VLFAlert

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What Does the End of Quantitative Easing Mean for You?

If all goes according to plan and the economy stays on track, it appears the **U.S. Federal Reserve (the Fed) is likely to finish tapering its quantitative easing asset purchases, thus ending the program, early in the fourth quarter of 2014.** There are varying opinions as to the impact this may have on the U.S. economy going forward. But what does the end of the program mean for you? What are the potential scenarios that could unfold? Does the history of Fed policy over the years provide us with any useful lesson for today?

Let's begin with a definition. Quantitative easing is an unconventional monetary policy wherein the Fed purchases bonds from the open market in an effort to lower interest rates and increase the money supply. The Fed implemented quantitative easing in response to the 2008 financial crisis with the goal of stimulating the economy, as interest rates were already near 0% and could not be lowered further. The latest round of quantitative easing, known as QE3, involved the Fed purchasing $85 billion worth of bonds each month, starting in December 2012. On December 18, 2013, then Fed Chair Bernanke announced the Fed would officially begin tapering, or reducing, its purchases beginning in January 2014. Under Fed Chair Yellen, the Fed continued to reduce its quantitative easing purchases by $10 billion per month each month since then.

What happens now? There are several potential outcomes.

- **Interest rates could rise quickly.** The Fed's bond holdings have risen since late 2008 from approximately $900 billion to approximately $4.0 trillion through its quantitative easing purchases. If the Fed opts to sell its holdings rapidly, the very size of the Fed's holdings could cause interest rates to rise quickly. Remember, there is usually an inverse relationship between bond prices and yield movements, so that bond prices fall when yields rise and vice versa. This is known as interest rate risk. That said, the Fed could opt either to hold its bonds to maturity or to sell them gradually, potentially mitigating the impact of interest rate risk.

- **Inflation may accelerate.** A faster pace of inflation could be triggered if the Fed sells its $4.0 trillion portfolio of bonds too slowly.

- **Volatility in the markets may increase.** Quantitative easing has helped to suppress volatility in both fixed income and equity markets. As quantitative easing comes to an end, market volatility may well increase as free markets set the level of interest rates rather than any extraordinary measures by the Fed. What is important to keep in mind is that the Fed is not yet tightening its monetary policy; it is making its monetary policy somewhat less accommodative.

- **Fundamentals may grow in importance when valuing U.S. equities.** With the end of quantitative easing, U.S. equity prices are likely to once again be evaluated based on the underlying fundamentals of each issuing company rather than on the unusual availability of liquidity provided by the Fed.

When considering these and other potential consequences to the end of quantitative easing, it is interesting to note that current conditions are not unprecedented. Following World War II, the Fed and the U.S. Treasury Department coordinated policy to suppress interest rates, as they attempted to reduce the cost of financing the massive federal debt incurred during the war years. The Fed bought most of the market's bond supply and kept short-term interest rates near zero.

Further, the Fed's bond holdings rose as a percentage of GDP in similar levels to what has happened in recent years, and inflation fears were widespread. While regulatory changes, a more integrated global economy

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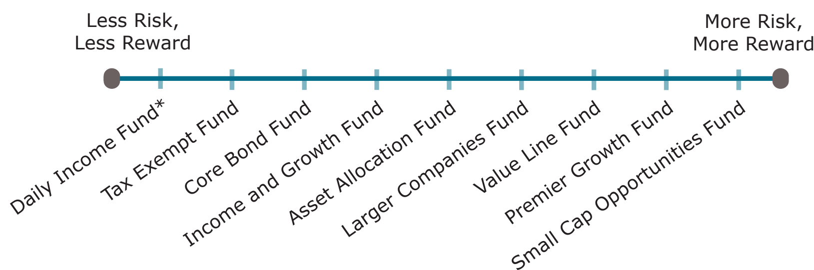
and potential economic growth rates point to some significant differences between then and now, there may be some lessons we can learn from history. Perhaps most pointedly, the end of quantitative easing may not cause interest rates to rise as quickly or as significantly as headlines may lead one to believe. In February 1932, long-term bond yields were at 4.11% before declining to a low in June 1941 of 1.98%. It then took 18 years—until April 1959—for long-term bond yields to move above 4% again.[1] While past performance is no guarantee of future results, the wait for long-term bond yields to rebound to pre-2008 levels could be a long one.

The portfolio managers of the Value Line Funds are very conscious of interest rate risk, inflation risk and the possibility of heightened market volatility—and they seek to reduce the potential impact of the end of quantitative easing by staying disciplined to their investment strategies, regardless of shifting monetary policy or macroeconomic, geopolitical and market conditions. They seek to do so by focusing on the data, including the fundamentals of individual securities and the issuing company's own track record. The portfolio managers of the Value Line Funds have had an enduring commitment to helping investors meet their long-term investment goals as prepared as possible for inevitable risk and uncertainty. We look forward to continuing to earn your ongoing trust.

Value Line Family of Funds Risk/Reward Relationship



What Might Be the Best Strategy for Value Line Fund Investors

If the end of quantitative easing means a rapid rise in interest rates, this scenario would be difficult for current fixed income investors because bond prices would be negatively affected, especially bonds with longer maturities. However, if history proves to be any guidepost at all, then long-term bond yields may take quite some time before rebounding to pre-2008 levels. At the same time, fundamentals may become greater drivers of equity valuations than Fed-injected liquidity with the end of quantitative easing. Rather than trying to time the market or determine which asset class might fare best, investors might consider an investment in one of the hybrid funds within the Value Line family of funds—either Value Line Asset Allocation Fund or Value Line Income and Growth Fund. These hybrid funds provide investors with exposure to multiple asset classes as our economy and the financial markets react to a new era of monetary policy.

If your portfolio is already heavily tilted toward one particular asset class, this may be a good time to consider a broader diversification approach. Investors might want to take another look at the equity funds within the Value Line family of funds. Our portfolio managers have long been focused on implementing a fundamentals-focused, bottom-up investment strategy—a strategy that has rewarded investors with a long-term perspective. Or the Value Line Core Bond Fund invests primarily in high quality, intermediate-term bonds that are expected to continue to generate income as the Fed begins to normalize interest rates. While the Value Line Core Bond Fund may invest in debt securities of any maturity, its portfolio tends to have a weighted average maturity of between three and 15 years.

For more information on how the family of Value Line Funds may help you navigate the effects of a transitioning U.S. monetary policy, visit our website, **www.vlfunds.com.**

For more information, call 800.243.2729 or visit our newly designed website www.vlfunds.com.

[1]Source: St. Louis Federal Reserve.

*Managed by Reich & Tang Asset Management, LLC, an unaffiliated investment manager with EULAV Asset Management. The Fund is distributed by EULAV Securities LLC.

Past performance is no guarantee of future results. You should carefully consider investment objectives, risks, charges and expenses of Value Line Mutual Funds before investing. This and other information can be found in the fund's prospectus, which can be obtained from your investment representative or by calling 800.243.2729.

Please read it carefully before you invest or send money.

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