ANDBANK RESEARCH

Global Economics &
Markets

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Ok. There is still a long way to see the "exit strategy" but the end of new QE may be close (and this is not fully incorporated in the market)

Working paper - 36

For the next months … a good trade could be "Short US Treasury – Long US banks".

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What lies behind the recent sell-off in the long end of the US bond market?

1. Easing of Basel III requirements in the US banks (allowing for more assets to be incorporated in the so-called liquidity coverage ratio – including some equities-) …

2. and the avoidance of the dreaded "fiscal cliff".

Remember our projected range for the 10year US Treasury Yield? (1.50% to 2.50%)

In early December 10Y yield was at 1.59% (in the lower band of our projected range) and most market participants were anticipating further declines (recommending buying Treasuries). Our recommendation was Sell Treasuries at that level.

Since then, yields have increased sharply (33 bp) resulting in a significant loss in price.

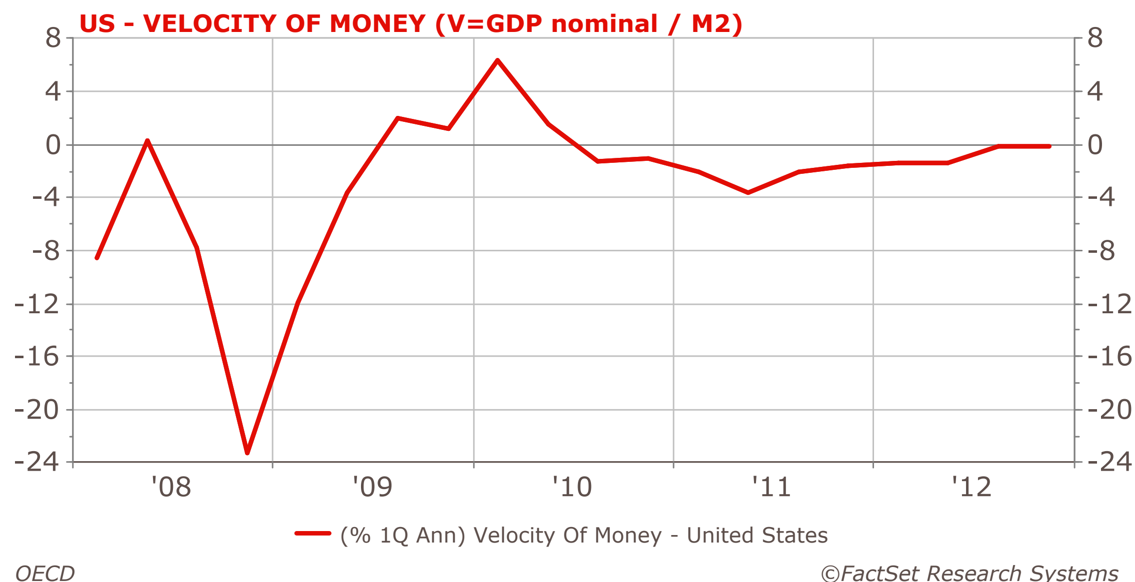
What is next?

We consider there are good reasons behind recent nuances from the Fed, … what means that **renewal of QE programs may stop in 2013.**

Why?
Since 2007, velocity of money has been plummeting (with the exception of one single quarter).
This makes sense, since during recessions the rational reaction is hoarding cash.

In order to have an impact on nominal GDP, central banks should expand M at a higher rate than the contraction of velocity (pushing even more lower the velocity), but …

What if velocity of money is no longer contracting?

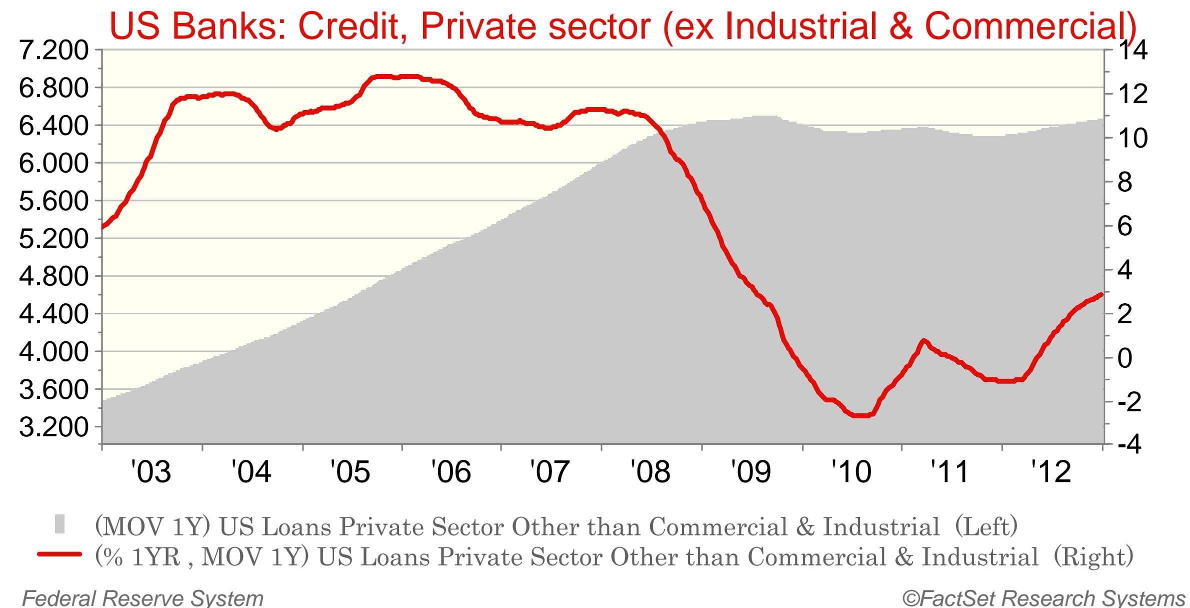


… if velocity of money is no longer contracting should fit with certain expansion of consumer credit …

… as is the case! (see the chart)

Thus, considering this, we should not be surprised to see some Fed's members openly considering the end of QE.

This means just no more QE (not the withdrawal of all the measures implemented so far. This will only happen when unemployment rates reach the 6.5% level and the inflation rate runs above 2.5%).



With no more QE at sight, it is legitimate to think that **the yield curve will steepen further (sell long dated Treasuries)** … which is very good news for US banks as a steep yield curve acts as a free subsidy. This, together with the new easing of Basel III requirements **may result in a bank outperformance, and a general positive environment for global equities.**

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