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The failure of QE

By Jan Dehn

Quantitative easing (QE) is failing. Instead of funnelling funds into the real economy, the policy is inflating bubbles in both equity and bond markets in the HIDCs (Heavily Indebted Developed Countries). Lately, as many HIDC bond yields approach zero, QE money is migrating into currency markets where it is causing growing volatility, which is now beginning to create serious economic problems.

These unintended consequences are undermining the effectiveness of QE and the failure of governments to reform and deleverage is compounding the problem. Today, a major attraction of Emerging Markets (EM) fixed income investment is one of insurance against large permanent loss – in EM you can still be confident that you are not buying into a bubble.

Turning policies of the 1930s on their head

The decision to respond to the collapse of the 'Greenspan Bubble' by slashing interest rates and printing money – QE – stands in sharp contrast to the policies that were adopted during the Great Depression in the 1930s. Instead of tightening monetary policy and forcing the economy into sharp economic contraction, the Fed Chairman at the time, Ben Bernanke, adopted a policy of extreme monetary policy easing to facilitate a very gradual adjustment of the underlying economy. Broadly the policies have also been enacted in response to similar economic problems in other HIDCs, including Japan and the Eurozone.

Good intentions…

The basic principle behind QE is simple enough. In order to stimulate demand money is printed to buy government bonds. By pushing down yields, not just at the short end of the curve but also further out, money is expected to move into the real economy in pursuit of better returns, thus stimulating demand and bringing about a sustained economic recovery.

…but unintended consequences

Unfortunately, QE has delivered a number of unintended consequences that now threaten to undermine its effectiveness. Rather than finding its way into the real economy, QE money has fuelled a bubble in bond and stock markets and is now also entering the currency markets, where it is contributing to greater and greater volatility. The bubbles and the associated uncertainty are undermining the economic recovery which QE was supposed to engender.

Equity market bubbles

Corporates in the HIDCs have been unwilling to invest their retained earnings in their own businesses. Instead, they have used these funds to buy back their own stock. This has added fuel to the QE equity bubble and pushed stock market valuations to levels that today are much higher than before the Greenspan Bubble, even though many of the problems of the economy have not been addressed, particularly the debt overhang. Company CEOs are aware that policy-makers are re-inflating bubbles, but they also have to deliver shareholder returns. As they buy their own stock, they become less, not more, likely to make real investments. The result is that the gap between equity valuations and the real economy continues to widen.

Fixed income bubbles

The bubble problem is even worse in fixed income. Switzerland for example recently issued a 10-year bond with a negative yield. Most so-called 'core' European economies now issue long bonds with yields close to zero. Yet, these countries almost uniformly suffer from massive debt overhangs and chronic growth challenges due to a plethora of structural issues that their political leaders have neither the willingness nor the ability to resolve.

Why would anyone buy such bonds? Part of the answer is that yields are expected to fall even further. But chasing momentum without reference to the economics of the trade is a dangerous strategy. The other reason is that many institutional investors simply have no choice in the matter. Pension funds and insurance companies are heavily restricted by their regulators in terms of what they can buy. QE actually worsens this problem. As central bank purchases of government bonds push their term yields lower, the funding status of pension funds erodes further, which then forces them to increase duration to make up for falling cash flows. As this is happening at the very tail end of a thirty-year

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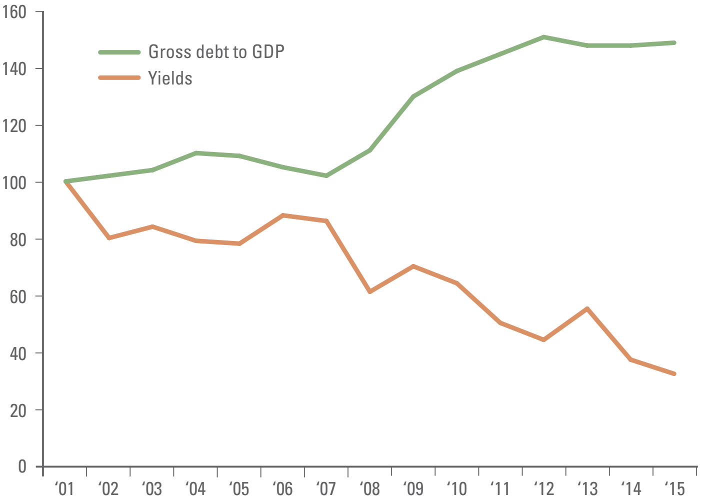
fixed income rally, the pension funds and other institutions are being set up for potentially crippling losses. This prospect of wanton wealth destruction in turn encourages savings, which prevents the very recovery QE is supposed to set in motion.

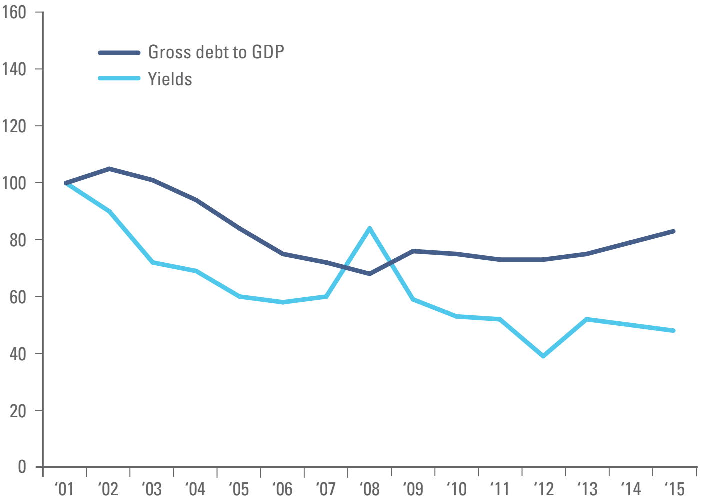
Figures 1 and 2 below chart the changes in debt levels and yields in developed and emerging countries. The data is indexed at 100 in 2001 to facilitate direct comparison. This demonstrates that bond yields in developed countries have fallen by nearly 70%, while debt has almost doubled. Yields in EM countries have fallen far less (by 50%) and debt levels have actually declined by 17% over the same period

Fig 1: **A developing bubble in HIDCs – rising debts, falling yields**



Source: Ashmore, IMF's World Economic Outlook, JP Morgan.
Data indexed to 100 on 1 January 2001*.

Fig 2: **Emerging economies – debt and yields more stable**



Source: Ashmore, IMF's World Economic Outlook, JP Morgan.
Data indexed to 100 on 1 January 2001*.

*The data uses the IMF's definition of advanced economies and developing countries for the debt to GDP ratios and uses the yield data from JP Morgan indices (JPM GBI Global Index for developed markets and JPM EMBI GD for EM).

Currencies are now beating bonds

Lately QE has also begun to sow the seeds of its own failure in the global currency markets. As an investment, a currency actually becomes superior to a bond when bond yields fall to zero. At zero yields, currencies have two distinct advantages over bonds in that they cannot default and they are vastly more liquid. In addition, currency trades tend to be wonderfully auto-correlated, particularly in the big three currencies (EUR, JPY and USD). This means that popular consensus trades can last for months, even years, which is enough time for investors to jump on the bandwagon and make some money even if they don't catch the exact turning points.

The liquidity liability

It should therefore not surprise that currencies have emerged as the single most dominant force in shaping global market sentiment today. Since 2011, global investor sentiment has been shaped by six easily recognisable global currency trades, whose impacts have extended far into markets that would not ordinarily be as sensitive to FX.

The two 'Abenomics' trades that saw USDJPY move from 80 to 105 and then from 105 to 120 were very powerful, but the first Eurozone debt crisis trade, which pushed EURUSD from 1.50 to 1.20 and the recent ECB QE trade that pushed EURUSD from 1.20 to 1.05 have been equally influential in shaping sentiment. For EM, the 'Taper Tantrum' and the EM FX sell-off prompted by the fall in commodity prices in H2 2014 were both highly influential in shaping investor sentiment.

It is both noteworthy and concerning that each of these six trades above involved buying USD and selling something else. The central role of the USD is due to its status as the most liquid of all currencies, but buying for this reason alone is no guarantee of safety. As investors the world over get more and more exposed to the Greenback, its very liquidity today could become its greatest liability tomorrow as limit long investors turn sellers all at once.[1]

Volatility…

QE's tendency to elevate a small number of global currencies to the status of global market sentiment drivers with scant regard to underlying fundamentals is already having serious adverse economic consequences. Some EM countries have experienced dramatic – and in some cases entirely unwarranted – currency volatility, including withdrawal of funding from their local markets by fearful international investors. This was particularly evident during the 2013 Taper Tantrum, where such outflows caused a 200bps increase in local bond yields, which in turn shaved 50bps off EM average growth in 2014. Fortunately, most EM countries had – and still have – the means to handle such volatility without too much fundamental distress due to their large FX reserves and generally strong economic fundamentals.

…and worse

It is of far greater concern what is happening in the HIDCs, where QE is now being deployed in deliberate 'beggar-thy-neighbour' type policies. Japan and Europe are openly engaged in exchange-rate intervention using QE. Indeed, the ECB launched QE just as the European business cycle began to turn up, which

[1] We regard the build-up of USD longs as worrisome, because the US is likely to become the first of the major HIDCs to experience inflation, yet without the economic strength to materially raise rates. This poses the risk of an inflationary episode, which could lead to a disorderly fall in the USD. For further detail see *"Disequilibrium and the Dollar"*, The Emerging View, May 2013.

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shows the policy was undertaken to weaken the EUR. American businesses have already been hurt as have currencies in Eastern Europe. The flight to the USD has also hurt energy sectors in the US and elsewhere by amplifying the sharp fall in oil prices that began in mid-2014 (recall that the USD rally of 2014 began on the very same day that oil prices began to decline).

Limits to USD appreciation

Even Fed officials are now recognising that the US economy, like other HIDCs, is simply not generating productivity gains fast enough to cope with endless currency appreciation. With a trend growth rate of only 2%, it is only a question of time before the US economy will get drawn into pursuing the same tactics as the other HIDCs. This could happen, for example, via a signal from policy-makers that they see advantages in a weak USD policy.

It does not take a great deal of foresight to imagine what comes next; retaliation and creeping pressures for trade protection now look more likely than at any time since the crisis began. Despite willingness by leaders in both countries to push the Trans-Pacific Partnership forward, Japan and especially the US will face increasing opposition to the free trade accord in their respective legislatures precisely due to the ever greater gyrations in currency markets.

QE was never meant to operate in isolation. To be effective it needed governments to deliver serious structural reform and deleveraging. Unfortunately in most cases this has not happened

The unintended consequence

What is it about QE that has generated such negative effects that the policy is now in danger of being an outright failure?

Importantly, the central bank architects of QE did not pay enough attention to the risk of speculation, myopia and herd behaviour among financial investors. Financial investments consist of both yield and capital gain (or loss). Simply driving bond yields to zero does not guarantee that financial markets plough money into the real economy. Instead, investors have chased capital gains in both stock and bond markets and, lately, as bond market yields have fallen to zero, increasingly also in currency markets – the most myopic and herd-driven of all. In this way, QE has actually discouraged the recovery by inflating bubbles, increasing myopia and raising the level of volatility in currency markets rather than encouraging real investments to support the economic recovery.

Neglect of the real economy

The other problem is that governments did not deliver on their part of the bargain - QE was never designed to operate in isolation. It is critical that it is complemented by serious structural reform and active deleveraging to ensure the restoration of health in the underlying economy. Unfortunately, apart from a few governments in peripheral Europe that were forced to reform at 'gun point', the HIDCs have uniformly failed to address their long-term fiscal and demographic problems, revamp their infrastructure, deleverage their economies, increase their trend growth rates and - in some cases - even fix their banks. Paralysed by fear of taking tough decisions and turning increasingly populist, they have largely squandered seven years of hyper-easy monetary policies.

QE will only be judged a success if, from the rubble, inflation and currency realignment emerge to help deal with the debt overhang and restore external competitiveness

Perverse

The United States has not delivered reforms that address the long-term fiscal problem in the last four presidential terms. The British government is proposing a referendum on EU membership with potentially serious risks to the UK economy – mainly for political reasons. Europe has failed to fix its banks or achieve meaningful deleveraging even as Fed hikes draw nearer. In each case, central bankers have repeatedly been called upon to deal with these symptoms of government inaction. Not only are central bankers finding it difficult to tighten policies in the face of ever lower realisations of trend growth rates, but in providing the 'band aid' of QE central bankers in the HIDCs are actually further inflating already dangerous bubbles and making their eventual deflation that much more painful.

Recovery by deception?

Unless they get serious about fixing their underlying economic problems, notably the debt overhang, it is likely that QE's euphoric effects will wane; the response will likely be more QE but each application becomes less effective and the addiction worsens. Volatility and the risk of bubbles both increase. The biggest risk is that ordinary people see through the money illusion that lies behind QE, so that they increase savings as they perceive big losses of future income ahead.

QE will only properly succeed as an economic rescue operation if it leads to inflation. The entire Western world is today actively pursuing policies that could, theoretically, result in a sudden resurgence of inflation. The US in particular has undertaken policies that give hope that inflation could resurface within the next couple of years, notably through bank recapitalisation and the clever use of the Fed's balance sheet to help household deleverage.

If inflation were to resurface today, aided by QE, the immediate damage would probably be significant, because inflation is entirely unexpected and would force upon markets some serious reassessments, including considering the prospects for further financial repression, but also a re-pricing of the US yield curve and the USD.

Ultimately, however, these would be temporary problems. QE will only be judged a success if, from the rubble, inflation and currency realignment emerge to help deal with the debt overhang and restore external competitiveness.

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Conclusion

Investment is a process that involves careful and detailed scrutiny of individual opportunities and, in the face of uncertainty, determining if it is worthwhile committing capital. If an investor can become convinced that a venture's expected return exceeds its perceived riskiness by a sufficient margin, he or she will strike.

Investing is therefore, at root, about making single bespoke decisions about individual opportunities. Yet, somewhere along the way, greatly aided by modern finance theory, investors lost track of what it means to make individual investments. Investing became a game of aggregation, of spreads, of indices and of the dynamics of the herd itself.

As markets became global in nature the crucial connection between prices that are determined in financial markets and risks that are determined in the real economy was severed. The divorce of price dynamics and underlying risks is extremely dangerous. Without an anchor in the real world, asset prices are free to go anywhere.

By fuelling bubbles, QE policies are contributing dramatically to widening the gap between financial asset prices and the real economy. It is also causing myopia and increasing volatility. These are not merely side effects of QE. By directly undermining confidence they undermine the recovery itself.

Ironically, in a global market place where the vast majority of asset prices have been inflated by QE the widespread perception that EM is 'risky' actually makes EM investments considerably safer. The cautious sentiment towards EM helps keep valuations for EM assets attractive – indeed, since QE has disproportionately gone into developed markets, almost every single EM stock and bond market is today significantly cheaper compared to developed markets than prior to QE.

Cautious sentiment towards EM also forces errant governments to fix their errors quickly, because they never get the benefit of the doubt, and this helps to keep issuers healthy. But we believe the greatest advantage of an EM investment today is simply that it offers a key assurance that you are not investing in a QE-inflated bubble.

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