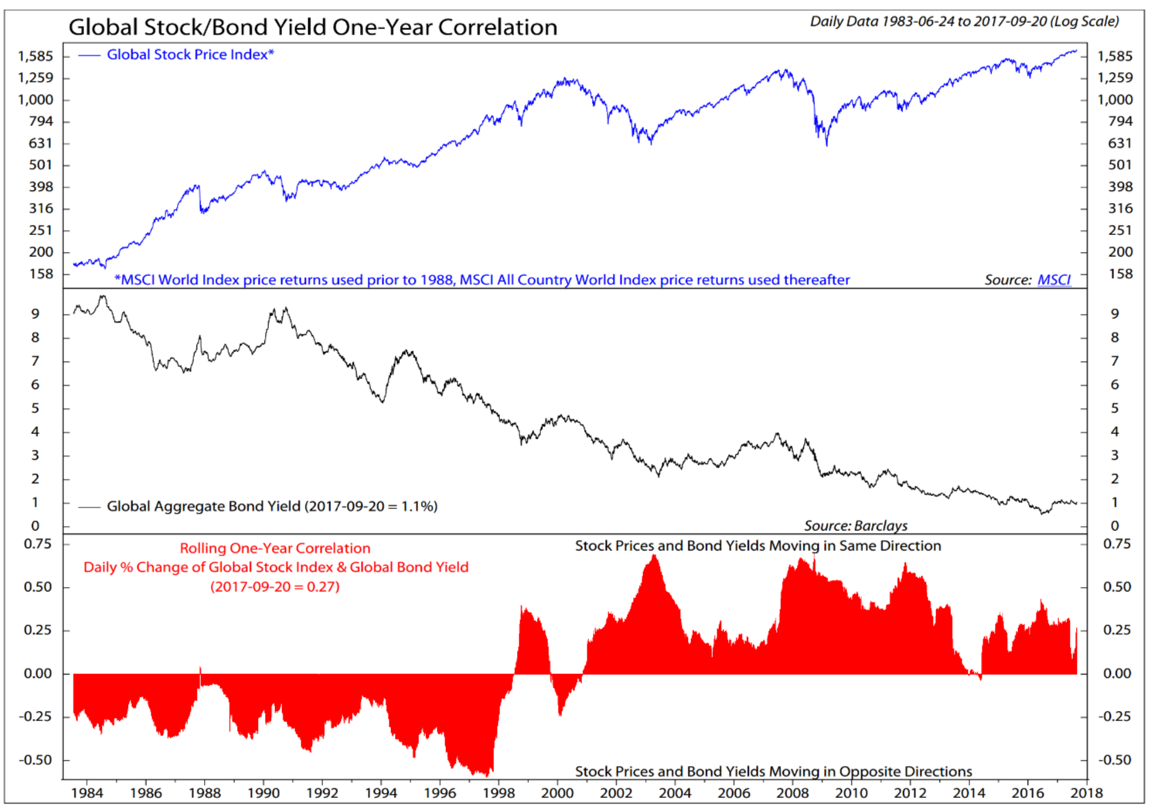
Lynx Investment Advisory

The End of Easy Monetary Policy: Implications for your Portfolio

As most are aware, central banks across the world engaged in an unprecedented Quantitative Easing (QE) program in response to the great recession of 2008. QE, in summary, can be described as the easing of monetary conditions by the Federal Reserve (Fed), which is done by increasing the size of its balance sheet. Specifically, the Fed creates reserves and uses these reserves to acquire assets. Many have debated the merits of engaging in QE and its impact, both direct and indirect, but there is little doubt it has fueled a rise in global equity markets while keeping interest rates low (see chart 1). As seen through the chart, as rates dropped, global equity markets soared. A Fed research paper found that engaging in QE which expanded its balance sheet to $4.5 trillion from $1 trillion, brought down long-term rates by a full one percent. The challenge for policy makers gathering last week in Washington for the IMF World-Bank meetings is to wind down this expansion without negatively impacting the world economy. In this paper we will look at some of the mechanisms, challenges and implications from this QExit.

Chart 1



Source: Ned Davis Research

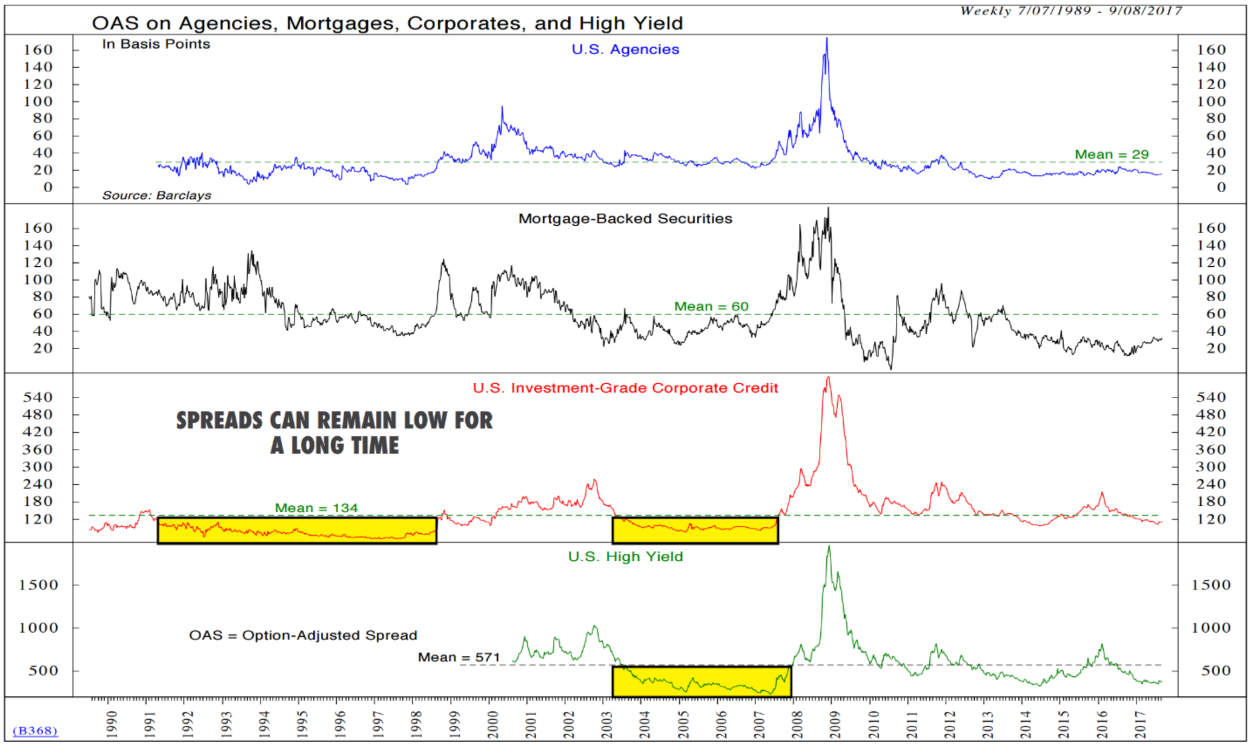
If QE led to the easing of monetary conditions and with it brought a 'new normal' in asset price equilibrium, reversing it should bring a 'new-new normal' by putting upward pressure on rates. There are a couple of ways the Fed could go about reversing QE: they could allow existing debt/securities to mature, a mechanism called run-off, or actively shrink the balance-sheet by selling assets to the private sector. For now the Fed has communicated that it will allow $10 billion a month worth of securities to run-off, gradually increasing this amount. It has also left open the possibility of selling assets. While the Fed hasn't specified the balance-sheet size it is targeting, it is safe to assume it would be considerably less than $4.5 trillion, though likely larger than the pre-QE balance sheet. Historically, the size of the Fed balance sheet has gradually increased along with growth in the economy.

At Lynx, while we want to understand the mechanisms and policy of the Fed, the ultimate objective is to understand their implications as they relate to capital markets and then what they may mean for portfolio rebalancing. We believe in valuation based investing; if an asset class is richly valued as a result of expansionary monetary policy, it is reasonable to assume that the reversal will see its turnaround.

Following are some of the implications from QExit and rebalancing recommendations.

Long term rates and spreads: While the Fed can easily target short-term rates by changing the Fed Funds rate, the economy is more impacted by long-term rates. Just as QE brought long-term rates down by changing the assets in the hands of the private sector, QExit should raise nominal rates. What is critical is not the direction of rates, which most pundits agree should be higher, but the extent of a rising rate environment. Most experts have argued for a gradual rise in rates, but we disagree. The change in long-term rates and associated spreads has rarely been gradual, tending to come more in the form of spurts. Long-term rates can be low for a long time, until they are not (see chart 2). According to the chart, we know that rates and consequently spreads have been abnormally low due to QE, therefore, the reversal of QE should lead them higher. As the higher long-term rates impact both fixed income and equity, our strategy in equity will be to rebalance from more expensive sectors such as technology to relatively cheaper sectors such as finance, which might also benefit from higher long-term rates. In fixed income, we advise caution towards all spread products that may have a longer duration.

Chart 2



Source: Ned Davis Research

Currency: Unlike rates, the movement in currency is unpredictable. Currencies are dependent on many different variables such as inflation, GDP, commodity price, external developments, and even weather. All things being equal, economic theory predicts a rise in currency should accompany monetary tightening. In that respect, it might be more prudent to have higher exposure in foreign developed parts of the world such as Europe as a weaker Euro is likely to help European exports. Europe, based on pure equity valuations, is also more attractive than the United States today.

Emerging markets: There is a widespread belief that tightening monetary conditions negatively impact asset prices in emerging markets. This belief was further strengthened during the taper tantrum of 2013 when the Fed announced it would begin tapering its $70 billion monthly bond purchases, which spooked the emerging world and subsequently that market experienced indiscriminate selling. Today, emerging market countries are attractively valued, but given the recent market rise, booking some gains might be a prudent approach.

As always, these recommendations are general in nature, your consultant/advisor can go into more detail and tailor them to your specific portfolio. We thank you for your trust and always welcome any questions.

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