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## QE2 Wealth Effect on Hold

QE2, the Federal Reserve's second big try at goosing the economy out of its doldrums, was based partly on the idea that buying \$600 billion of Treasury securities would pull interest rates down, inspire capital spending, improve home affordability (and thus home prices), and make "safe" investments all the more uncomfortable by lowering their yields ever closer to zero and thus tempt anyone with idle cash to throw caution to the wind and commit anew to risk assets. Falling interest rates would jack asset values up, creating a consumer "wealth effect" – that feeling of rosiness hypothesized to come with seeing gains on paper and spending them as if they'd already been realized – and robust aggregate demand would finally emerge unspooked by its own shadow.

While my letter last month described QE2 as a potential non-starter, I didn't think it would wobble so quickly.

Interest rates have jumped, and the benchmark 10-year Treasury yield is up some 0.6%. This sounds like a mere smidge until you consider that it's proportionally 20% higher than it was when we were still finding Halloween candy wrappers in our kids' coat pockets.

While stocks have climbed a bit (nothing like gun-to-the-head monetary policy to elicit that response from equity traders), bond prices have stumbled. This is all the more remarkable given a global backdrop which should have been great for Treasuries as a safe place to hunker far from both the Eurozone's circus of dysfunction and North Korea's tantrums-by-howitzer – not to mention all the more ironic given that mutual fund investors had been net sellers of stocks and net buyers of bonds for

months prior (no wealth effect there, so far as recent investments go).

And what's this mean for housing? Somehow, we doubt this chart fell within Professor Bernanke's confidence interval for QE2's immediate outcomes:



Source: [www.bankrate.com](http://www.bankrate.com)

The prospective homebuyer who a month ago could put 20% down and borrow for 30 years fixed at 4.45% now must shoulder a loan at 4.90% – still a nice rate, sure, but one which means he can afford about 4% less house than before (keeping his cash downpayment and monthly principal and interest constant). It will take a recovery in household incomes to offset the challenge higher mortgage rates pose to real estate values. No wealth effect here either.

Well, can't stocks save us all? The funny thing is that they too, like all risk assets, price relative to a risk-free rate of return whose proxy is none other than (drum roll, please) the term structure of Treasury interest rates. While no T-bond maturity is long enough to approximate the duration on equities, we can infer from the abrupt jump in the Treasury curve that the appropriate risk-free rate is higher than it was a few weeks ago. Discounting at a higher rate means a future dollar is worth less today, so unless a snappier recovery is around the corner, either this higher risk-free rate is eating into the equity risk premium that can be earned, or stock prices will meet headwinds as they adjust for numbers running away from where QE2 intended. Not the end of the world, but not rosy either.