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Life After QE

There are big changes underway in central bank balance sheet policy globally. The Fed has been letting its holdings of Treasury and mortgage-backed securities roll off. The ECB is about to stop making net purchases.

These actions are significant steps in a global shift away from active use of the balance sheet in monetary policy, which rose to prominence across developed markets in the wake of the 2008 global financial crisis (GFC). We consider it a milestone, and many market participants are trying to quantify the effects of smaller central bank balance sheets. We view this inflection point differently and expect it to have little explicit or mechanical near-term impact on yields.

MANAGER INSIGHT

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Key Takeaways

- Central banks have been pivoting away from expansive balance sheet policies.
- We think this will likely have little explicit near-term impact on yields; economic outlook and the path for interest rates should be the main drivers.
- But considerations remain about the impact of balance sheet policy and future inflation rates, fund flows, and central bank reaction function.
- Understanding key theories that precipitated QE may be the best guide for thinking about life after.

The economic and market environments today are very different than those that prompted policymakers to implement quantitative easing (QE). Going forward, the economic outlook and the path for interest rates should dominate our view on yields.

But there are still important considerations related to the impact and future use of balance sheet policy, and they highlight areas of uncertainty – about future inflation rates, fund flows, and central bank reaction functions. Given how significant a turning point this is from a policy environment that shaped markets for over a decade, there is a good chance that this uncertainty may not be fully compensated. As investors think about this uncertain future, the past may be their best guide. Understanding the theories that helped make the case for quantitative easing may also be relevant for thinking about life after. We will examine three key areas:

1. Portfolio Balance: this concept has shaped balance sheet policy in recent years and may still be relevant when it comes to thinking about rates.
2. Negative Policy Rates: this is closely related to balance sheet policy and has had specific implications for currencies, particularly in Europe.
3. The Future for Balance Sheet Tools: what considerations regarding the use of balance sheet tools could central banks wrestle with going forward?

Glut, Balance Sheets & Real Yields

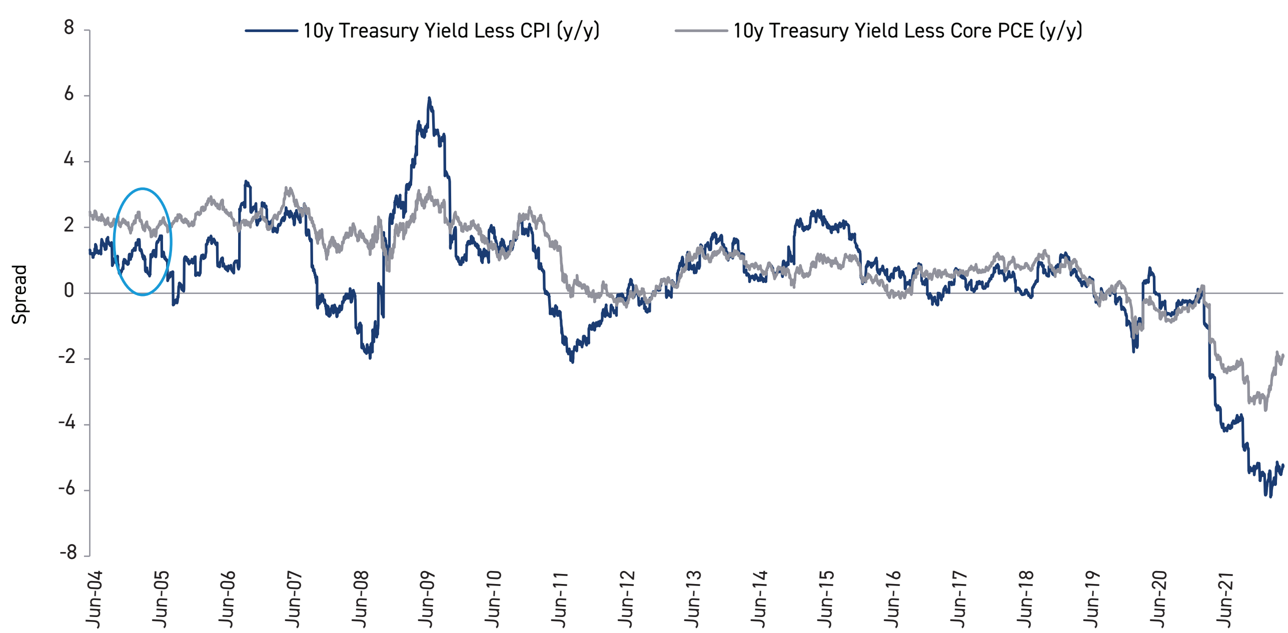
The global saving glut concept can play a role in the thinking behind QE policymaking and raises questions about the future path for real yields.

In a 2005 speech, former Fed Chair Ben Bernanke suggested that a global saving glut was causing a "relatively low level of real interest rates." He theorized that there was a sufficiently large pool of funds that needed investment and would buy Treasurys at yields that might not attract other investors.

Bernanke cited similar themes at his 2010 Jackson Hole speech, where he set the stage for the large-scale asset purchase program known as QE-2. He suggested that this program would operate through the portfolio balance effect, by which the Fed's purchases would lean on long-term yields and push investors into other assets. The central bank would, by design, operate like the saving glut.

Now, as the Fed steps back from the Treasury market, we are left with something of the same question Bernanke considered in 2005: what is the size and makeup of the universe of buyers who desire Treasurys at a relatively low level of real yields? Even determining "relatively low" is an open question. At the time of the saving glut speech, US 10-year yields were around 4.5%, and CPI had just printed at 3.15%. By contrast, as the Fed now lets its balance sheet run-off, the 10-year yield is just around above 3%, and CPI is just above 8%. If we instead used the Fed's 2% inflation objective as our inflation assumption, the 10-year would offer some real yield potential—but still less than in 2005. This leaves us with key questions for the curve: Just how much faith is there in the inflation objective? When might it be met? And what premium would the investor universe, whatever its makeup, require to keep this faith? Many of the conditions of the 2005 saving glut have changed. We feel this is a good reason to suppose the shape of the "glut" universe has as well.

10Y TREASURY YIELD – CPI (SAVING GLUT SPEECH CIRCLED)



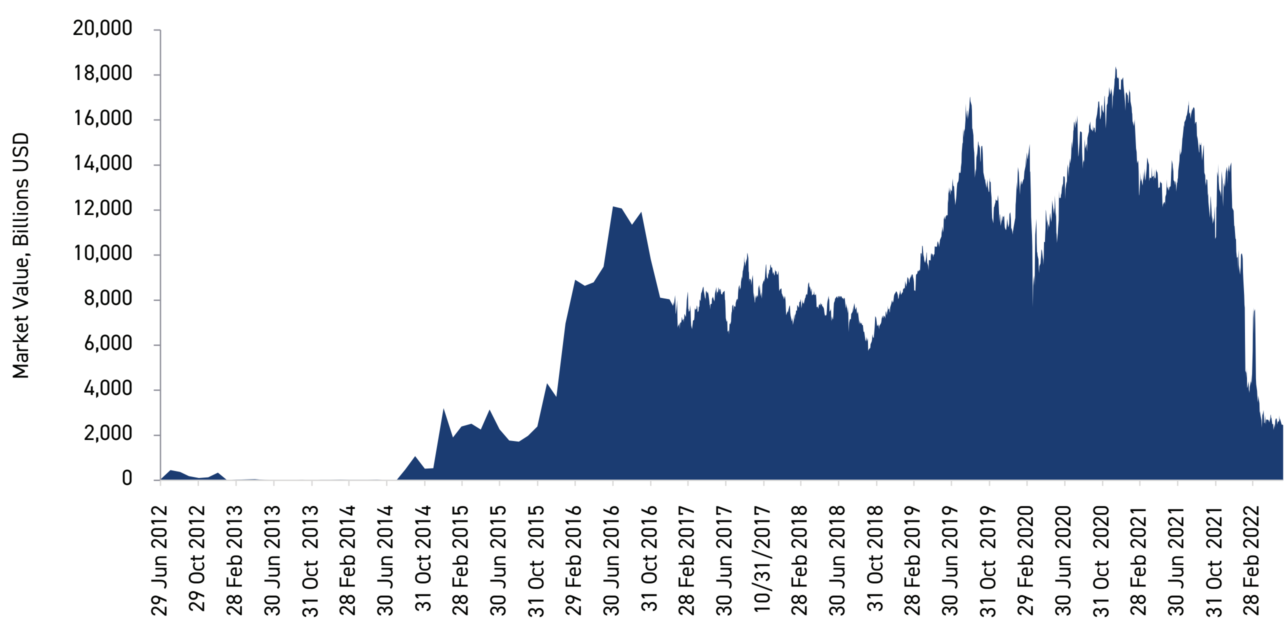
Source: Bloomberg, as of 8 June 2022.

Negative Rates and a Meaningful Complement

The ECB has said it will exit from negative policy rates by September. This is no surprise for a central bank with a single mandate of targeting 2% inflation. Euro-area inflation now exceeds 8%, and there are more signs that the low inflation risks that plagued the euro area for many years have diminished or may be gone.

During its era of low-inflation, the ECB cut rates into negative territory. As former ECB President Mario Draghi explained in a 2014 speech, the strength of the currency was exacerbating downside risks to the inflation target. Negative rates would force money to flow elsewhere, with investors selling euros in exchange for other currencies – an effective portfolio rebalancing. Just a few months later Draghi took his turn at Jackson Hole, laying the groundwork for the ECB's version of QE—a broad-based program of sovereign bond purchases, focused on the expanding the balance sheet—and looking to also bring down longer-term yields. In many cases, these became negative. Even at the 30-year point, and even in countries thought to be at serious risk of default a few years ago—evidence that balance sheet expansion and negative rates complemented each other with extraordinary power.

GLOBAL AGG, AMOUNT OF NEGATIVE-YIELDING DEBT



Source: Bloomberg; data 3 Jan 2004 – 17 May 2022.

Conditions were notably different this February, when ECB executive board member Isabel Schnabel started laying the groundwork for a strong euro bias – which would require speeding up the end of net asset purchases, as the ECB has done. It seems there is no longer a desire to see funds flow out of Europe. We believe the opposite may be true. It is unclear if this combination of comments, the end of net asset purchases and a rate hiking cycle will in itself move the euro much. But the stock of the private sector exposure to euro-denominated fixed income has been heavily influenced by many years of policy calibrated to deflation risks. With so much of the sovereign bond universe yielding below the ECB's 2% target, Bernanke's 2005 questions remain pertinent. Even though the ECB has not—yet—let its balance sheet roll off, its currency bias may be sending an explicit instruction to the investment universe.

Policy Assessments and Evolution

Asset purchases in response to the COVID-19 crisis had a first-order objective of restoring market function and liquidity. This was a different application from the carefully calibrated monetary policy approach that Bernanke outlined at Jackson Hole in 2010. But policy objectives quickly pivoted from stabilization to monetary easing, even as the tool remained the same.

At the virtual 2020 Jackson Hole Conference, Bank of England Governor Andrew Bailey argued that reducing balance sheet holdings acquired during stabilization actions are important to retain the power of this approach. This was quite a shift for the Bank of England (BoE), which had not reduced the balance sheet expansion it began in 2009. It has now begun to do so, and is currently assessing active sales of its holdings as opposed to simply letting securities run off. Amid what will likely be a long period of consideration of the appropriate calibration of asset purchases in the COVID-19 crisis, Bailey's approach may be important in the evolution of future policy considerations. Particularly so if inflation risks persist.

The BoE and the ECB have both suggested that they will consider climate-impact factors in the future management of their holdings of corporate bonds. This appears to be an important aspect of the forthcoming adjustments in the ECB policy framework, and will likely be further complemented by measures aimed both at supporting Paris Accord objectives, and at assessing and managing climate-related risk on the central bank balance sheet. But, as with the portfolio balance effect, the policy signal is a key factor. It could become quite powerful.

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