Quantitative easing has benefited from global macro events and appears likely to continue for the rest of the year. Markets, though, will continue to anticipate how the current policies will eventually be unwound.

A number of macro trends have proven fortuitous for the Federal Reserve’s implementation of quantitative easing (QE). The European financial crisis and recession, as well as the depreciation of the yen, have driven global investors to dollar-denominated assets as a safe haven. The relatively strong dollar has kept input prices down, giving the Fed greater leeway to be extremely accommodative in tackling the unemployment problem without stoking inflation.

As evidenced in yesterday’s congressional Joint Economic Committee hearing, the Fed is facing increasing scrutiny over potential exit strategies for its asset purchase program and has been making an effort to communicate clearly with the markets to avoid surprises. One of the more attractive options for the Fed appears to be to let its portfolio wind down over an extended period, instead of selling assets. If the Fed takes this route, it could increase bank reserve requirements to opportunistically restrict money growth, or engage in reverse repurchase agreements to drain liquidity out of the system as needed.

Economic Data Releases

Mixed Data and Low Inflation Leave Room for Continued Quantitative Easing

- Industrial production fell by 0.5% in April, the most in five months.
- Housing starts dropped 16.5% in April to a five-month low of 853,000 at an annualized rate.
- Building permits jumped 14.3% in April to a annualized rate of 1.017 million, the most since June 2008.
- The NAHB homebuilder confidence index rose to 44 in May, the first improvement in five months.
- Initial jobless claims for the week ended May 11th rose to a six-week high of 360,000.
- The University of Michigan consumer confidence index jumped to 86.7 in May, the highest since July 2007.
• The leading indicator index had the best one-month gain in over a year in April, rising 0.6%.
• Regional Fed indices disappointed, with the Empire, Philadelphia, and Chicago indices all unexpectedly falling.
• CPI inflation fell to 1.1% in April, the lowest since 2010.

Eurozone Recession Reaches Record Length, Signs of Abenomics Impact in Japan

• GDP in the eurozone contracted for a record sixth straight quarter, falling 0.2% in the first quarter.
• German GDP rose a less-than-expected 0.1%, while France saw a second consecutive quarter of contraction, and Italian GDP shrank for a seventh quarter.
• The eurozone CPI fell 0.1% in April, putting the year-over-year CPI at 1.2%, a more than three-year low.
• Home prices in the U.K. increased 2.1% in May to a record high.
• U.K. consumer prices rose less than forecast in March, putting the CPI up 2.4% from a year earlier.
• Japan’s GDP grew at a better-than-expected 3.5% annualized rate in the first quarter.
• Japanese industrial production rose for a fourth straight month in March, the best streak since 2011.

Chart of the Week

Selling Not Required

If the Fed continues its current pace of asset purchases through the rest of 2013, the total amount of assets on its balance sheet will reach approximately 24% of GDP by the end of the year. When the Fed changes its monetary policy, it can do so by either selling its current assets or simply letting the bonds mature by holding them to maturity. If the Fed holds its bonds to maturity, its total assets to GDP ratio could fall to below 10% by 2023.

FED’S BALANCE SHEET ASSETS AS PERCENT OF GDP PROJECTION*
*Note: We assume the nominal GDP will grow at an average rate of 5% per year. We also assume the Fed will continue its current asset purchase pace throughout the end of this year but stop purchasing with no asset sales starting next year. Only maturing principals will be absorbed. Interest income will be retained for operating and money supply purposes.

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