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Il Sole 24 ORE

Global markets

TAPERING: THE UNKNOWNS

The European case

The market awaits the reduction of quantitative easing (QE) in 2018: stock markets and bonds could suffer from the changes

Reactions

The stock markets (+19% per year in the US) have gained most in the stimulus era

ECB and Fed: ready to put the brakes on the stock market rally

The possible impacts of the exit strategies

"There are two ways to reduce inequality: enrich the poor, or impoverish the rich. The Federal Reserve and the European Central Bank (ECB) will follow the second path: they'll impoverish the investors of Wall Street". With a touch of sarcasm the Bank of America strategists, Michael Hartnett and Jared Woodard, sought to answer the question many are asking on the financial markets: what will happen when the ECB begins to reduce its injections of liquidity and the Fed starts to slim down its balance sheet? What will happen, in short, when the central banks, which for almost a decade now have been pouring fuel into the markets, withdraw this tide of liquidity? The two strategists feel that the financial markets that have gained most from QE are the ones that will pay the price, but without the real world receiving any great benefits. The inequality gap will get narrower, they say, but with a downwards shift.

And they're not the only ones who see things that way. For years the financial markets have been steered upwards by injections of liquidity from the central banks. As we can see from the graphs, the performance of the stock market and bonds has always been related to the increase or reduction of these doses. It's true that the Fed has raised interest rates several times in recent years without Wall Street feeling the effects. But it's also true that the Fed has been tightening the purse strings while the other central banks have been printing large quantities of bank notes. A look at the last few months is all that's needed to grasp this: in April the world's central banks printed a total of 350 billion dollars in new notes, in May 300 and in June over 100. At the global level, therefore, monetary policy has always been expansionary. But in the future the tune might change. Gradually, of course. But change is in the air. At least six central banks have altered their stance recently, becoming much more restrictive. Even without inflation. In short, from a global monetary expansion, we're moving to global restriction. This will be a slow, very slow, process. The central banks will try to take as "soft" an approach as possible. But it will be a Copernican revolution for the markets.

A change of pace

The minutes of the Fed (which has already been raising rates for some time) reveal that a division has emerged inside the central bank, on whether or not it's a good idea to start gradually selling the securities it has purchased. But the debate has started and sooner or later the US central bank will begin to sell the government bonds purchased in the QE years. In other words, it will withdraw liquidity. The minutes of the ECB reveal an equally restrictive message: it's preparing to start the tapering process, i.e. a reduction of the monetary stimulus provided by QE. The Bank of England is taking a similar stance. A few days ago the Swedish central bank, the Riksbank, removed any mention of possible new rates cuts from its communiqué. "The message from the central bankers is clear", write the economists of Morgan Stanley. "They expect a better future, and if it really is better, they'll remove the stimulus".

Returning to the ECB, the markets think it will reduce its QE-based bond purchases (so, injections of liquidity) from the current €60 billion per month to €40 billion by mid-2018, and then to zero, or to €20 billion, at the end of the year. The ECB could even raise interest rates in late 2018. In recent weeks this has shaken up the markets considerably, especially the bond markets. So it's legitimate to ask: what will happen in the future if this monetary restriction really does come to pass?

Winners and losers on the markets

To try to imagine this situation, it might help to consider which sectors have gained or lost the most in these years of monetary stimulus. The stock markets have been the big winners: since March 2009 the average annual gains have been 19% in the US, 13.5% in Europe, 12.4% in Great Britain and 12.3% in the emerging countries. As for sectors, the winners have been Biotech (+19.9% per year) and technology (18.9%). Now that the monetary support is being reduced, they could however turn out to be the losers. The technology sector is already wavering. "The stock markets are stretched", observes Francesco Castelli of Banor Capital. "Today they're paying high multiples, especially on Wall Street, while corporate profits have reached their peak for the cycle and the peak in profitability because companies are more efficient. The market believes in economic growth and hopes that the recovery in margins continues, but I'm having trouble believing that. I'm convinced that the wind is changing direction". GMO's economists are also forecasting negative performances in the coming years for the bourses, except for those of the emerging countries. The analysts at Capital Economics are not so concerned, however. "We're convinced that the increase in market rates will not affect stock markets too much", they observe. "The principal reason can be found in the situation of favourable economic growth". So the debate remains open.

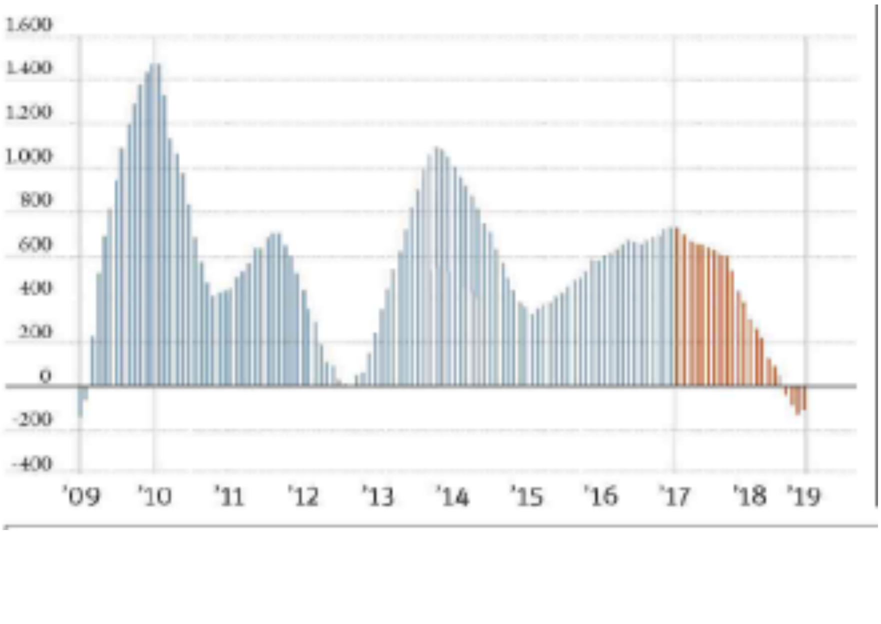
In the case of bonds, opinions show greater consensus: yields will increase. Or to put it another way, bond prices will fall. "We're convinced that sales of bonds will continue in the second part of the year", write the analysts at Capital Economics. Andrea Delitala and Marco Piersimoni, of Pictet Am, think the effect of the central banks' policies, regardless of how they behave in future, will range from "extremely negative" to "negative" for bonds. Only in one case, that of an error in monetary policy, might the effect on bonds be "neutral". Bonds have, after all, been the other big winners in the QE era: especially corporate "junk" bonds (which have seen average annual gains since 2009 of 9% for CCC-rated to 13.7% for high-yield European and US bonds), but also sovereign bonds. If rates were to rise (even though we need to see how inflation goes), it's likely that market returns could rise.

The winners in this case could be certain small countries, starting in Europe with Switzerland, Denmark and the Czech Republic. If the ECB were to become more restrictive and the euro were to strengthen (as is happening now), their currencies could weaken slightly against the euro, thus avoiding the need for costly intervention by the central banks. But in general, considering that the abundant liquidity of recent years has benefited all of the markets to some degree, it's possible that times could get harder more or less everywhere. The central banks know this: that's why they'll be taking great care to manage their exit strategies cautiously. So far, the Fed has managed to do so. And the ECB enjoys great credibility on the markets. So we shouldn't assume that the departure of the stimulus will necessarily be traumatic. There are still plenty of cards to be played.

From central bank balance sheets to the market: how monetary policy influences shares and bonds

CENTRAL BANK WITHDRAWAL

Combined Fed/ECB balance sheets, year/year changes. The red part is estimated on the basis of current central bank communications



CENTRAL BANKS' IMPACT ON SHARES

Gains/losses (%) on the of the average US, European and Japanese share indexes

Annual % change in the combined Fed/ECB balance sheet in local currency

CENTRAL BANKS' EFFECT ON GOVERNMENT BONDS

Risk premiums for 10-year bonds
% of US government bonds held by the Fed and foreign central banks (inverted scale)

Source: Tim Bond, partner and strategist at Odey Asset Management