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Central banks calling the shots

Tim Farrelly | farrelly's | 22 October 2013

Central banks are dominating investment headlines and, in the short term, have become the dominant influence on day-to-day market movements. It's interesting to note the range of very different strategies employed by different central banks around the world, in response to the very different problems faced in their countries. What of it is important from a longer-term perspective?

1. THE US AND THE END OF QUANTITATIVE EASING

Speculation around the end of QE by the US Federal Reserve has been the cause of much sharemarket volatility - in both directions - over the past few months. The key uncertainties seem to be when QE will end and what impact that will have?

Before dwelling on the impact of the removal of QE, it's worth spending a little time reflecting on the impact it has had over the past few years. This is the subject of much heated debate. Our view is that large scale buying of bonds decreased US bond rates by about 0.8% to 1.0%. Lower bond rates appear to have helped support the residential real estate prices and, perhaps, equities. We say 'appears to have' because it is not clear to what extent it is low cash rates or low bond rates that is supporting equity prices or, indeed, by how much. What QE has done is inject substantial liquidity into the US banking system with the result that the banks are flush with cash that has been placed on deposit with the Fed. This has in turn resulted in US term deposit rates being very low because US banks don't have to compete for deposits as there is excess cash in the system.

What QE does not appear to have done is increase lending activity by the banks. And, what it certainly has NOT done is caused runaway inflation despite all the talk of printing presses and unchecked money creation.

In all of this, the most important question seems to have been left hanging - when will short-term US interest rates be increased? To cut to the chase, our expectation is that :
1. Bond purchases by the Fed will be pretty much phased out within two years.
2. The impact will be negligible.
3. US cash rates will not get above 1% per annum until 2018.

1.1 When will QE end?

Ben Bernanke has been somewhat equivocal on this subject. At first, there was the expectation that bond purchases will be slowed and stopped by June 2014. That was then

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watered down to suggest that purchases would be slowed when or if structural employment improved and inflation showed signs of increasing. These are two very major caveats. Most of the decline in US unemployment has been due to a reduction in the participation rate rather than an increase in employment - that is, the improvement in the unemployment figures are due to people dropping out of the workforce rather than them getting jobs. This is what we believe Bernanke was referring to when he mentioned a structural decrease in unemployment. Right now, US unemployment really isn't improving.

There is also little sign of inflation in the US. It has hovered between 1.0% and 2.5% per annum for the past five years. As discussed many times, farrelly's views QE as mildly inflationary with all of the inflationary impact being caused by increased demand as a result of low bond rates, rather than as a result of money creation.

To get inflation really moving in the US, we'd need to see strongly increasing wages - and it is really, really hard to imagine that anytime soon given the employment picture remains bleak. Soaring prices for commodities or Chinese imports really aren't going to do it. For example, Chinese goods make up just 2.7% of US expenditure. Even a 10% overnight increase of import prices would shift the inflation needle by just 0.3%. Similarly, a 50% rise in oil prices would result in a one-off inflation impact of less than 3% (which would not even be counted in the core CPI figure, which is the Fed's main indicator). Wages are the key. They make up 70% of the US cost base, so without continuing wage inflation, CPI inflation will remain modest.

For these reasons, farrelly's expects to see continued purchasing of bonds for longer than originally contemplated by Bernanke - probably for another two years, at least.

1.2 What impact will phasing out QE have?

farrelly's believes the impact of QE phasing out will be negligible, other than causing short-term volatility. If the main impact of putting QE in place was 1% lower bond rates then the main impact of its removal should be 1% higher bond rates - and the market has already factored that in. The reason why farrelly's doesn't anticipate US bond rates rising further over the next year or so is that they are already quite high - not historically, but compared to likely cash rates as will be discussed below.

1.3 What happens after QE ends?

The end of QE is generally thought of as the end of the outright purchases of bonds, however that is not really the end of the process. While bonds are no longer being bought, they will still be held by the Fed - this still represents a massive increase in liquidity compared to the position pre-Global Financial Crisis.

Of real interest is the Fed's exit strategy for its bond holdings. Will they be sold into the market - which could really create a stir - or simply be allowed to mature gradually over

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time? The latter is not as benign as it sounds. When bonds mature, they have to repaid and replaced by new bond issues – new buyers have to be found – and this would put pressure on bond rates. But, that is well and truly many years down the track and a concern for another day.

What is relevant today is what all this means for the second leg of the Fed's strategy – ZIRP, the zero interest rate policy. While QE is being wound back, it is unlikely that cash rates will be increased, as the Fed is already nervous about the impact on markets and sentiment of winding back QE. After the end of QE – say, two years from now – any increases in cash rates are likely to be very, very slow unless the US economy is roaring ahead which is doubtful. As a result, farrelly's would be surprised to see US cash rates above 1% per annum inside of the next five years.

All of this suggests that, on average, cash rates will be around 0.5% per annum for the next five years and, even a spike to 3% after that would still only result in an average cash rate of under 2% per annum for the next decade. Against that benchmark, current US 10-year bond rates of 2.8% seem attractive and therefore unlikely to go much higher with or without QE.

For all of these reasons, we see the end of QE in the US as a bit of a non-event; it's already in the price of securities.

2. A NEW BURST OF QE IN JAPAN

While the changing nature of QE in the US is something of a non-event, nothing could be further from the truth in Japan. Shinzo Abe's dramatic plan has taken QE to another level and has clearly already had an impact. Japanese-style QE is almost three times the size of the US program and, in addition to government bonds, the Bank of Japan is also buying Japanese shares and REITs. The stated aim is to create some confidence in a very depressed economy along with a little inflation. The true aim has been to restore competitiveness via a lower Yen and, with it, confidence. On both counts, the program has been hugely successful so far – the Yen fell 30% and Japan's stock and REIT markets soared.

The fall in the Yen has had a huge impact on the profitability of Japanese exporters. If they choose to pass on half of this by way of lower prices to their export markets, they should gain both market share and profitability. This, in turn, has led to a surge in confidence and with it, private sector consumption and investment. So far so good!

The big question is whether the recovery is sustainable. It's like applying a defibrillator to a heart attack victim – is the patient too far gone to be saved?

With dreadful demographics and no inclination to encourage immigration, Japan's workforce is set to decline by 1% per annum over the next decade. On this basis, productivity will have to grow by 2% per annum to get GDP growth of just 1% per annum.

And, there is the problem of soaring Japanese government debt, now at 240% of GDP. A 1%

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per annum real growth rate means growing its way out of debt is just not an option for Japan.

Inflation helps a bit, but rising interest rates would be a disaster. With average interest rates on government debt at 0.8% per annum, interest payments represent 30% of government revenue. At 2.8% per annum, interest payments would be over 80% of government revenue. So, they have to raise taxes - and that too is part of the plan; the second of the so-called three arrows of Abenomics. But we know that raising taxes kills domestic growth. So everything will hang on exports saving the day.

The third arrow is restructuring Japan's very inefficient economy. This will be critical and the key to getting the 2% per annum or more productivity improvements that it desperately needs. This will also be key for Japanese equities' performance. Short of an economic disaster, Japanese equity performance should be somewhat independent of the growth of the economy. Low GDP growth may indeed mean low earnings growth but, in a low growth environment, using retained earnings to aggressively buy back shares can still result in reasonable earnings per share growth. But, the critical piece will be generating enough earnings to fund the buybacks.

Maybe Japan can muddle through. More likely, it is too late. It will be fascinating to watch it unfold. For a year or two, the news could be good but, after that, the fun will start. And, if it gets really ugly, expect Japanese companies to be dragged down with the rest of the economy. But that too is a few years off - another problem for another day.

3. A CURRENCY CRISIS IN BRAZIL, INDIA AND INDONESIA

On the face of it, the currency crises in Brazil and India are something of a mystery. In most parts of the world, the strategy (or hope) is to get a country's currency lower - Abenomics was designed to deliever Japan a weaker Yen, US and Chinese authorities regularly accuse each other of artificially holding their currencies down and, in Australia, the Reserve Bank breathed a sigh of relief when the Australian dollar finally began to fall.

In stark contrast, central bankers in Brazil, India and Indonesia are wondering how to defend their plunging currencies. You could be forgiven for assuming that the main aim of central bankers everywhere was to push currencies down - why on earth would they be trying to defend their currencies? The logic goes like this. All three countries have high'ish inflation to which the central bankers are allergic and desperate to reduce. But, the problem with a plunging currency is that it makes inflation worse as the cost of imports soars. Furthermore, currency crises can be self fulfilling. Fear of a fall in the currency causes outflows of hot money which in turn causes further falls, further outflows, and so on. This is important to countries which run current account deficits and rely on external financing to fund growth - no external financing, no growth - and hence, the desire to protect the currency. Finally, as all three countries are focused primarily on domestic growth (unlike, say, South Korea, Taiwan, and Singapore which are export focused), a falling currency can do more harm than

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good.

Interestingly enough, those countries with export-focused economies and strong current account positions have seen very little change to their currencies but would probably welcome a fall of 10 or 15%!

4. DAMPENING CONFIDENCE IN CHINA

At the other end of the central banking spectrum is the People's Bank of China (PBOC). While in the US, Japan, India and Indonesia, central bankers have been busily trying to rebuild or restore confidence, the PBOC has been trying to inject some fear into the economy. June's mini credit crunch, when interest rates spiked from 3% per annum to over 12% per annum in the space of just a few weeks, was intended to dampen confidence in order to limit the growth of the shadow banking sector.

The PBOC has imposed strict controls on the amounts and rates at which China's commercial banks can lend and borrow. Like all good bankers, the Chinese have found ways around the rules – the so-called shadow banking system with its off balance sheet lending and investment through the sinister sounding WMPs (wealth management products). WMPs are a bit like CDOs or mortgage trusts in that they pay a higher rate of interest than term deposits and are used to fund risky property and infrastructure projects. Like CDOs, investors think they are safe because they assume the PBOC will bail out any that fail. Not surprisingly, the prospect of high returns and low risk has proven irresistible to investors. These products have grown so rapidly that they have become the main source of finance for new lending activity in China. The PBOC was determined to control their growth. The solution? Create a liquidity shortage, driving up short-term interest rates and sending a few WMPs to the wall. Now, everyone knows these vehicles can fail and won't be bailed out. All of a sudden, the shadow banking system does not seem so attractive to investors.

The key issue here for Australian investors is that the PBOC is determined to protect the integrity of China's banking system – and that means lower lending growth in future which, in turn, means lower economic growth and, in particular, lower investment in resource-intensive projects. Its good news for investors in China, and bad news for resource producers.

5. WHAT'S IMPORTANT IN ALL OF THIS?

For long-term investors, the following are the critical takeouts from all of this:

1. For the US, the key indicator to watch is when short-term interest rates will rise and by how much. If, as we expect, short-term rates stay at zero or close to that for two years or more, a major bond market sell off is unlikely.

2. In Japan, the long-term problems remain significant (perhaps insurmountable). Given that

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the Japanese equity market has already risen dramatically, most of any improvement has probably already been priced in and there is considerable risk that Japanese equities will fall back into their old ways.

3. Emerging market currencies - indeed all currencies - are not a one way bet. This is particularly true given that many emerging market economies have high inflation, and inflation tends to weaken currencies in the long term.

4. The Chinese are indeed serious about moving from an investment-led economy to a consumption-led economy. This means somewhat slower long-term growth and, in particular, much slower growth in China's consumption of commodities for construction, in particular, for iron ore and metallurgical coal. This is likely to mean lower prices for key Australian exports with clear implications for the Australian resources sector.

5. Central banks are likely to dominate investment news for years to come. (And, we didn't even mention Mario Draghi and his friends at the European Central Bank!) Much of this news will cause considerable volatility in the markets, but most of it will be noise. However, some of it will be critically important, even for long-term investors. This will generally be around news that drives interest rates and inflation in the long term. Most of the rest will just create buying opportunities.

Tim Farrelly is principal of specialist asset allocation research house, farrelly's Investment Strategy, available exclusively through PortfolioConstruction Forum. Tim is a member of PortfolioConstruction Forum's core faculty of leading investment professionals.

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