Tightening central bank belts:
The end of quantitative easing

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UOB Asset Management

Summary:

- The years following the global financial crisis have been marked by a global regime of extraordinary monetary policy stimulus, implemented through quantitative easing.
- With global macroeconomic conditions improving over the past couple of years, the need for easy monetary policy has begun to recede.
- Signs of a regime shift continue to grow stronger as the US Federal Reserve rolled out a process for gradually shrinking its balance sheet back to a more typical size last September. The European Central bank announced its own bond purchase tapering plan from January 2018 while the Bank of England raised interest rates in November 2017.
- This material shift in monetary sentiment presents many challenges for multi-asset investors although financial conditions remain easy and sentiment robust despite the technical sell-off witnessed recently.
- We observe two key investment implications of policy normalisation – the potential adverse impact of rising interest rates on bond prices and quantitative tightening on income-generating assets – and have positioned the portfolio to manage potential risks through diversification and valuation discipline.

The years following the global financial crisis have been marked by a global regime of extraordinary monetary policy stimulus, implemented through quantitative easing. The clearest evidence of this is the expansion of central bank balance sheets (Figure 1).

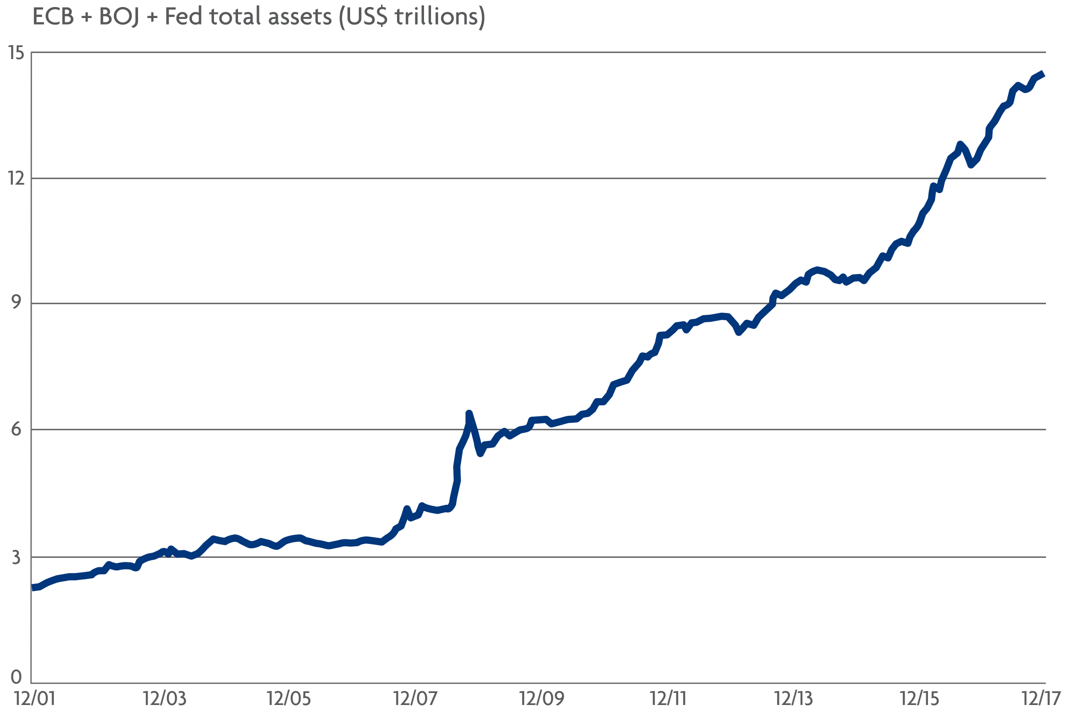

Figure 1: Central bank balance sheets have kept growing

Sources: European Central Bank (ECB), Bank of Japan (BOJ), and US Federal Reserve (Fed) via Bloomberg

This regime was necessary to help overcome the hangover from the financial crisis and support the global financial system. But with global macroeconomic conditions improving over the past couple of years, the need for extremely easy monetary policy has begun to recede.

Signs of this regime shift began to emerge with the first rate hike in December 2015 by the US Federal Reserve (the Fed), followed by four more as of February 2018. Last September, the Fed rolled out a process for gradually shrinking its balance sheet back to a more typical size. The European Central Bank announced plans to taper its purchasing programme beginning January 2018. Finally, the Bank of England raised interest rates in November 2017 for the first time since 2007, whilst noting that further hikes could follow should inflation remain elevated.

This is a material shift in monetary sentiment and presents many challenges for multi-asset investors. To date the market has digested this shift reasonably well; financial conditions remain easy and sentiment robust despite the technical sell-off witnessed recently. However, there are two key investment implications of policy normalisation that warrant continued observation.

The first of these is the path of interest-rate increases. To date, we have positioned the portfolio for rising rates in the US by focusing on a diversified basket of investment-grade bonds and avoiding exposure to US Treasuries, which we view as less attractive from a valuation standpoint. Meanwhile, we continue to assess other opportunities for further diversification. We have also been very tactical in managing the portfolio's duration — a measure of sensitivity to changes in interest rates — as the current market cycle progresses. We expect such positioning to be a key lever we deploy in 2018 as we balance the need for diversification, return and income opportunities, and prudent risk management.

Second, quantitative tightening may adversely impact income-generating assets and, more specifically, high-dividend stocks and high-yielding credit. Simply put, an increase in government yields (widely regarded as "risk-free") diminishes the relative attractiveness of income assets and may spur a correction in valuations that are currently rich by historical norms. In our portfolio, we have been focused on ensuring that rigorous valuation processes are applied whilst paying close attention to liquidity. These efforts will remain key focuses in 2018.

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