

INVESTMENTS & WEALTH MONITOR

A reprinted article from September/October 2018

IMPLICATIONS FOR ADVISORS

Quantitative Easing to Quantitative Tightening

By Bob Rice



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Quantitative Easing to Quantitative Tightening

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The business press is breathlessly speculating about the number of U.S. Federal Reserve rate hikes we'll see before December 2018. But that issue is a detail compared to the real fixed income story of 2018, and most likely the next several years: the global central banks' transition from quantitative easing (QE) to quantitative tightening (QT). Their balance sheet normalization programs portend a much trickier road ahead for portfolio construction than do a few short-term rate hikes.

FROM QE ...

Here's a number for you: \$12 trillion. That's the increase in central bank assets since the great financial crisis, effectively all purchased through quantitative easing (see figure 1).

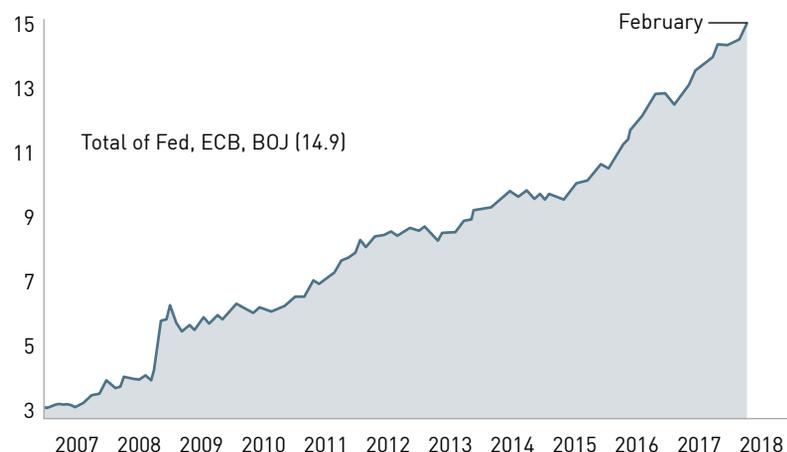
The magic of QE, of course, was that the banks purchased those assets with money that, well, didn't exist. They just credited electronic blips to the sellers' accounts for the bonds and mortgages they bought, and the recipients suddenly had cash instead of those assets.

So now, to make good on their protestations that they were very definitely not "printing money" in the QE process, and to return to their pre-crisis asset holdings, the banks have to undo that \$12 trillion of value creation. Hence, quantitative tightening, or QT.

Before delving into that process, though, let's take a moment to consider the correlations between those QE liquidity injections and financial asset prices.

Figure 1

MAJOR CENTRAL BANKS—TOTAL ASSETS
TRILLION DOLLARS, NSA



Source: Haver Analytics

Figures 2 and 3 show central bank balance sheet flows versus investment-grade bonds and the S&P 500. The dotted lines are projections about future flow changes based on the banks' current plans. Ignore figures 2 and 3 if you will, but it sure does seem that global asset prices were responding quite directly to the QE flows.

... TO QT

Today, the global tidal wave of liquidity is ebbing. The European Central Bank (ECB) has reduced its buying and confirmed that it will terminate purchases altogether later in 2018. The Bank of Japan (BOJ), whose QE program has, rather incredibly, made it a top-ten shareholder in about 70 percent of shares in the Tokyo Stock Exchange first section, has very quietly reduced its QE purchases and nearly all commentators see it in a wind-down mode similar to the ECB's.

But most importantly, the Fed is actively reducing its holdings and is scheduled to quicken the pace. It began shedding assets in October 2017 at the rate of \$4 billion per month and has been increasing that rate to \$20 billion per month by October 2018.

It's fun to think about exactly how QT works, because it's probably not what you'd expect. The Fed continues to accept regular interest and redemption payments on its holdings of QE bonds and mortgages, but then does something very odd with the proceeds: It destroys them. Quite literally. The old explanation when the stock market tumbles is that the lost value goes to "money heaven"; QT is going to create a very long line at the pearly gates.

Please note, however, that for a while the inflows (interest and repayments) from the Fed's QE holdings still will exceed

Figure 2

**CENTRAL BANK BALANCE SHEET FLOWS VS. INVESTMENT-
GRADE BONDS**

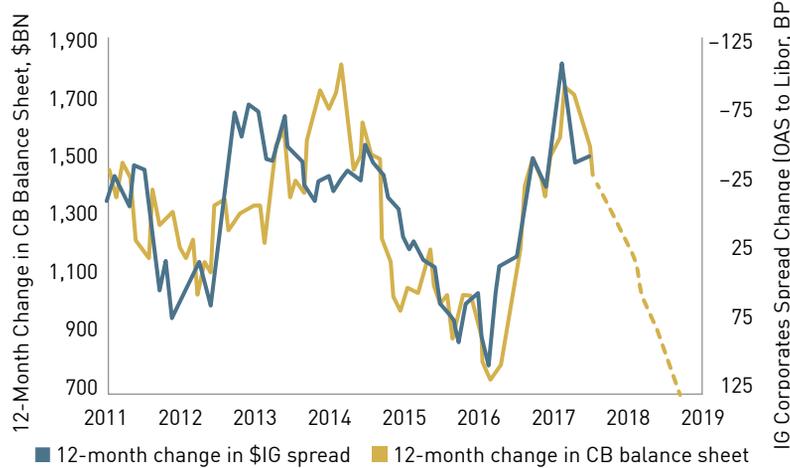
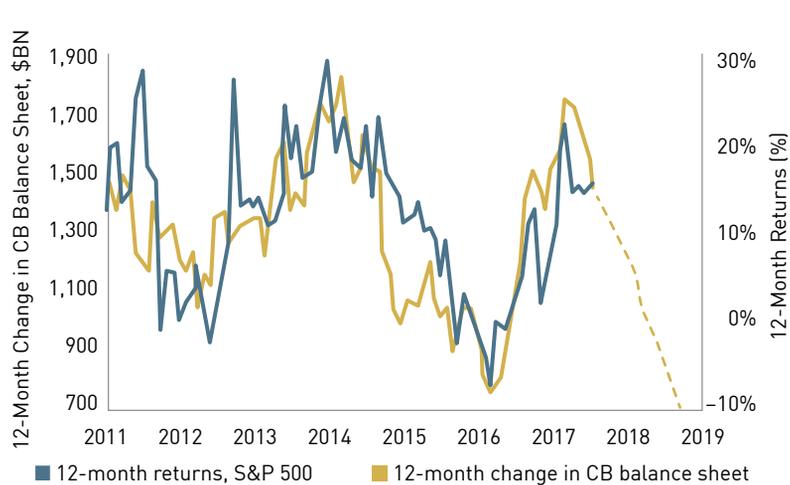


Figure 3

CENTRAL BANK BALANCE SHEET FLOWS VS. S&P 500



the amounts it destroys each month; the balance will be redeployed. Thus, the Fed will remain a net buyer of financial assets for a while, albeit an ever-smaller one as the QT process accelerates. But soon the lines will cross, and the Fed will vacate the market. Under this plan, the balance sheet will shrink to its 2008 levels by 2020.

IMPLICATIONS

We must bear in mind that QE was a completely artificial, enormous, and unique phenomenon in financial history, a massive gamble even in the minds of the central bankers. Logically, its reversal can be nothing less. Turns out that the cat was indeed able to run up the

tree; but whether it can get back down safely is not known.

All we know for sure is that the withdrawal of trillions of dollars of liquidity from global markets is an enormous wild card, not accounted for in standard investment risk or asset allocation models. As a result, autopilot portfolio construction easily could lead to disappointment.

A quick example: 2020 target-date funds are up only 1.7 percent year to date (YTD) as of this writing; and the average allocation fund with a “normal” 50-70-percent equity holding is up just about 2.5 percent YTD—and had been

down as of Independence Day. These returns were tied directly to the first two consecutive quarters of investment-grade bond losses since 2008—and the advent of QT.

Bond losses, and muted equity returns, are certainly what one would have expected from a program of liquidity contraction; and that’s just what we have seen.

So let’s consider some of the investment implications of this sea-change, and what advisors might do as the pace of QT begins to quicken.

First off, of course, is the direct impact on interest rates: The biggest buyer of Treasuries over the past few years is backing away, strongly implying less demand at the auctions—and thus higher rates regardless of any other moves by the Fed. That would be true in most environments, but now we are looking at the strong potential of a double whammy effect: The Treasury will not just need to refinance the old debt it’s paying off, but it also will be borrowing ever more to cover the hugely larger federal deficits foretold by the recent tax law and budget bills.

And, at the same time, we’re now seeing the first real whiffs of inflation in many years.

Although continued bond price declines are not certain, QT makes them a risk that savvy advisors simply cannot ignore. But that’s just the most obvious element of the story.

In forecasting where QT might have its greatest impact, what could be more logical than looking at where QE had its greatest impact? And that answer is: in emerging markets.

The various QE programs actually confounded their instigators, because instead of providing a quick jolt of economic activity in the central banks’ respective home countries, the newly minted cash did what it likes to do in a

Figure
4

CHANGE AGAINST THE U.S. DOLLAR



Source: FactSet

global economy: seek out the best returns internationally. With interest rates stuck near historic lows in developed countries, therefore, much of the newly minted QE cash found its way into emerging markets (EM), and very often into high-rate dollar-denominated bonds issued by eager international borrowers.

As a result, the Bank of International Settlements reports that emerging-market debt ratios as a whole have jumped to well more than 200 percent of gross domestic product (GDP). Emerging-markets debtors have something like \$10 trillion of dollar-denominated debt outstanding, more than 30 percent of GDP.¹ As Urjit Patel, chairman of the Central Bank of India (and who therefore should know), has warned, the combination of QT and the new U.S. deficits are likely to make dollars significantly more precious, damaging EM issuers' ability to repay these dollar-denominated debts—and putting their currencies in the crosshairs.

This is reflected in the big declines we've seen in many EM currencies in 2018, and an accelerating QT program will just ratchet up the pressure (see

figure 4). Of course, there are other reasons for these declines too, including tariff threats and political instability. QT is both a cause in itself, and an amplifier of other problems.

POSSIBLE RESPONSES

Perhaps the Fed will change its normalization plans should these adverse consequences of QT become real problems for the U.S. economy. But such a hope is not the same thing as a plan for portfolio construction. QT is now underway and the risks are real; advisors who wish to guard against them might consider these ideas.

BONDS: FAVOR ACTIVE MANAGEMENT

For fixed income, this is no time for simplistic indexed investing. Active bond managers have been significantly outperforming passive approaches for several years now; QT is very likely to increase that discrepancy. Most critically, discretionary managers can tailor their holdings given how specific instruments may respond to the intricacies of the QT process, and can pivot between a broader range of instruments, such as convertible bonds and floating-rate asset-backed securities. They also can use more timely and sophisticated

strategies, such as relative value, in constructing their portfolios.

EQUITIES: SELECTIVITY IN EM; U.S. SECTORS IN FOCUS

Despite the difficulties that probably lay ahead for many EM issuers, others offer some of the best growth opportunities in the world today, for the simple reason that their home countries' rapidly growing middle classes can drive much greater consumption and faster economic activity than can developed markets. And not all are guilty of having taken on too much dollar-denominated debt over the past several years. So selectivity is the key here. To paraphrase the old saying: it's not an emerging-country stock market, it's a market of emerging-country stocks.

As for U.S. stocks, one (surprising to many people) impact of QT already has started showing up: the relative outperformance of U.S. small caps. Tariffs completely aside, internationals could suffer easily from both lower revenues and adverse earnings translations as a result of quantitative tightening and the strengthening U.S. dollar it implies.

One other unintuitive area of potential QT-driven outperformance: stocks of

defense companies. You could say these are still enjoying their own special kind of “QE”: Governments around the world are injecting cash (however acquired or created) into their militaries at a higher rate than ever before; this helps insulate them from macro forces.

MANAGING EQUITY VOLATILITY

The most profound single implication of QT for advisors is probably that plain vanilla bond portfolios may well cease functioning as ballast for stock volatility.

The idea that bonds should insulate portfolios from equity volatility dates to the early days of modern portfolio theory and became utterly ingrained over a five-decade bull market in fixed income. But just as QE ushered in a period where both asset classes rose in lockstep, QT (and the other policy shifts) could send them both the other way. The evidence for this is already quite plain: In the first quarter of 2018, major bond and stock indexes were down together; and in the second quarter, bonds were down overall while stocks barely budged. Those examples are likely precursors of quarters ahead.

So how can we bolster equity volatility protection? As noted above, the most basic response is a more sophisticated and broad-based fixed income portfolio than pure indexing and bond ladders. But advisors also might consider long-short or other equity-hedge styles, which can be accessed through traditional mutual fund formats. Although many advisors have complained about the “performance” of liquid alternatives since 2008, that’s largely because no insurance-style approach will match long-only returns when the market is going straight up. And the first half of 2018 demonstrated that such strategies can work well in the kinds of market environments that an accelerating QT program augers.

PRIVATE MARKET OPTIONS

A newer place to ride out any QT-related storms is likely to include various kinds of private investment vehicles, because

these very often focus on asset classes and sectors that will be less exposed to global macro factors. Several interval-style funds may be worth consideration, such as those focused on middle-market private credit. These should be appealing for the same basic reasons that small-cap stocks are, they frequently offer higher yields than most public instruments, and typically hold a high percentage of floating-rate debt (and hence lower levels of duration and interest-rate risk).

CONCLUSION

QT is a fundamental shift in the macro-economic framework, and comes at a time when almost all government and corporate debt levels are at historic highs. It demands re-evaluation of portfolio construction precisely because it is not, and cannot, be accounted for by standard investment formulas and

models. Advisors should very carefully consider the exact composition of their bond portfolios and re-evaluate how to best insulate their equity portfolios from volatility. Going forward, bonds and equities may be acting less like counterweights and more like twins. ●

Bob Rice is managing partner at Tangent Capital and Rice Partners, a director of Nasdaq Private Markets, and senior advisor to Neuberger Berman and Wilshire Associates. Contact him at rer@ricepartners.com.

ENDNOTES

1. Bank of International Settlements and *Financial Times*. Emerging Markets Under Pressure as Debt Mounts (March 6, 2018), <https://www.ft.com/content/c6df7af2-1c9f-11e8-956a-43db76e69936>.

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INVESTMENTS & WEALTH INSTITUTE®
formerly **IMCA**

5619 DTC Parkway, Suite 500
Greenwood Village, CO 80111
Phone: +1 303-770-3377
Fax: +1 303-770-1812
www.investmentsandwealth.org

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