

Beware of Quantitative Tightening

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In our view, the current risk pricing environment for high quality assets is quite extraordinary in a historical context. Pricing for sovereign credit, high quality corporate and financial credit and other high quality defensive assets is at, or near, record highs at present. The pricing of high quality assets reflects the prevailing environment of ultra-low policy rates and massive Quantitative Easing (QE) programmes over the past eight years by the G4 central banks (Fed, the Bank of England (BOE), the Bank of Japan (BOJ) and the European Central Bank (ECB)) and the accumulation of foreign exchange reserves by China, Saudi Arabia and Switzerland, which have had policies to peg their currencies to either the US Dollar or the Euro. We refer to these collectively as the G7 Central Banks.

The G7 Central Banks have bought around US\$10 trillion of sovereign bonds and other high grade credit/assets over the past eight years. This represents approximately 70% of the total increase in government debt by the US, Euro nations, the UK and Japan over this period.

This buying activity by the G7 Central Banks has had a major influence on sovereign bond yields around the world:

- Yields on 10-year US treasuries have fallen from around 4.4% (five year average prior to 2008) to around 2.2%
- Yields on 10-year UK gilts have fallen from around 4.7% (five year average prior to 2008) to around 1.8%
- Yields on 10-year German bunds have fallen from around 3.9% (five year average prior to 2008) to around 0.5%
- Yields on 10-year Australian bonds have fallen from around 5.6% (five year average prior to 2008) to around 2.7% and

Two-year sovereign bond yields in numerous European countries (Germany, France, Spain, Italy, Belgium, Switzerland and the Netherlands) are currently or were recently negative.

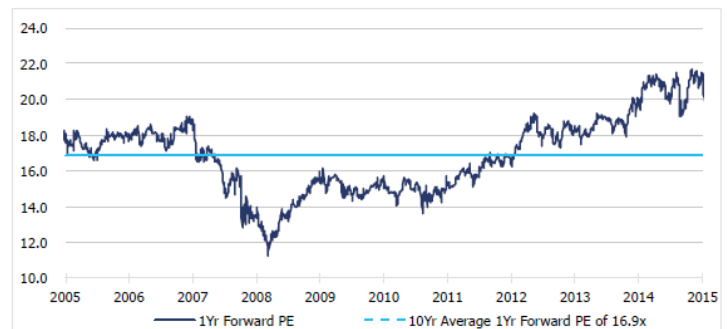
The pricing of sovereign credit reflects more than the current subdued economic outlook. In our view, buying activity by the G7 Central Banks has not only distorted the pricing of sovereign credit but has affected the pricing of all risk assets. Asset purchases by the G7 Central Banks affect asset pricing in the following ways:

The first effect is to push up prices of sovereign bonds which are being purchased by the central banks, thus lowering yields:

- The second effect is to push up the price of high grade non-sovereign domestic credit as investors become attracted to their higher yields, relative to sovereign bonds
- The third effect is to push down the currency of the nation which has implemented QE. This occurs as investors reach for yield abroad, requiring investors to sell local currency and buy foreign currency.
- As the central banks continue to pump liquidity, the cascading search for yield continues until all assets eventually get repriced upwards, including equities, credit and commodities.

This is what happened over the past eight years as displaced sovereign bond investors were effectively forced into higher risk assets. As more and more liquidity was pumped into the system, investors were pushed out along the risk spectrum and bought emerging market assets, commodities and high yield debt.

The following chart (figure 2) sets out the 1-year forward price/earnings multiple of the major consumer staples companies in the US and Europe over the past 10 years. The chart indicates that major consumer staples companies are currently trading at around 20 times forward earnings, which is materially above the historical average.



Source: Thomson Reuters and Magellan Asset Management Limited.

The question we all need to ask ourselves is whether asset prices predominantly reflect the current economic reality of lower growth and inflation, or are they being significantly distorted by the extraordinary monetary policy (including asset buying) and foreign exchange policies of the G7 Central Banks?

We believe, as central bank asset purchases diminish over the coming years, there is potential for material price declines in some assets. We refer to this reversal as Quantitative Tightening (QT).

It is likely that we have seen the first “canary in the coal mine” of QT. Over the last 12 months, we have seen a change in the foreign exchange policies of China, Saudi Arabia and Switzerland:

- China has commenced selling foreign exchange reserves in response to capital outflows and a slowing economy (China’s foreign exchange reserves have fallen approximately US\$500 billion over the past 12 months)
- Saudi Arabia’s foreign exchange reserves have shrunk by around US\$100 billion over the past 12 months, in response to its ballooning budget deficit due to the collapse in the oil price
- 15 January 2015, Switzerland ended pegging the Swiss franc to the Euro, which has ended the policy of accumulating foreign exchange reserves by the Swiss National Bank.

This has resulted in a progressive decrease in monthly bond buying activity by the G7 Central Banks over the last two years. Having peaked at around US\$200 billion per month in 2H 2013, G7 Central Bank bond buying fell to approximately US\$150 billion in 1H 2014, US\$75 billion per month in 1H 2015, and most recently US\$50 billion per month in 2H 2015. The reduction in the buying activity of the G7 Central Banks has coincided with a material repricing of the riskiest assets in the world:

- Major emerging markets (outside of China) have experienced major falls in their currencies. In the year to 31 December, the Brazilian real has fallen 33%, the Russian rouble has fallen 16%, the Turkish lira has fallen 20%, and the Mexican peso has fallen 14% against the US dollar.
- US CCC corporate (junk) bond credit spreads increased by approximately 670 bps in the year to 31 December, and junk bond funds likely had their first annual loss since the global credit crisis. These funds are also experiencing significant outflows, with the Third Avenue Focused Credit Fund freezing redemptions in December 2015.
- Major industrial commodities (iron ore, coal, copper, zinc) have been in free fall.

We do not believe that China, Saudi Arabia or Switzerland are about to change course and commence accumulating foreign exchange reserves again in the near future. The likelihood of a material rebound in emerging markets, junk bonds or industrial commodities is also low, in our view.

Notwithstanding the dramatic repricing of some riskier assets seen recently, prices of developed world sovereign bonds, high grade credit and high quality defensive equities remain at, or near, 20-year highs. We believe a key reason for this is the continued massive asset purchasing programmes by the ECB and BOJ (approximately US\$120 billion per month) and the fact that the Fed and BOE have not yet commenced programmes to shrink their balance sheets.

While investors are expecting that the Fed will gradually increase the Fed Funds rate over the next few years, the futures market is currently pricing US 10-year Treasury yields at only 3.1% in 2025, compared with the current yield of around 2.2-2.3%. This would be a low 10-year Treasury yield by recent historical

standards and we believe that the market’s expectations for such a low yield to prevail in 10 years’ time reflects anchoring bias to current rates (that are distorted by the aforementioned policies) rather than our view of the more likely outcome of US 10-year Treasury yields in the range of 4-5%. This suggests a reasonably large range of outcomes (from 3-5%) and the bookends are likely to have very divergent consequences for investors. Where the market lands in this range will depend in part on the asset accumulation or divestment strategies of the G7 Central Banks.

In order to assess the possible outcomes, it is necessary to understand the steps central banks will take to tighten monetary policy following QE:

- Step 1 is to cease asset purchases; the Fed ceased its asset purchases in October 2014.
- Step 2 is to increase the cash rate; the Fed commenced lifting the Fed Funds rate on 16 December 2015.
- Step 3 is to shrink the central bank’s balance sheet; this is likely to start by ceasing reinvestments of maturing bonds.

While the market is myopically focussed on the speed and direction of the cash rate, we believe the impact on the “flow of liquidity” via steps 1 and 3 is probably more important to the ultimate level of long term interest rates and, hence, asset values overall. We believe that it is likely that the Fed and BOE will commence shrinking their balance sheets, via ceasing their reinvestment policies, over the next three years, as they continue to gradually tighten monetary policy. We estimate that tighten global liquidity initially by around US\$240-US\$400 billion per annum (US\$20-33 billion per month). As demand for bonds weakens, this will place upward pressure on longer-term bond yields.

The real elephants in the room are what the ECB and BOJ will do over the next three years. Together, the ECB and BOJ are currently purchasing approximately US\$1.4 trillion of bonds and other assets per annum (approximately US\$120 billion per month). Our base case scenario is that the BOJ will continue its asset purchasing programme almost indefinitely, as sensible policy options are no longer available, and the ECB will cease its asset purchase programme within the next three years as the European and global economic outlook stabilises.

We regard the following three events as the “essential trinity” of QT:

1. the reversal of the foreign exchange reserve accumulations by China, Saudi Arabia and Switzerland;
2. the cessation of reinvestments by the Fed and the BOE; and
3. the end of asset purchases by the ECB

When these three events occur, cumulative net purchases by the G7 central banks should fall further. Already having fallen from a peak of roughly US\$200 billion per month in 2H 2013 to US\$50 billion per month in 2H 2015, these net purchases could become net sales in the next three years. This could result in materially higher long-term bond rates than the market is currently expecting, and a repricing downwards of assets globally.

While investors appear solely focused on the Fed, in our view the most significant issue to weigh is the actions of the ECB over the next three years. The ECB is likely to be the biggest swing factor in the level of net purchases by the G7 Central Banks and therefore where longer-term bond rates and asset prices may be headed.

If the ECB continues its QE programme for the next 3-5 years then it is likely long term bond rates will remain lower (probably in line with current market expectations), even if the Fed and the BOE commence a programme to tighten monetary policy and shrink their balance sheets. If the ECB ceases its QE programme this will result in a material change in the aggregate demand for sovereign bonds. Combined with the likely tightening by the Fed and the BOE, this would likely lead to materially higher bond yields than the market is currently anticipating (probably 10 year US Treasuries yields of around 4-5%).

What the ECB does will depend on economic developments in Europe and globally over the next three years. Our base case outlook for the next three years assumes a continued recovery in the United States with modestly rising inflation, a continued slowdown in China (but not a financial crisis or hard landing), and an improvement in the economic outlook for Europe. In these circumstances we believe it is likely that the ECB will take the first steps towards monetary tightening by ceasing its QE programme at some point in the next three years.

Of course, there are outlook scenarios where the global and European economies deteriorate and the ECB continues to extend its asset purchases, suppressing global bond yields and supporting higher asset prices (particularly for high quality assets). However, the situation is fluid and no one knows what will transpire. It is our view that there is greater than a 50% probability that markets are mispricing the medium-term outlook for bond yields. It is prudent to remain cautious on asset prices in this environment.

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