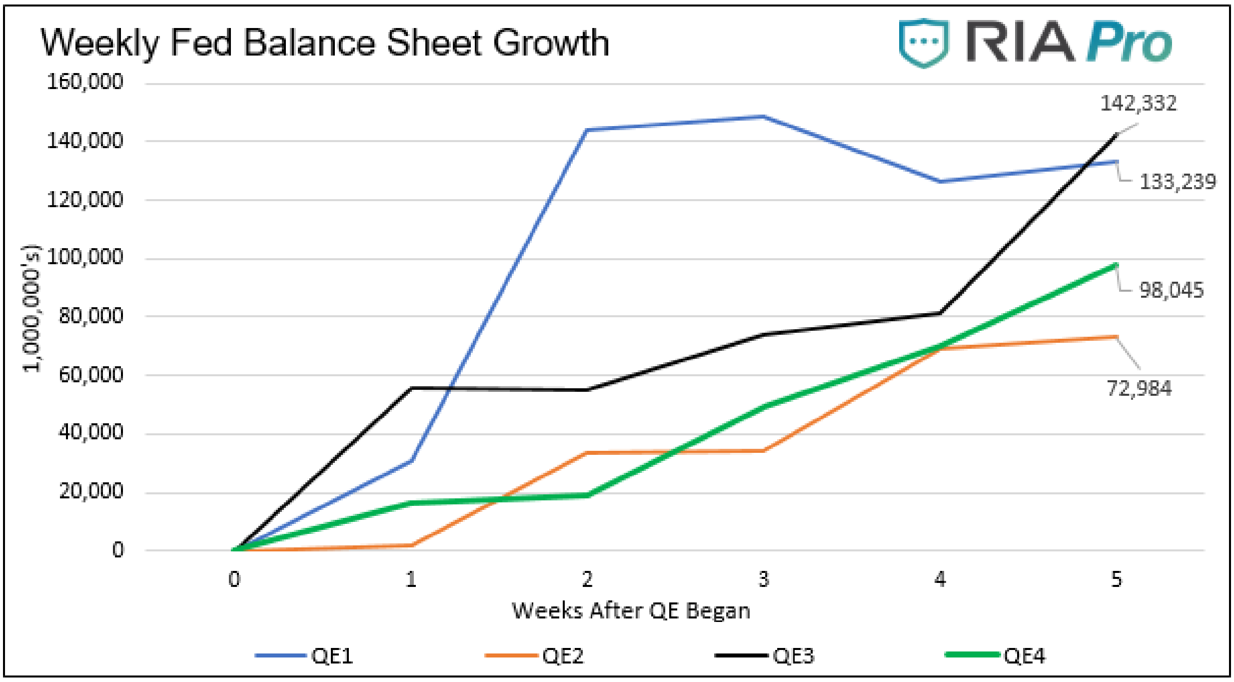
In our RIA Pro article, [To Buy, Or Not To Buy- An Investors Guide To QE4](), we studied asset performance returns during the first three episodes of QE. We then normalized the data for the duration and amount of QE to project how QE4 might affect various assets.

With a month of QE4 under our belt, we update you on the pacing of this latest version of extreme monetary policy and review how various assets are performing versus our projections. Further, we share some recent comments from Fed speakers and analyze trading in the Fed Funds market to provide some unique thoughts about the future of QE4.

QE4

Since October 14th, when QE4 was announced by Fed Chairman Jerome Powell, the Fed?s balance sheet has increased by approximately $100 billion. The graph below compares the current weekly balance sheet growth with the initial growth that occurred during the three prior iterations of QE.



Data Courtesy St. Louis Federal Reserve

As shown above, the Fed is supplying liquidity at a pace greater than QE2 but slightly off the pace of QE 1 and 3. What is not shown is the $190 billion of growth in the Fed?s balance sheet that occurred in the weeks before announcing QE4. **When this amount is considered along with the amount shown since October 14th, the current pacing is much larger than the other three instances of QE.**

To put this in context, take a step back and consider the circumstances under which QE1 occurred. When the Fed initiated QE1 in November of 2008, markets were plummeting, major financial institutions had already failed with many others on the brink, and the domestic and global economy was broadly in recession. The Fed was trying to stop the worst financial crisis since the Great Depression from worsening.

Today, U.S. equity markets sit at all-time highs, the economic expansion has extended to an all-time record 126 months, unemployment at 3.6% is at levels not seen since the 1960s, and banks are posting record profits.

The introduction of QE4 against this backdrop reveals the possibility that one of two things is occurring, or quite possibly both.

One, there could be or could have been a major bank struggling to borrow or in financial trouble. The Fed, via repo operations and QE, may be providing liquidity either to the institution directly or indirectly via other banks to forestall the ramifications of a potential banking related default.

Two, the markets are struggling to absorb the massive amount of Treasury debt issued since July when Congress extended the debt cap. From August through October 2019, the amount of Treasury debt outstanding grew by $1 trillion. Importantly, foreign entities are now net sellers of Treasury debt, which is worsening the problem. For more read our recent article, *Who Is Funding Uncle Sam?*

The bottom line is that the Fed has taken massive steps over the last few months to provide liquidity to the financial markets. As we saw in prior QEs, this liquidity distorts financial markets.

QE4 Projections and Updates

The following table provides the original return projections by asset class as well as performance returns since October 14th. The rankings are based on projected performance by asset class and total.

Equity Index	QE4 Expected Return	QE4 Perform. to date	Actual Vs. Exptected	Index Rank	Total Rank
S&P 400	9.25%	4.04%	43.69%	1	2
S&P 600	8.82%	4.75%	53.89%	2	4
Russell 2k	8.18%	5.30%	64.77%	3	9
All Equity Avg.	6.98%	4.72%	67.61%	4	10
NASDAQ	6.44%	5.61%	87.07%	5	14
Value	5.94%	5.95%	100.25%	6	15
S&P 500	5.89%	4.64%	78.73%	7	16
Growth	5.87%	4.28%	72.96%	8	17
Dow Jones	5.35%	3.75%	70.05%	9	18
S&P 100	4.81%	5.03%	104.47%	10	22
Equity Sector	**QE4 Expected Return**	**QE4 Perform. to date**	**Actual Vs. Expected**	**Sector Rank**	**Total Rank**
Discret.	8.89%	-0.37%	-4.16%	1	3
Health Care	8.52%	8.51%	99.84%	2	7
Industrials	8.24%	5.59%	67.81%	3	8
Materials	6.97%	3.49%	50.06%	4	11
Real Estate	6.72%	-1.10%	-16.36%	5	12
Energy	6.60%	1.16%	17.59%	6	13
Financials	5.24%	7.12%	135.99%	7	19
Staples	4.84%	1.21%	25.00%	8	20
Technology	4.84%	6.56%	135.67%	9	21
Utilities	2.43%	-1.36%	-55.95%	10	24
Comm.	1.96%	4.60%	235.28%	11	25
Treasury & Commodities	**QE4 Expected Return**	**QE4 Perform. to date**	**Actual Vs. Expected**	**Commodity Rank**	**Total Rank**
2yr*	(0.03)	-0.02	n/a	n/a	n/a
10yr*	0.19	0.05	n/a	n/a	n/a
30yr*	0.14	0.04	n/a	n/a	n/a
Silver	12.78%	-2.39%	-18.71%	1	1
Crude Oil	8.68%	4.41%	50.78%	2	5
Copper	8.61%	0.74%	8.59%	3	6
Gold	4.04%	-0.72%	-17.81%	4	23

Here are a few takeaways about performance during QE4 thus far:

- Value is outperforming growth by 1.67% (5.95% vs. 4.28%)
- There is general uniformity amongst the equity indexes
- Equity indices have captured at least 50%, and in the case of value and large caps (S&P 100) over 100% of the expected gains, despite being only one-sixth of the way through QE4
- The sharp variation in sector returns is contradictory to the relatively consistent returns at the index level
- Discretionary stocks are trading poorly when compared to other sectors and to the expected performance forecast for discretionary stocks
- Defensive sectors are trading relatively weaker as occurred during prior QE
- The healthcare sector has been the best performing sector within the S&P as well as versus every index and commodity in the tables
- The yield curve steepened as expected

- In the commodity sector, precious metals are weaker, but oil and copper are positive

Are Adjustments to QE4 Coming?

The Fed has recently made public statements that lead us to believe they are concerned with rising debt levels. In particular, a few Fed speakers have noted the sharp rise in corporate and federal debt levels both on an absolute basis and versus earnings and GDP. The increase in leverage is made possible in part by low interest rates and QE. In addition, some Fed speakers over the last year or two have grumbled about higher than normal equity valuations.

It was for these very reasons that in 2013, Jerome Powell voiced concerns about the consequences of asset purchases (QE). To wit:

?What of the potential costs or risks of the asset purchases? A variety of concerns have been raised over time. With inflation in check, the most important potential risk, in my view, is that of financial instability. ***One concern is that our policies might drive excessive risk-taking or create bubbles in financial assets or housing****.?*

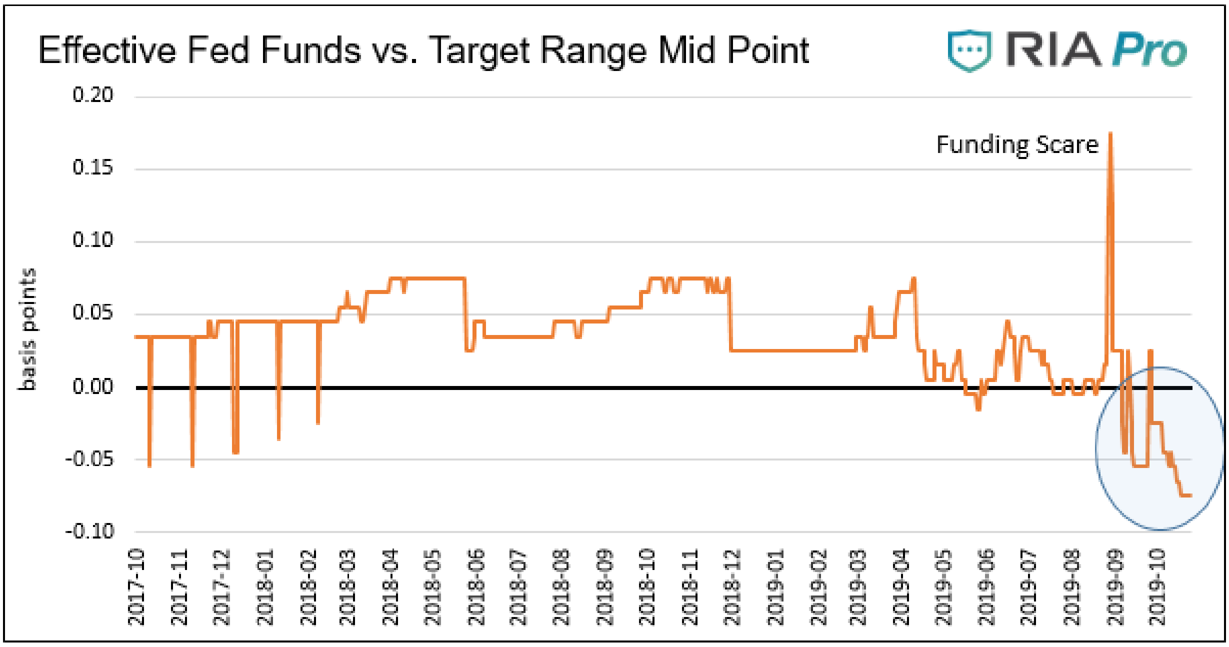
Earlier this month, Jerome Powell, in Congressional testimony said:

"The debt is growing faster than the economy. It's as simple as that. That is by definition unsustainable. And it is growing faster in the United States by a significant margin."

With more leverage in the financial system and higher valuations in the equity and credit markets, how does Fed Chairman Powell reconcile those comments with where we are today? It further serves to highlight that political expediency has thus far trumped the long-run health of the economy and the financial system.

Based on the Fed?s prior and current warnings about debt and valuations, we believe they are trying to fix funding issues without promoting greater excesses in the financial markets. To thread this needle, they must supply just enough liquidity to restore financing markets to normal but not over stimulate them. This task is much easier said than done due to the markets? Pavlovian response to QE.

Where the fed funds effective rate sits within the Fed?s target range can be a useful gauge of the over or undersupplying of liquidity. Based on this measure, it appears the Fed is currently oversupplying liquidity as seen in the following chart. For the first time in at least two years, as circled, the effective Fed Funds rate has been consistently below the midpoint of the Fed?s target range.



If the Fed is concerned with debt levels and equity valuations and is comfortable that they have provided sufficient liquidity, might they halt QE4, reduce monthly amounts, or switch to a more flexible model of QE?

We think all of these options are possible.

Any effort to curtail QE will be negative for markets that have been feasting on the additional liquidity. Given the symbiotic relationship between markets and QE, the Fed will be cautious in making changes. As always, the first whisper of change could upset the apple cart.

Summary

Equity markets have been rising on an almost daily basis despite benign economic reports, negative trade and tariff headlines, and Presidential impeachment proceedings, among other worrisome factors. We have little doubt that investors have caught QE fever again, and they are more concerned with the FOMO than fundamentals.

As the fresh round of liquidity provided by the Fed leaks into the markets, it only further advances more misallocation of capital, such as excessive borrowing by zombie companies and borrowing to further fund unproductive stock buybacks. Like dogs drooling at the sound of a ringing bell, most investors expect the bull run to continue. It may, but there is certainly reason for more caution this time around as the contours of the economy and the market are vastly different from prior rounds. Add to this the incoherence of this policy action in light of the record expansion, benign inflation readings, and low unemployment rate and we have more questions about QE4 than feasible answers.