Central Banks: Buyer turns Seller – January 2018

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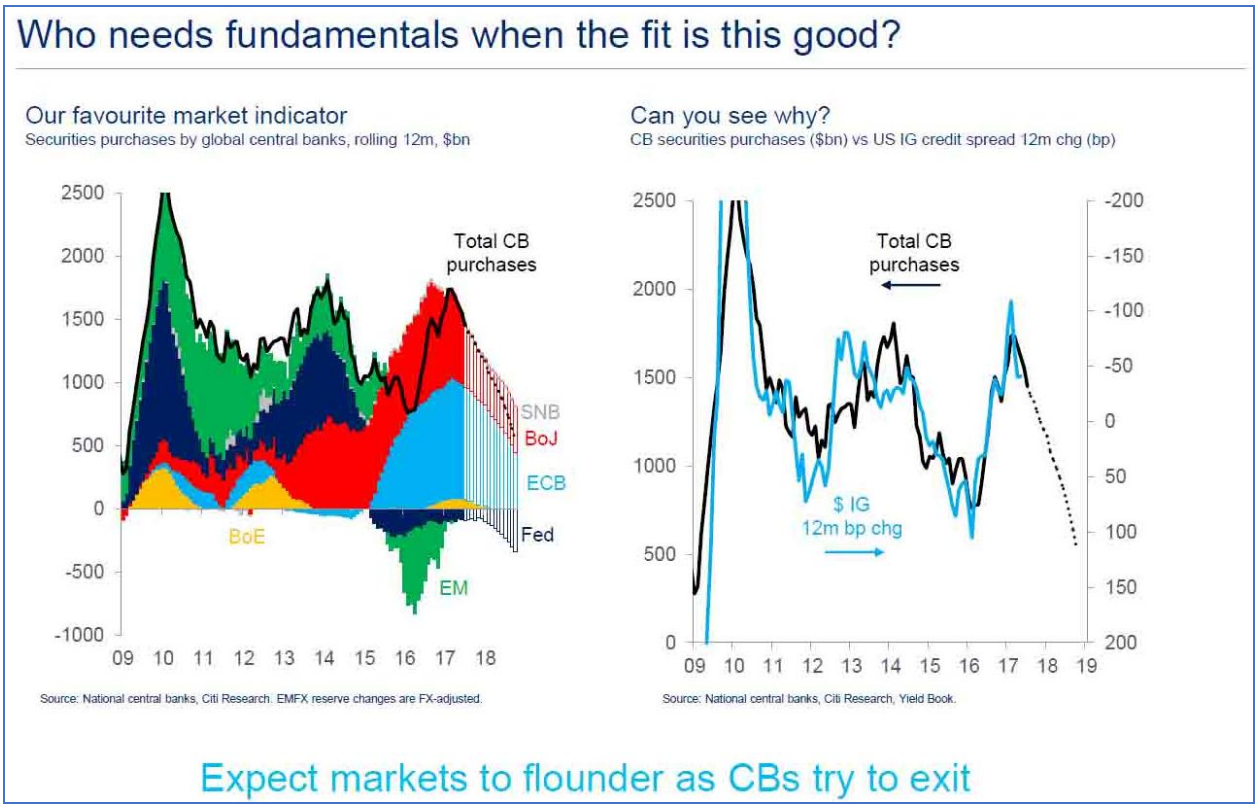
The current era in financial markets has been defined by the extraordinary actions of global central banks and the unprecedented rate at which they have purchased a range of public securities. This has been, in the short-term at least, a positive for economies, but even more so asset prices. Today the global economy is delivering the best and most synchronised growth since the financial crisis. This in turn has led the central banks to reduce, and in some cases, reverse their monetary accommodation and asset purchase programs. The Fed has raised rates and is set to reduce the size of its balance sheet. The ECB has signaled it will significantly reduce and eventually phase out its QE program. The BoJ has moved to a policy of yield curve targeting which has had the effect of reducing the number of securities it buys. The BoE has raised rates for the first time since Rihanna's "Umbrella" was number one in the UK charts (they even had charts then).

Given the importance of QE in getting to where we are today, it seems likely that the future trajectory of central bank balance sheets will have an important impact on the performance of asset markets going forward.

Chart 1: Total Central Bank Asset Purchases, Historic and Projected (LHS). Correlation of Asset Purchases to Changes in Investment Grade Credit Spreads (RHS).



Source: "Markets Unbalanced", Matt King, Citigroup Research, June 2017.

The chart above shows this dynamic playing out. The left-hand chart shows rolling 12-month purchases from central banks falling from around $1.7tn in early 2017 to around $500bn by the end of next year. The second chart shows how these purchases correlate almost perfectly with changes in investment grade credit spreads (inverted scale). As purchases fall off, credit spreads widen, and vice versa. Note how the current level of purchases is still associated with modestly tightening spreads but also how the projected levels of asset purchases in the years ahead are associated with spread widening. While the data in this chart is based on credit spreads, the inference extends to risk assets in general.

These are unprecedented times, and although we know that QE has been the defining feature in markets for many years, we cannot be sure how the unwind will play out. Further still, we need to price in how central banks will respond in the future both to developments in the economy and the markets. Taking this a step further, markets' pricing in future central bank actions will affect outcomes in a reflexive way. While it is impossible to foresee how this plays out, it is nonetheless important to focus on the key questions to help us invest.

Stock or flow?

Asset prices (equities and credit) have exhibited a high degree of correlation with asset purchases. In the last two years, central banks have purchased more assets than the market has issued. Economics lesson one tells us this should result in increased asset prices. Next year, however, that is forecast to change. According to current projections for central bank purchases, the private sector will have to absorb more securities next year than any year since 2012. Central banks argue that their balance sheets (the stock) are still big and rates are still low, so they are still highly accommodative, even if the purchases (the flow) are reduced. Historic correlations suggest that is the flow, rather than the stock, that matters to markets.

Priced in or not?

The argument here is that markets are a discounting mechanism. As such, since the reduction in central bank balance sheet expansion has been well flagged to markets, it is already priced in, and when it occurs it will have little impact. The counter to this argument is that while deep, liquid and efficient markets are excellent discounting mechanisms, markets that are dominated by a single enormous price-insensitive buyer are not. The historical correlations show that the impact of QE has been contemporaneous. Correlations can change, but so far it is the actual buying that has mattered more than the signals.

Why are central banks doing it?

If reducing asset purchases is likely to have a negative effect, the obvious question is why are central banks doing it? The equally obvious answer is that they can't continue forever and maintain credibility. If just printing more money was a route to prosperity it would have been mandated a long time ago. While central banks may publicly deny the magnitude of their impact, and that the unwind is priced-in, they have no choice but to pursue this narrative. Politically they have no option to take the window of opportunity that the current benign environment has given them. What they do in the future however, if markets or economies turn down is a different matter.

Bringing it all together

The data suggests that it is the flow of QE that matters most to markets and that when the flow reverses, markets will find it more difficult. However, this fails to consider how markets will price in future central bank responses to economic and/or financial market weakness. Will central banks ultimately have to reverse course? When will they blink? Do they have the power to guarantee good outcomes? While we have little conviction about the path things take, we have much more conviction that central banks will be back in the markets buying assets before the completion of this cycle.

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