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Market view

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What could be likely tenor of QE3 hope rally?

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Despite 3 years of experimentation with two versions of QEs and tons of new money, US Fed is concerned about growth. With stability returning to Europe and improving domestic data, no one expected US Fed to downgrade economic assessment in its latest meeting. This is a matter of concern and not celebration that most risky assets showed recently. Most of us thought that US recovery is the silver lining amid clouding global growth. But, commitment to low rates till late 2014 vindicates that Fed expects recovery to remain soft or tentative for next 3 years. With declining growth in China and multi-quarters of contraction in Europe as likely scenario, the big picture is of caution for economists. Traders, however, are happy with the sign of new money – same as they were in Sep 2010. They will realise ground realities once enthusiasm fades – same as they did in Feb 2011. The tenor of ongoing rally is the top question in everyone’s mind.

QE brings complications

Artificial boosts, in form of QEs, have complicated the economic picture for everyone. Market has become volatile, economic growth unpredictable and business cycles shorter. This doesn’t help long-term business investments that the world needs now. Volatility sends retail investors to safe assets, banks to pile up cash in central bank deposits and hot money to flow into emerging market assets. Looking from all angles, QE doesn’t do anything to spur “real” growth.

QEs are tools to fund banks with loads of cash. These, thus, help stabilising financial markets. QE1 and LTRO achieved these objectives successfully in US and Europe respectively. Beyond that, QE has limited role. Hundreds of years of economic cycles tell us that long period of stability and asset under-valuation seeds growth and next bull cycle; QE does just the opposite – brings volatility and inflates asset prices. No surprises that QE2 failed to trend economies higher.

Guessing tenor

QE1 lasted 15 months (Jan 2009 – Apr 2010). QE2 lasted for 6 months (Sep 2010-Feb 2011). Both these rallies got checked by poor economic data, mostly in summer period. One can (arguably) use these patterns to assume that QE3 hope rally will last shorter than QE2 and will be eventually tested by economic data.

Goldman admits seasonality in US economic data, especially due to Lehman's failure in Sep 2008. Accordingly, growth in Oct-Mar period gets inflated. Combining this with Fed's assessment makes a case for slowing growth in US in coming quarters. Most leading indicators suggest that Chinese growth has scope to soften further. Europe and UK may contract, most agree. Accordingly, we don't subscribe to turnaround story in base metal prices yet. We find exuberance overshadowing ground realities.

Consumers should remain patient in such volatile times and stay dip buyers for the nearby periods. Hedging using options could be good idea for producers to allow participation in rally extending from here.

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