Ten Seconds Into The Darkness

Central banks have been printing money aggressively since 2008. The US Fed is now slowing its money printing with a view to a static stance in the near future. What are the consequences for markets and the economy?

When money is printed it has to go somewhere. So far it has gone into asset markets to a far greater extent than it has to the real economy. The transmission mechanism from large scale asset purchases and suppressed interest rates has directed liquidity to stabilizing the mortgage market, and keeping interest rates low across the USD term structure. This has stabilized the housing market and restored household balance sheets to stronger equity positions, strengthened bank balance sheets through their mortgage loan portfolios, and driven yield seeking investors to supporting the corporate bond market which in turn finances share buybacks buoying the equity markets. The impact of QE on financial markets and capital values has been significant yet the impact on the real economy, on employment and wages and on cash flows has been less ebullient.

After 3 rounds and 5 years of QE we are only beginning to see some impact on employment, investment and output. Yet the Fed began, in 2013, to slow its Large Scale Asset Purchases and is expected to end it altogether by October 2014. It is unclear when the Fed will actually either raise rates or shrink its balance sheet; it is currently expected to continue to reinvest coupon and maturing bond principal. The implications of an expanding Fed balance sheet are now known but what about the effects of a static or shrinking balance sheet?

The transmission of QE has thus far directed liquidity to asset markets, notably the agency mortgage backed securities market and the US treasury market. Liquidity, however, has struggled to spur bank lending to financing growth as banks lend out of capital and not just liquidity, and the SMEs which rely on bank lending have faced tight credit underwriting standards. The treatment of riskier, smaller loans under bank regulatory capital rules also hampers such lending. Larger businesses, usually with listed equities, have access to the corporate bond market and have taken advantage of lower rates to raise debt capital. Companies with listed equities have aggressively raised debt to buy back shares thus increasing earnings per share growth without the challenge of having to actually grow their businesses organically. Smaller companies without listed equities do not have this luxury.

That business investment has been slow is concerning. Corporates have raised significant levels of debt in the bond markets, yet hold substantial cash on balance sheet, or engage in share buybacks and M&A. Surveys of business sentiment notwithstanding, the actions of business leaders is not encouraging.

Equity valuations in the developed markets are no longer cheap. Even in Europe, the market has been selective and quality is expensive. Asia is the only region showing any significant value. Yet for equities to push higher, assuming fundamentals are in place, liquidity needs to flow into the asset class. The US Fed is close to neutral, the BoJ, ECB and BoE are all expansionary and the PBoC is probably at an inflection point ready to run loose again. As long as the world's central banks are in aggregate accommodative, markets will find some support. Under neutral liquidity, such as in the US, for equity and other risky assets to rise, liquidity must be diverted from the real economy. The equity market is therefore highly vulnerable to inflation since such would signal a substation to current consumption. Low inflation has been a sign that liquidity was being directed to investment. The other example is Europe, where inflation has been significantly below expectations and targets. Absent direct asset purchases, a pick up in inflation is in fact a bear signal.

The current structure of the economy is possibly a consequence of income and wealth inequality and that policy has favored the rich. Whereas expansionary monetary policy is normally inflationary, where the benefits of such policy accrue to the rich, the tendency to save or invest the new wealth is high and the marginal propensity to consume is low. Perhaps this is one price of inequality: that monetary policy is blunted and diverted towards more investment and less consumption. Policy makers may wish to consider how the distribution of wealth impacts policy efficacy. Policy that is blind to the distribution of wealth and income can create positive feedback loops which lead to unstable paths or accumulating imbalances.

6 years after the crisis, monetary and fiscal policies have not improved the economy significantly, especially when taken in the context of the financial resources and measures deployed. Global growth has slowed, unemployment remains high and where it has recovered has done so at the expense of the participation rate, income inequality has worsened at the individual and commercial level and geopolitical turbulence has risen, in part from America's energy boom but in no small part due

to growth withdrawal symptoms. What is concerning is that central banks and governments appear to have exhausted their crisis management resources and tools. Interest rates are acutely low, negative in the Eurozone, central bank balance sheets are grossly inflated, and sovereign balance sheets while improving, remain fragile. That inflation is low is a relief for high inflation would inflict serious losses for holders of duration heavy assets such as government bonds which fill the balance sheets of many commercial banks, but low inflation is also failing to erode the value of the stock of debt.

How long can central banks and governments go on supporting asset markets in the hope that sentiment can drag along the real economy? How long can wealth and income inequality continue or worsen, aided and abetted by current economic policy? How long are central banks happy to carry on with their policy tools fully deployed while their efficacy has become blunted? What are the consequences of resetting policy tools such as asset purchases and suppressed interest rates? What if inflation picks up?