

## The End of QE2

### What do we know? What has the Fed said?

- The Federal Reserve's program of buying \$600 billion of Treasury securities (QE2) will end next month.
- The Fed will maintain the size of its balance sheet by reinvesting maturities and prepayments. Therefore, the Fed will still purchase nearly \$50 billion of Treasury securities per month for at least several more months.
- There will be no QE3 unless the economic landscape changes dramatically. The Fed believes the risks associated with another round of quantitative easing outweigh the potential economic benefits.
- When the Fed stops reinvesting maturities and prepayments, its balance sheet will begin to shrink and this will be an early stage of the tightening process.
- The Fed will remove the phrase "for an extended period" from its statement two to three months prior to its first interest rate increase.

### What are the implications of the end of QE2?

Conventional wisdom is that interest rates should rise once a very large buyer of Treasuries, the Fed, leaves the market. However, QE2 has been providing stimulus to the economy, commodities and stock market since late last year and removing this stimulus may create a real or imagined drag on the economy, putting downward pressure on rates. The reality is that the market has priced in the end of the program and its likely impact on Treasury supply as well as the economy. The end of the program will not provide any new information to the markets.

### How are we investing bond portfolios for the end of QE2?

- Our portfolios are duration neutral to the benchmark. The risk that rates rise as a large buyer of Treasuries is removed from the market is offset by the risk that rates remain downward biased with increasing economic uncertainty.
- The end of Fed easing suggests that peak yield curve steepness has passed. The yield curve will flatten as the Fed shifts from easing to neutral and eventually to tightening. This change in Fed policy will ultimately benefit a more barbelled maturity structure.
- The Fed is shifting from easy to neutral policy due to the belief that the fundamental underlying strength of the economy has improved to a point where it is sustainable absent stimulus. The end of QE2 may temporarily interrupt the cyclical improvement in spread sectors as investors grapple with uncertainty, but the discontinuation of the program is consistent with further yield spread compression in corporates and taxable municipals over the long run.



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