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Crisis of confidence Monetary stimulus might not work **Alan Rohrbach, Page 24**

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INSIGHT

'Taxulationism' – why the Fed's QE2 might not succeed

There are upbeat expectations for US "QE2". The hope is that quantitative easing will force long-term interest rates to truly abysmal levels, encouraging companies to seek returns via capital spending.

That is driving positive stock market expectations in spite of sceptics who point out it will not directly foment better conditions. The risk remains QE2 might not cure the US economy, yet will still weaken the US dollar and push Treasury bond yields up. As in 2009, during the Federal Reserve's first round of QE, an equities rally that reflected hopes that the economy might be on the mend raised the prospect of higher inflation expectations. That, in turn, pushed bond yields up – and prices lower – despite the Fed's buying Treasuries.

The reason QE2 might not work is that the real US crisis is not one of liquidity but of confidence borne of confusion on tax and regulatory expectations. Surveys of small business confidence by the National Federation of Independent Business have repeatedly shown that smaller companies see the future as bleak and also fear that currency confrontations might foment protectionism.

I call the combined impact "taxulationism". This is a creature of Congress that the Fed is being asked to tame. Yet it lacks the tools, which are legislative and not monetary. Unless some major portion of "the Obama programme" is repealed, the risk is that it will weaken the US economy and equity markets next year.

Hope in that arena is placed on Republican gains in US midterm elections. But positive sentiment that the US economy will be set right by Republicans holding almost half the Senate is misguided. The specific requirement that makes any real difference is a Grand Old Party majority in the Senate. With some Democrats running well to the Right, there will probably be a split US legislature.

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Any attempt to claw back even the most pernicious aspects of the legislation will be plagued by continued Democratic control of Senate committees. The majority party appoints the chairmen, and more members in many cases.

Which makes it likely all (or almost all) the programmes passed into law by the current partisan Congress will become real next year into 2012, because Barack Obama is seemingly no Bill Clinton. He has proved deaf to *vox populi* on pet projects. Healthcare reform was a massive distraction from the economic mission, and already highly unpopular by the time it was forced through Congress.

Having run as a moderate but governed from the Left, Mr Obama will almost surely view keeping one house of Congress a split decision. It will allow him to feel America should still experience his programme rather than have it dismantled. (Look for vetoes as a last resort.)

Higher taxes are a mistake during major cyclical credit deleveraging, as are regulations such as the unprecedented requirement that Americans purchase health insurance or be fined. The latter will be a drag on disposable income or corporate profits. Many major employers are considering ending health plans because it is cheaper to pay fines, shifting that burden to employees.

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Nobody can know for sure the outcome from all these possibilities post November 3. What we do know is that newly elected right-wingers will not be in a mood to compromise. And Mr Obama will want to maintain what he sees as benefits for the people. Unfortunately that will be at the expense of the productive portion of the American economy, and the equity markets as well if the burden is as extensive as some suspect.

That leaves two practical questions. First, will we still get QE2? Yes. Regardless of recent criticism from Pimco's Bill Gross and others that it is an unnecessary Ponzi scheme, Ben Bernanke is smart enough to apply game theory. The economy and markets may strengthen in any event, and the Fed can take credit. If they weaken, he can point to the obvious non-monetary root of the problem.

How will markets react after the election? Initially Republican gains will probably bolster equities believing that Mr Obama will need to compromise. There could be a temporary rally to near or even above the 1,220 S&P 500 spring high. QE2 might spark a drop of several percentage points in the US Dollar Index as well as a jump in bond yields.

However, the political discourse might degenerate into gridlock on taxes and especially Obama-care. If so, those looming burdens along with a still burgeoning US foreclosure problem may derail equities. In that case, bond yields may perversely fall not so much from QE2 as the return of a flight-to-safety mentality.

The potential is for a classic "buy the (accommodative Obama) rumour, and sell the (not happening) fact." Rather than taking comfort from QE2, we should fasten our seat belts for a rough taxulationism ride.

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