QE3. QE(N)

Finally Bernanke has tired of announcing successive bouts of quantitative easing, he's just announced that the Fed will be buying assets until the labour market picks up.

Buying what? US treasuries don't really need a lender of last resort; Basel 3 has made them the asset of last resort for all the private commercial banks, who incidentally have loaded up on over twice the amount they bought last year, and this just till August this year.

So what's all this MBS buying all about? For commercial banks, creating a mortgage consumes capital. The capital efficient trade is for banks to keep buying US treasuries. So what gives? What's the Fed up to?

The Fed is not buying non-agency MBS, arguably a better trade given that the market has dumped them with the bathwater. But profit is not the objective.

The Fed is hoping that supporting the housing market will restart the credit machine.

A rising housing market would reduce the proportion of homeowners with negative equity, providing them the opportunity to refinance.

Bank's lending standards since the crisis has tightened up considerably. The Fed hopes that rising housing prices may loosen lending standards.

Rising housing values opens the avenue to HELOCs, once an important source of funding for discretionary consumption.

Perversely, lower mortgage rates discourage mortgage lending since cost of capital is fixed. Only a robust securitization market might encourage mortgage origination.

Also, banks will not loosen underwriting standards unless they are able to transfer the credit risk off their balance sheets. With the Case Shiller index turning just positive, the first time since the crisis in 2008, the Fed may be attempting a momentum trade by encouraging a stronger recovery in housing.

Its not entirely responsible to address a problem of excessive debt by creating more debt, but what can you do? They have to try something.

Since the US economy recovered in 3Q 2011 asset prices had stabilized until the Europeans and their half baked efforts to secure the Euro fell flat and China landed with a thump (and is still looking moribund.) Today, the global economies look to be in a synchronized slowdown. Policy makers the world over certainly think so. Every central bank has plans to print and every government who can afford it has plans to build.

While the real economy sags, asset prices have been buoyed by super-loose monetary policy. There is a chance that animal spirits may be invoked to rescue the world. However, the exit is as yet unclear. What exit? Why the unwinding of banking system balance sheets which now stand at 5-6 times multiples of what they used to be before 2008. If there’s a plan for reversing the balance sheet inflation that has so far been deployed to save the world, once the world has been saved, I’d like to hear it. There’s just this little risk of inflation… QE, Debt Monetization and Hyperinflation Risk
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