clear risks to bond and equity markets. However, in and of itself, it will not stall the US recovery. Equities and bonds broadly rallied on news of both QE1 and QE2. Market performance following the end of the first liquidity program was likely more a function of other exogenous factors, such as Greek sovereign debt crisis.

While there were fears that the end of QE1 would result in rising mortgage-backed securities spreads, Libor option-adjusted spreads on mortgage-backed securities actually tightened after the end of QE1. Equities, however, sold off due to the onset of Greece's debt woes and weaker US economic data.

Therefore, our view is that the end of QE2 should not trigger a spike in rates that will dent US economic activity and market performance. In this regard, our view is that US Treasury yields will probably remain range-bound for the rest of 2011, as most market participants would have already priced in the end of the QE2 over the past few months. For example, 10-year yields are now more than 100 basis points above the level seen in October last year when QE2 was officially unveiled. Furthermore, the Fed retains the option of reinvesting the proceeds from its mortgage-backed investments into Treasuries after the programme.

Long-term interest rates may see limited movement, as the long-end of the curve has remained largely sticky over the course of monetary easing. Given that short rates such as two-year yields are more dependent on incoming economic data and Fed's policy stance, it is unclear if the end of QE2 will trigger a broad-based sell-off in Treasuries.

The end of QE2 increases the risks that markets may react to external shocks. Significant increases in oil prices, sovereign debt woes, Middle East turmoil and further housing issues in the US may have a more pronounced impact should they happen.

The end of QE2 is likely to increase market risks

We would summarize that the end of QE2 may increase market risk. However, if one assumes that oil prices ease or at least stabilize at current levels, while the unrest in Middle East ebbs away, then it is likely that equities can still rise further, even if US long term rates drift higher from here.

While overall US economic data is still encouraging, we note some pockets of softness in confidence and ISM non-manufacturing. US growth expectations have been revised downwards since the end of the first quarter.

In this environment, we continue to recommend overweight in equities and commodities as the base case outlook remains favourable. But we highlight that the risks are increasing and we will likely adopt a slightly more cautious approach to the investment portfolios in the coming months.

Contact Details

Address 80 Raffles Place UOB Plaza 2 Level 3 Singapore 048624

24-hour Hotline 1800 222 2228 (Local) • (65) 6222 2228 (International)

Fax (65) 6532 3868

Email uobam@uobgroup.com

Website uobam.com.sg

Regional Offices

Singapore

Institutional Investments

Dennis Siew

Senior Director

Retail Investments

Norman Wu

Senior Director

Regional Investments

Faizal M. Fazluddin

Senior Director

Structured Investments

Chong Jiun Yeh

Executive Director

International Business (China)

Jasmine Lim

Senior Director

Brunei

Kamal Muhd

General Manager

Japan

Masashi Ohmatsu

Chief Executive Officer

Malaysia

Lim Suet Ling

Chief Executive Officer

Taiwan

Juang San Tay

General Manager

Thailand

Vana Bulbon

Chief Executive Officer

Important Notice & Disclaimers

This publication shall not be copied or disseminated, or relied upon by any person for whatever purpose. The information herein is given on a general basis without obligation and is strictly for information only. This publication is not an offer, solicitation, recommendation or advice to buy or sell any investment product, including any collective investment schemes or shares of companies mentioned within. Although every reasonable care has been taken to ensure the accuracy and objectivity of the information contained in this publication, UOB Asset Management Ltd and its employees shall not be held liable for any error, inaccuracy and/or omission, howsoever caused, or for any decision or action taken based on views expressed or information in this publication. The information contained in this publication, including any data, projections and underlying assumptions are based upon certain assumptions, management forecasts and analysis of information available and reflects prevailing conditions and our views as of the date of this publication, all of which are subject to change at any time without notice. UOB Asset Management Ltd ("UOBAM") does not warrant the accuracy, adequacy, timeliness or completeness of the information herein for any particular purpose, and expressly disclaims liability for any error, inaccuracy or omission. Any opinion, projection and other forward-looking statement regarding future events or performance of, including but not limited to, countries, markets or companies is not necessarily indicative of, and may differ from actual events or results. Nothing in this publication constitutes accounting, legal, regulatory, tax or other advice. The information herein has no regard to the specific objectives, financial situation and particular needs of any specific person.

You may wish to seek advice from a professional or an independent financial adviser about the issues discussed herein or before investing in any investment or insurance product. Should you choose not to seek such advice, you should consider carefully whether the investment or insurance product in question is suitable for you.

UOB Asset Management Ltd Co. Reg. No. 198600120Z