



# ▶ CENTRAL BANKS STEP BACK FROM CENTRE STAGE

**The Federal Reserve (Fed) raised interest rates by 25 basis points last week, in a move that was highly anticipated by the markets. This marked the Fed's fourth rate hike since the start of 2017 and is part of a wider move to scale back the unprecedented quantitative easing (QE) that global central banks had embarked on during the Global Financial Crisis. Market volatility is likely to rise as liquidity ebbs. When that happens, investors who are contrarian in their analysis and flexible in their approach are likely to better navigate the post-QE world.**

There have been numerous episodes throughout history where central banks have risen above their core mandate of maintaining price stability and in some cases, full employment, to provide a backstop for the economy. On those occasions, central banks acted as a lender of last resort and provided liquidity to key institutions that were at risk of failing in order to prevent negative ramifications for the broader economy. The Fed and the Bank of England (BoE) have taken different types of policy actions post the bursting of multiple asset bubbles across the years. While the European Central Bank (ECB) has a shorter track record, investors are likely to recall Mario Draghi's pledge to do "whatever



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it takes" to preserve the euro and protect the Eurozone from collapse during the European debt crisis in 2011.

During the Global Financial Crisis (GFC) in 2008, global central banks acted to provide liquidity to underwrite the financial system. The BoE nationalised banks in the UK and the Fed rescued several systemically important institutions in the US. At the depth of the crisis, central bankers slashed interest rates and embarked on a large scale asset buying program, causing an unprecedented expansion in global central balance sheets. This unconventional monetary policy or QE was seen necessary to restore confidence in the banking system and avert a 1930s style depression.

Almost ten years down the road post the GFC, the world has not only averted a global economic crisis, developed and emerging market economies have enjoyed a synchronised recovery in 2017 and may repeat the feat in 2018. The 8-year rally in the equity markets has also shown few signs

of abating, although volatility has risen recently. Hence the stage is set for central banks to start preparing to exit from QE.

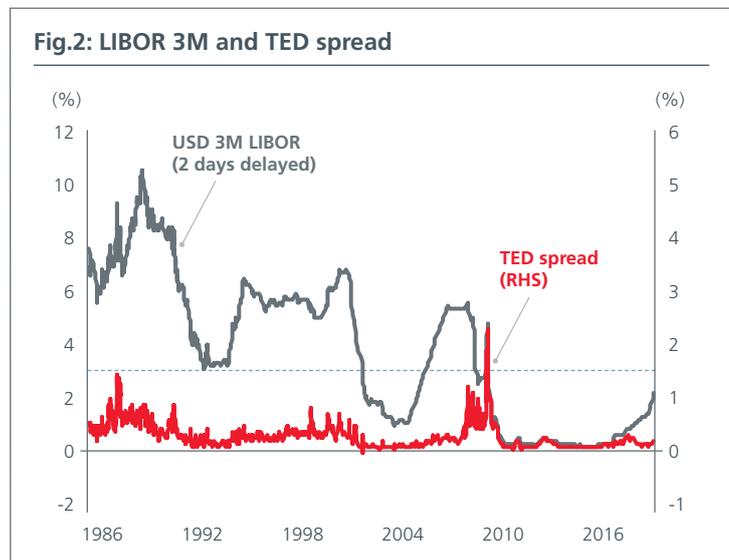
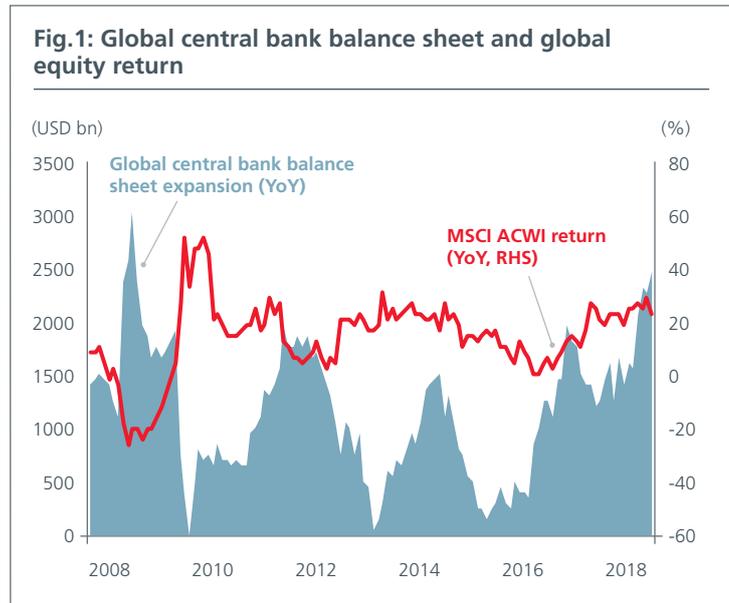
Central banks will start to raise interest rates, a normal action at this stage of the cycle and which has precedence for the markets. Central banks will also embark on quantitative tightening by selling assets into the market and withdrawing liquidity out of the system. For this there is no precedence. What will be the economic and market implications as liquidity tightens? Although the direct correlation between global central bank balance sheet expansion and equity market returns is less obvious, the more recent expansion of asset purchases by central banks in the last few years has coincided with equity market outperformance. (see fig.1)

Given the complexities of the financial system, determining the exact impact on the financial market will be challenging. The global economy is also in a very different state as compared to when QE started. To assume that central bank tightening will unravel all the improvements in the global economy and markets over the last 10 years is perhaps too simplistic.

## FINANCIAL CONDITIONS CONTINUE TO SUPPORT THE REAL ECONOMY

We believe that the rise in interest rates will be a slow and gradual process. As such, interest rates are still supportive of economic growth and we expect this to be the case for as long as inflation remains subdued and inflation expectations stay anchored.

Over in the US, we note that funding has not been adversely affected by rising rates despite the Fed having raised interest rates by 100 basis points since the start of 2017. The TED spread, which measures the difference between the interest rates on interbank loans and the short term US Treasury bill, has been remarkably well-behaved. (see fig.2). This suggests that that the current creditworthiness of banks is not compromised by rate rises, so far. Globally, financial conditions in the US, Eurozone



and Asia (ex Japan), are still not tight, although they are not as loose as before, and should continue to support growth. (see fig.3).

## THE FALL OF LIQUIDITY AND THE RISE OF ACTIVE INVESTING

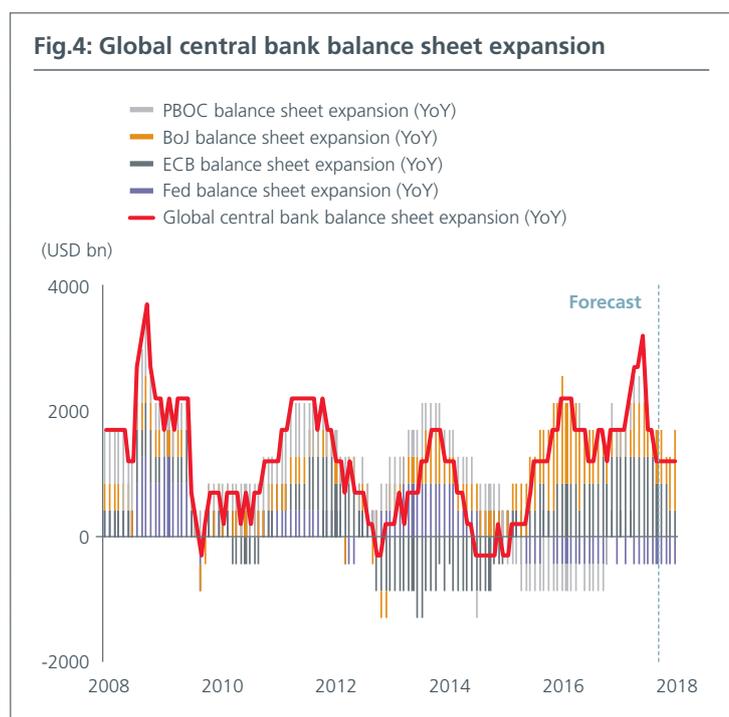
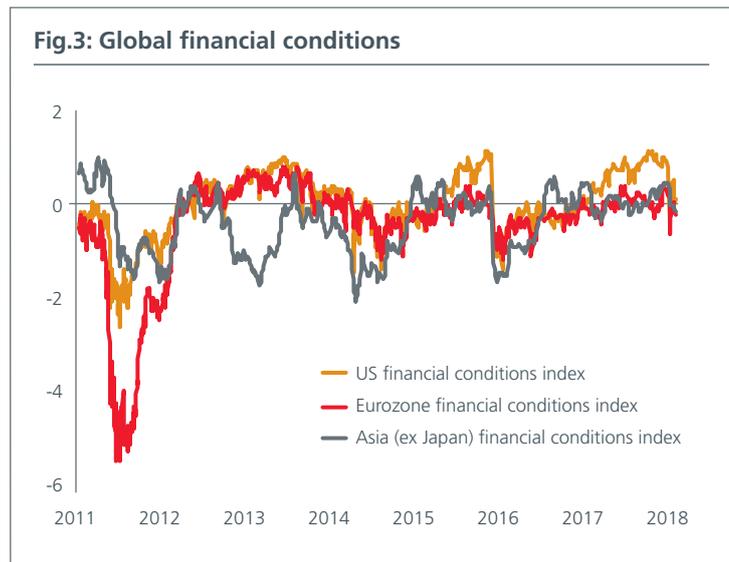
Beyond interest rate hikes, the more interesting discussion is perhaps around the impact of the balance sheet unwind on the financial markets.

The Fed is no longer reinvesting the proceeds of maturing Treasuries and mortgage backed securities while the ECB and Bank of Japan (BoJ) are buying fewer assets. Figure 4 shows the announced path of the balance sheet unwind by major central banks. Note that global central banks' balance sheets are still expanding in aggregate although the Fed's balance sheet will be shrinking.

The unwinding of the Fed balance sheet is expected to reduce the quantity of US dollars in the financial system, potentially leading to stresses in US dollar funding. This is currently not apparent in the US with banks' creditworthiness still healthy as seen from the steady TED spread. However, funding pressures may materialise outside the US as we are in the middle of a synchronised global economic upswing and a significant portion of trade is financed in US dollars. Borrowing rates may need to rise given the reduced supply of US dollars. Investors will need to navigate carefully across highly indebted companies and economies.

Adding to this uncertainty, the great balance sheet unwind is taking place amidst the changing of guards at key central banks. In the US, with newly-installed Jay Powell at the helm of the Fed, we are currently still awaiting the nomination for the Vice Chairman. In Europe, although Mario Draghi will step down as the ECB president in October 2019, speculation over his successor is already well under way. Meanwhile, China has named US-educated economist Yi Gang as the country's new central bank chief, taking over Zhou Xi Chuan after a record 15-year tenure. Besides the question of policy continuity, concerns over the independence of central banks will continue to dog investors – we have already seen overt political oversight of the BoJ.

With central banks withdrawing their unconventional stimulus against this backdrop, we expect risk premiums to rise across asset classes, as investors rebase their expectations. The resulting lift in market volatility will present a buying opportunity, as long as the spike in volatility does not adversely affect the real economy. As liquidity ebbs, the importance of company fundamentals



will come to the fore, allowing skilled stock pickers to add alpha for investors. In addition, investors who are able to be contrarian in their analysis and flexible in their approach are likely to better navigate the post-QE world.

Sources: Fig.1. Thomson Reuters Datastream, as at 18 January 2018. Fig.2. Thomson Reuters Datastream, as at 2 March 2018. Fig.3. Bloomberg, Eastspring, as at 5 March 2018. Fig.4. Thomson Reuters Datastream, as at 20 March 2018.

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