CNBC.com

Fed's 'QE Infinity': Four Things That Could Go Wrong

BUSINESS NEWS

By:Jeff Cox | CNBC.com Staff Writer

CNBC.com | Friday, 14 Sep 2012 | 1:28 PM ET

The Federal Reserve's latest stimulus target is intended to rouse the housing market, generate wealth and drive down unemployment, all of which conceivably could happen.

But it will be the assortment of unintended consequences that all the money printing and price-boosting — even outside of the obvious inflation risk — will have that will keep Fed Chairman Ben Bernanke awake at night.

So while investors were busy Thursday and Friday buying up stocks and metals and selling bonds and the U.S. dollar, financial experts were sizing up what "QE Infinity" also might bring to the economy and marketplace.

A few of the risks:

1. Moral Hazard, Washington Version

Bernanke has time and again exhorted lawmakers in the nation's capital to get serious about fiscal reform and economic growth.

But with Thursday's announcement that the Fed will engage in quantitative easingfor as long as it takes to get the economy rolling again, he may have taken the onus off Washington to put its own house in order.

That's dangerous, considering Congress and the White House need to reach deficit-reduction goals or risk falling off the fiscal cliff of mandated tax increases and spending cuts.

"My sense is that Ben and his colleagues at the Fed do not expect much support from a trade policy that would be more growth-oriented, from fiscal policies that would be more longer-term," former Fed governor Kevin Warshsaid on CNBC. "So they've got to be worried about these things, and they are trying to compensate for these other failings."

Result: The dollar will continue to tumble because of Fed policy. In another time, that would give policy makers time to act while conditions improve, but if Washington stays in gridlock there could be no end in sight for U.S. currency weakness.

"In the US, avoiding the fiscal cliff and agreeing on a credible long-term fiscal plan before or soon after the elections would support a more sustainable recovery," Bank of America Merrill Lynch rates strategist Ralf Preusser said in a note to clients.

"In the Eurozone, stronger reform implementation in the periphery would strengthen market confidence. However, if the US fails to address its fiscal problems, more Fed printing in response to higher unemployment would magnify the negative (dollar) impact."

2. Moral Hazard, Wall Street Version

The concept of moral hazard essentially means the rewarding of bad behavior.

But it also extends to the notion that somebody will be there to support you no matter what. The Fed, with its perpetual QE, seemed to appoint itself as the stock market's nanny for years to come, even though the Standard & Poor's 500 and Dow industrials are within a few percentage points of historical highs.

"The real unfortunate impact of this latest Fed action is to continue to propagate the idea the economic recovery remains on life support and the U.S. stock marketis simply on a sugar high," said Jim Paulsen, the perpetually bullish chief market strategist at Wells Capital Management in Minneapolis.

Indeed, the stock market cheered the latest QE announcement by sending the Dow up 200 points Thursday and still more Friday.

But now what?

"There's a reason 'exit' is a four-letter word," Warsh said. "It's very difficult. The history of central banks is it is harder getting out than getting in."

3. Hurting Confidence

With the latest round of easing, the Fed's balance sheet will soar past $3 trillion and could get to $4 trillion in electronically generated cash before everything is finished.

In doing so, it has created a good news-bad news scenario: The good news is that the Fed is willing to go to extreme measures to pump up the economy; the bad news is that the economy needs it.

Paulsen cited a litany of measures indicating a recovery is happening — a declining though elevated unemployment rate, a modest rebound in housing, and improving consumer confidence — that he feels should have been enough to dissuade the Fed from more money creation.

"While this most recent Fed action may marginally help economic fundamentals...it will likely continue to hurt confidence," he said. "It is not so much that yesterday's Fed announcement will hurt the economy in the future as it is the Fed missed a great opportunity to treat what really needs some medicine — economic confidence.

"Rather than bring another shock and awe to a recovery no longer in crisis, the Fed would have been more helpful by simply looking and sounding confident in the future and standing down."

4. It May Not Work

All of the economic progress Paulsen cited may be valid, but there's still the reality that $3 trillion in new liquidity — along with more than $800 billion in fiscal stimulus — has generated the worst recovery since the Great Depression.

So is it worth the aforementioned risks if the economy will continue only to creep along, as it usually does after financial crises?

"This is the nuclear option for them. This is a never-ending weapon that is being fired at the middle class," said Fed critic Michael Pento, the founder of Pento Portfolio Strategies and an economist concerned with the effects QE is having on future inflation and on savers who are getting no interest on their deposits.

"If the unemployment rate stays elevated, as I know it will, and inflation eclipses (Bernanke's) 2 percent target, what is his next move? What part of the Fed mandate takes precedence?" he added. "Economic growth comes from more people working and more people becoming productive, and all the Fed can do is destroy our currency's purchasing power."

Even among those watching asset prices grow, doubts remained abundant.

"It's a bold move, but we're skeptical that it will have a significant impact," said David M. Darst, managing director and chief investment strategist at Morgan Stanley Smith Barney. "These (measures) are all useful, but they obviously do not alter the longer-term outlook in a meaningful way."

URL: http://www.cnbc.com/49034067