Stimulus Cut-back: Are the World's Central Banks About to Take us off QE Life Support?

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"There is no stimulus like that which comes from the consciousness of knowing that others believe in us"
Orison Swett Marden

Over the last eight-and-a-bit years, unorthodox quantitative easing policies have become the central tenant of policy-making by the leading central banks of the world. The notion of printing money to buy government bonds, with the aim of stimulating the local economy, shifted from economics text books to actual policy as a temporary source of monetary policy stimulus to back up ultra-low interest rates. But what was dubbed temporary has, until very recently, had a semi-permanent look as leading central banks concluded that such instruments still had a relevance in today's economic backdrop.

Recently however, a change in central bank communication has occurred. Unsurprisingly, this started with the Federal Reserve of the United States, which was not only one of the earliest to adopt unorthodox policies, but in terms of resulting economic growth over the last few years has been one of the most successful in creating a positive impact. The surprising words of Janet Yellen, the Chair of the Federal Reserve, at her June press conference, outlining the likely multi-year reduction of the quantitative easing boosted Federal Reserve balance sheet, came at least six months before most commentators thought she was likely to opine an opinion.

Due to the early nature of their quantitative policy implementation, the Federal Reserve did have some clear decisions to make, in both 2018 and 2019, as to whether they wanted to 'roll over' all of these bonds or not. The comments of Janet Yellen suggest that this is unlikely, and the Federal Reserve's balance sheet will start to materially contract next year.

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Such a move implies a confidence about the current status of the American economy, a feeling deepened by the three interest rate rises sanctioned by the Federal Reserve in the last eight months, albeit that policy remains very loose compared to the norm of the last couple of generations. Policy remains very loose elsewhere too, and whilst the size of central bank balance sheets are still expanding in countries like the UK and Japan, as well as in the European Union, talk about the limits of central bank stimulus efforts appear legion. At one well-known economics conference, at least three central bankers from different geographies expressed similar opinions about reaching the upper bound of efforts, an occurrence which has made many observers conclude such communications are co-ordinated.

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Stimulus Cut-back: Are the World's Central Banks About to Take us off QE Life Support? (cont.)

G4 CENTRAL BANK BALANCE SHEET (FULL YEAR CHARGE IN BILLION US DOLLARS)				
	2017e	2018e	2019e	2020e
Federal Reserve	-3	-336	-483	-378
European Central Bank	1049	102	-96	-75
Bank of Japan	954	454	91	23
Bank of England	50	14	15	15
Total	**2050**	**234**	**-473**	**-415**

Source: BoA-ML

Communication – rather than explicit forecasts or guidance – is a much used weapon by central banks wishing to test out the sensitivity of financial markets to various potential policy instruments. Judging by the rise in bond yields (i.e. the fall in bond prices) that has occurred since this communication exercise commenced, there is a sensitivity – and quite rightly so. Government bond markets have become more dominated by central banks, and the extremity of the Japanese government bond market – which essentially did not trade for over a week due to the sheer dominance of the local authorities – reflects this better than anything.

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Japan is the poster child for what happens if stimulus becomes too fixed. Over a quarter of a century since the Japanese market peaked, the difficulties of the Bank of Japan, and their government cohorts the Ministry of Finance, to raise headline inflation or inflationary expectations remains a clear warning to other major global central banks. As is often the case with too much of anything, the marginal impact gets ever diminished – and even outside of Japan the apocalyptic fears of many monetarist thinkers that material quantitative easing would inexorably led to high inflation has proved incorrect. We can thank the continued fall in the rate money circulates within the economy for this latter occurrence, but it raises an interesting point. Quantitative easing helped stop the rot emanating from the 2007-8 global financial crisis, but it is of little new extra use. By contrast, other policy forms – for example supply side reform to increase demand and boost dynamism, flexibility and productivity through tax reforms, infrastructure

plans, labour market changes and related – may now make more sense in the policy bucket. Central banks may exhort on these areas, but it is governments who draft legislation and enact policy here.

So how is this all going to pan out? My conclusion would be that quantitative easing as we know it has peaked and all major central banks – with the possible exception of Japan – will be contracting their balance sheets within a couple of years, following the guidance lead by the United States. However as a quid pro quo, all this means is that interest rates will remain low as central banks respond to still low inflation, and a fear that policy makers may be ineffective in enacting supply side reform and change.

A cynic would say this is just swapping one form of stimulus for another. At a certain level, this is true. However our debt heavy, deteriorating demographic profile world continues to need help. If policy makers have a similar sense of purpose that central bankers generally have had in the last eight or nine years, the global economy, equity markets and corporate earnings have nothing to fear from the shift to more supply side centred stimulus. By contrast, over time in this scenario, interest rates and bond yields will return to more normal levels.

In short, for risk-embracing assets, you should not be overly worried about the slow wind down of quantitative easing stimulus by central banks so long as you have faith in the supply side reform programmes in America, Europe and China among others.

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KEY TAKEAWAYS:

- The Federal Reserve started a trend for central banks to talk more cautiously about further QE expansion
- Japan indicates that long-held faith in QE is not wise
- Anticipate over time central bank balance sheet sizes to fall
- With supply side policy increasingly taking the strain, the question is how successful can governments / policymakers be implementing these necessary reforms

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