What Happens After QE2 Ends?

The Fed's highly controversial QE2 program is scheduled to end in June

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The Federal Reserve's second round of quantitative easing, which began in November and is commonly referred to as QE2, is slated to end in June. Experts expect the Fed to finish the program, in which it pledged to buy $600 billion worth of treasury bonds to keep interest rates low and help spur lending and economic growth. There has been much speculation about what will happen in the markets—stock, bond, as well as commodities—when the Fed ends QE2 and the economy is left to stand on its own without any stimulus.

Proponents say the economy is better off because of the program, while inflation hawks say it has propped up asset prices across the board. They caution that markets are in for a reckoning after the Fed program winds down. Here are a few possible scenarios for the markets after QE2 ends:

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Bond yields continue to rise. Even with QE2 in place, treasury yields have slowly moved higher. On Nov. 4, 2010, the day of the Fed's announcement, the 10-year treasury yield stood at 2.5 percent. Today, it yields about 3.4 percent. Bond guru Bill Gross, who manages the world's largest mutual fund, PIMCO Total Return, is forecasting a spike in treasury yields. Gross has sold off all of the T-bills in his flagship fund because of his concerns about the end of QE2. In his investment outlook for March, Gross writes, "Bond yields and stock prices are resting on an artificial foundation of QE II credit." He adds: "Who will buy [t]reasuries when the Fed doesn't?" The Fed has been buying an average of about $75 billion in bonds a month since it instituted the program in November. Critics say that by buying large amounts of bonds, the Fed has kept rates artificially low. Gross estimates the 10-year treasury yield is about 1.5 percent lower than it should be when viewed in historical context, and when compared with expected nominal GDP growth of 5 percent.

Some experts are less concerned about a dramatic run-up in treasury rates. After the Fed exits, "you wouldn't have a big buyer, but it's still not the same as them selling them," says Stacey Schreft, director of investment strategy for The Mutual Fund Store. "You could see a small jump [in yields]." The Fed also has the option to reinvest proceeds from its purchases, which means it may not completely exit the market. Whether the Fed continues to reinvest or slowly lets the holdings roll off its balance sheet will be something to watch in the coming months.

Stocks could take a hit. The S&P 500 has risen about 6 percent since the Fed launched QE2. "Financial assets have become much more valuable when interest rates are so low," says Thomas Winmill, manager of the Midas Fund, which primarily invests in companies involved in the mining and production of metals like gold, silver, and platinum. "When interest rates are high, they might not be so valuable."

[See Why Big U.S. Stocks Look Like a Good Bet.]

How the wind-down is perceived by investors is also important. "If the market takes it as a sign of confidence in the economy, that's a good sign," says Bob Gelfond, CEO of MQS Asset Management. "On the other hand, if [investors are] worried that yields are now going to start heading up, that could be a negative for the stock market." Higher yields are generally associated with an economic recovery, but a quick jump could impact stocks negatively.

Still, others contend that the market has already priced in the effect of the end of QE2 and stocks are bound for higher gains. "My guess is that stocks will be higher after June by the end of the year than they are today," says Brian Gendreau, market strategist with Financial Network. But he warns that the stock market never moves in a straight line and that there are always bumps along the way.

Rally in commodities slows. Commodities have also benefited during the Fed's easing program. Gold still trades around $1,400 per ounce, and silver is hovering around historic highs of about $35 per ounce. Oil is now trading around $100, which some attribute to unrest in the Middle East. Winmill expects gold's run to continue, but he's concerned that silver's streak may end. That's because it's primarily used for industrial purposes, and higher interest rates could stunt economic growth, Winmill says.

[See What's Next for Gold?]

Soaring food prices have become a concern in emerging markets like China, India, and Brazil. Critics place some of the blame for higher food prices on the Fed's program, and they're worried that the end of QE2 may not be enough to stem rising inflation abroad. If the Fed decides to end its easing programs, one thing will remain the same: The Fed funds rate is still set at virtually zero, where it's been since December 2008. "[Fed] policy is still going to be easy, and that's probably not going to be helpful for the dollar, and it's probably not going to put a cap on commodity prices, unless the world economy starts having a downturn," Gelfond says. The dollar remains the world's reserve currency—meaning that many commodities throughout the world are priced in dollars—and a weak dollar has effects throughout the world, Gelfond says. He says a stronger dollar could help slow some inflationary pressures throughout the world.