

Central bankers and the intractable problem of QE

This year's meeting of the world's central bankers in Jackson Hole takes on a particular importance. Central banks face the unique challenge of beginning the long goodbye to the QE programmes. Nervousness in the treasury and stock markets is fully justified. The lack of worries regarding the alternative investment universe, not so much.

Next weekend, the annual Jackson Hole meeting will take place. It is a get-together where virtually all the world's central bankers participate. The meeting is an opportunity for central bankers and their closest staff to discuss the wider trends of the world economy in a quiet setting.

The meeting this year takes on a particular meaning as the dominant theme is likely to be finding the complicated answer to a simple question: how should the central banks begin to reverse the gigantic bond purchase programs that have essentially kept down interest rates and bond yields ever since the onset of the financial crisis in 2008.

Background

To recapitulate, the financial crisis saw the global economy go in reverse because of a dramatic contraction of credit in the wake of the CDO/sub-prime scandal. Across the world, governments did little to help the economies to recover (as in the USA where political deadlock prevented it) or directly introduced policies making the situation worse (as in the EU where Germany imposed austerity policies).

The elected governments relied upon unelected central bankers to provide the necessary support in the form of low interest rates provided through massive purchases of government bonds, an activity referred to as "Quantitative Easing" or just QE.

As the global economy seemed to be on its way to dig itself out of the hole when Covid-19 struck, the global economy went in reverse. Global central banks simply applied the tools invented after the Great Financial Crisis. But this time the governments did not hesitate to also open the floodgates of public spending.

No economic historian will have problems in explaining the historical boom in asset prices we have witnessed in the past 13 years. Hardly any asset class has escaped the voracious demand triggered by savers and investors chasing yields, sometimes in absurd asset classes like the cryptos

But this time it seems to be serious.

The global economy is in rapid recovery why the counter-productive effects of stimulus are coming into focus, such as rapidly increasing inequality and the overall risk of mis-allocation of capital. It is time to turn the overall

economic policies from "highly expansive" to "most likely neutral".

Fiscal spending programmes will expire and lead to a fall in demand. This will already put some limits on the actions of the central banks: they are not free to simply begin selling their

enormous holdings of mostly government bonds. If they did, it would create a very troublesome combination of higher interest rates, bond yields and falling demand.

Predicting this situation, central banks have already given themselves an escape route: beginning with the US Federal Reserve already in June of last year, central banks have subtly distanced themselves from the very strict definitions of acceptable inflation rates.

In this way central banks have already signalled that the financial markets should not expect strong intervention in case the inflation

rates were to climb into territory not seen for decades.

This “expectation management” from central banks does not solve their problem – how to get out of the QE programmes. It just buys them time. They will need more time than programmed in Jackson Hole to work that one out.

Particularly as many governments inexplicably have omitted to extend the duration of the bond portfolios to the maximum. It means that higher bond yields quickly will lead to an increase in the government debt servicing expenses.

The setup for investors

For investors, the situation is not any easier. Will we end up with a major collapse in the stock market? We would not be the slightest surprised if that happened.

But we want to point out that many investments in the past years have been in the so-called alternative space: private equity and real estate and infrastructure

These investments are currently considered almost impervious to the rumblings in the bond market. That could quickly prove to be an illusion.

Their defenders will claim that they deliver solid cash flows and that the investments are

inherently sound. Maybe that is true. But if the discount factors used to calculate the present value of the cash flow begin to move upwards, it will have a dramatic negative effect on the present value.

Just like “the tide has lifted all boats”, there will be few places for investors to hide if the central banks do not manage their highwire act correctly. The best advice will be to follow the situation closely and to be ready to get out. And not to believe in the habitual noise from long-only asset managers and private banking advisors to “stay put and follow your long-term strategy”.

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