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Why the Fed tapering could cause a seven month Slump

Quantitative easing programs are programs intended to stimulate a country's economy as part of its monetary policy. They have become an important monetary policy tool for many central banks around the globe.

The Federal Reserve has used these to raise the money supply within the US economy without changing the Federal Fund rate. US Quantitative Easing programs have a greater impact on many financial markets than any other because of its size and the contribution of the US to the global economy. They are likely to affect interest rates and asset prices in many countries.

Ever since the collapse of Lehman Brothers in 2008, The Federal Reserve has launched three QE programs as a tool to fight against rapid unemployment in a recessionary environment. All these actions have resulted in the unemployment rate drifting downwards to 7.6% from the pre-crisis levels of11%.

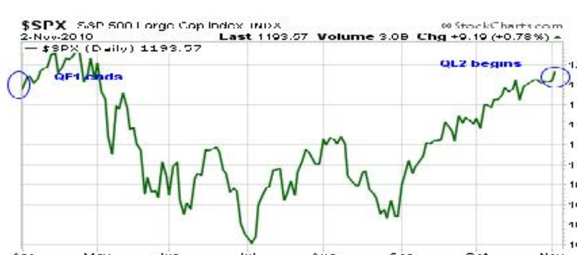
QUANTITATIVE EASING 1(QE1)

This program was carried out for the period December 2008 to March 2010 under which the Fed announced that it would purchase up to $600 billion in agency mortgage securities (MBS) and agency debt. However on March 2009, the FOMC announced that the program would be expanded by an additional $750 billion in the purchase of agency MBS and agency debt and $300 billion purchase of treasuries.

The following table illustrates the effect of QE 1 on major indices and commodities

Index/Commodity	Dec-08	March-10	% Change
S&P 500	**880**	**1166**	**32.50%**
DJIA	**8700**	**10900**	**25.29%**
FTSE	**4100**	**5720**	**39.51%**
NIFTY	**2755**	**5300**	**92.38%**
Crude	**48.9**	**82.37**	**68.45%**
Gold($ per ounce)	**768**	**1113.6**	**45.00%**

This exuberance was lost when the Fed decided to pull the plug on QE 1 as a result of which stocks fell 11% in just over two months that followed post QE 1. It took until November when a second round of QE was implemented for stocks to fully recover.



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QUANTITATIVE EASING 2(QE 2)

Under this program, the Fed announced that it would purchase $600 billion of longer dated treasuries at the rate of $75 billion per month. This program was carried out for the period November 2010 to June 2011. The following table illustrates the impact of QE 2 on major indices and commodities.

Index/Commodity	Nov-10	Jun-11	% Change
S&P 500	1199	1343	12.01%
DJIA	11192	12582	12.42%
FTSE	5745.32	5989	4.24%
NIFTY	6117.55	5647.4	-7.69%
Crude	75.3	79.7	5.84%
Gold($ per ounce)	1318.6	1486	12.70%

As QE 2 ended on June 30, 2011, the five weeks that followed witnessed a 16.5% fall in stocks which didn't return to the end of QE 2 levels until early February. Once again, the recovery took seven months. This reaction is demonstrated in the chart below.

QUANTITATIVE EASING 3(QE 3)

This program was started on September 13 , 2012 under which the Fed articulated its commitment to purchase $ 40 billion of agency MBS per month until the labor market improved substantially. Then on December 12, 2012, the Fed authorized an additional $45 billion purchase of long dated treasuries taking the total tally to $85 billion.

Since QE 3, the S&P 500 is up by 11.5% which is just ahead of the 10.2% jump the index returned during QE 2 but well short of the 37.3% return posted during QE 1.

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CONCLUSION:

Empirically, markets have witnessed a sharp downtrend when QE ended. Given the not so favorable history, it's easy to see why investors have shown so much trepidation when they hear the Fed chief may soon be tapering its monthly bond buying program. It took almost seven months for the markets to recover from its first two QE closings with an average pullout of roughly 14%.

However, with the Fed announcing a glooming review of the US economy, certain headwinds does persist which makes it critical to continue with QE 3. In other words, tales of the Fed tapering its QE program was grossly premature. For the time being, investor fears are allayed after the Fed chief made a note last month with respect to tapering the program. Since that reference, a sense of trepidation has gripped onto investor which was again evident on June 19, 2013 when the Fed announced an optimistic outlook on the US economy resulting in a 1.38% drop in the S&P 500.

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