CHART OF THE MONTH

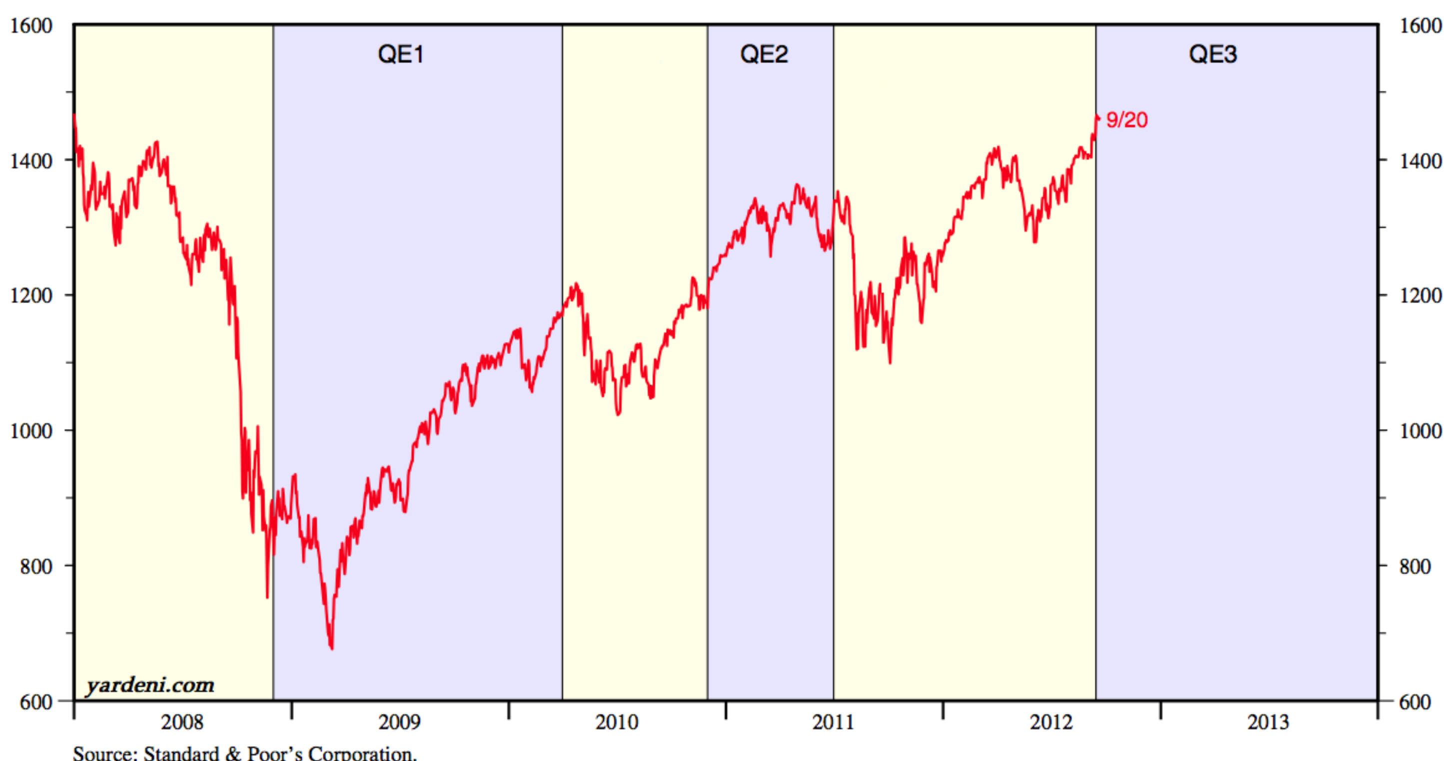
SEPTEMBER 2012

Two weeks ago, the Federal Reserve's Federal Open Market Committee agreed to "increase policy accommodation by purchasing additional agency mortgage-backed securities at a pace of $40 billion per month," ushering in another round of quantitative easing (QE3). The Committee believes "these actions should put downward pressure on longer-term interest rates, support mortgage markets, and help to make broader financial conditions more accommodative."

The pale-blue areas in the graph below mark the beginning and end of the prior quantitative easing programs. As shown, the Standard & Poor's 500 Index rallied during the previous two QE periods and fell sharply afterwards. According to Ed Yardeni of Yardeni Research, the S&P 500 increased 36.4% during QE1, 24.1% in QE2 (starting with Fed Chairman Ben Bernanke's speech at Jackson Hole on August 27, 2010), and 4.2% since Bernanke's remarks at Jackson Hole on August 31, 2012. In addition, the market has gained 18.1% since the European Central Bank's long-term refinancing option (known as LTRO) was executed on December 20, 2011 and 7.8% since ECB President Mario Draghi's "whatever it takes" presentation on July 26, 2012.

Will QE3 work out as well as QE1 and QE2? We would be surprised. Despite the correction that took place last spring, it is important to note that the S&P 500 has climbed substantially since the Fed implemented Operation Twist (an action designed to flatten the yield curve by selling shorter-term debt and buying longer-term bonds) in September 2011 and extended it in June 2012. As a result, the newest stimulus program appears to be largely priced into stock prices.

Instead, the elections on November 6 will most likely determine if there will be a year-end rally or a sell-off. More gridlock raises the risks that politicians will be unable to resolve important fiscal issues in the final two months of the year. Absent new legislation, tax increases and spending reductions ("sequestration") will automatically expire or go into effect on January 1, 2013, negatively impacting GDP by as much as 4%-5% and turning a sluggish recovery into another recession.



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