The Big Unwind

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Meketa Investment Group
Global Macroeconomic Research Series

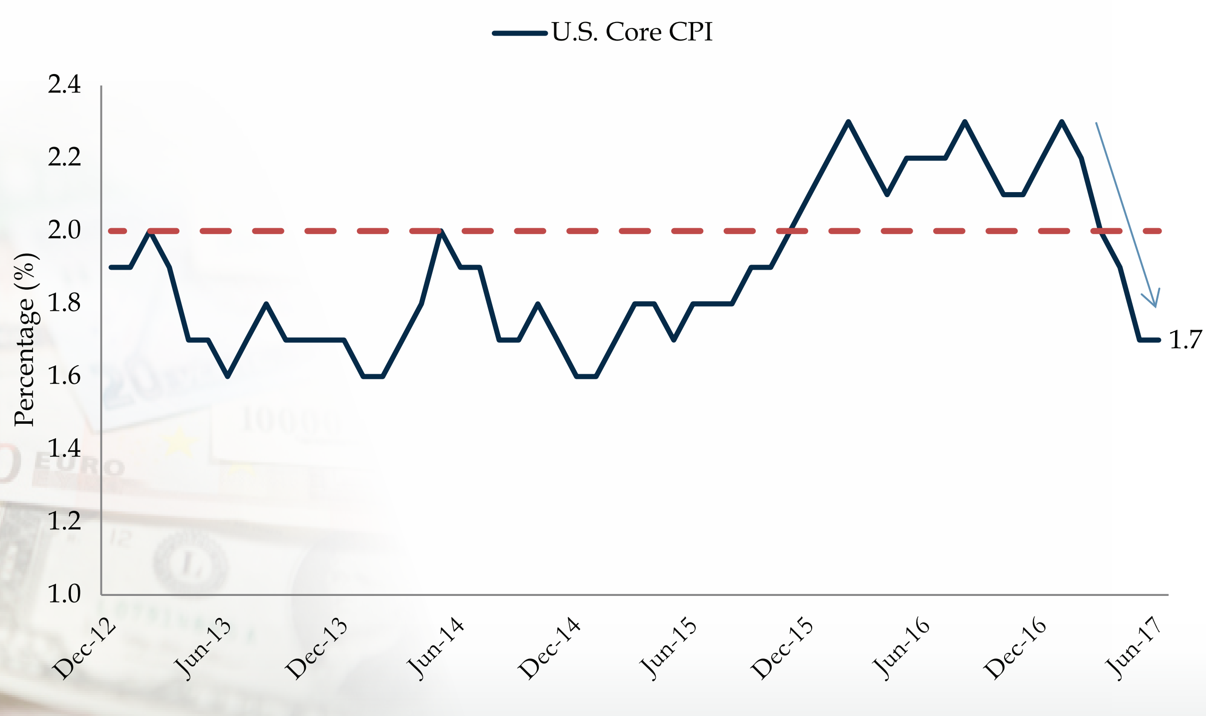
Since the Global Financial Crisis, central banks around the world have unleashed unprecedented amounts of monetary stimulus. What was initially intended to be a short-term solution instead turned into a nine year run of near-constant liquidity injections. While the timing has always been uncertain, investors knew eventually the day would come when central banks would begin to remove support in the hopes that global economies and capital markets were finally strong enough to stand on their own. We may have now reached that point. What will the unwind of nine years of central bank stimulus look like, and what will be the impact on financial markets? This may be the single most important question facing investors in the years to come.

Fed Tightening

Much attention has been paid, and rightfully so, to the increasingly hawkish stance of the Federal Reserve. The Fed has raised interest rates at each of the past three quarterly meetings through June, and has gone to notable lengths to communicate their intention to continue tightening liquidity conditions. Importantly, this tightening does not just include the traditional rate increases, but a shrinking of its roughly $4.5 trillion balance sheet as well.

While a gradual reversal of its unprecedented monetary stimulus policies was inevitable, it has caught many market observers by surprise that the "data-dependent" Fed has remained steadfast in its resolve despite the fact that much of the data on which it is supposedly dependent, like the inflation rate, has deteriorated.

U.S. Inflation



Source: Bloomberg

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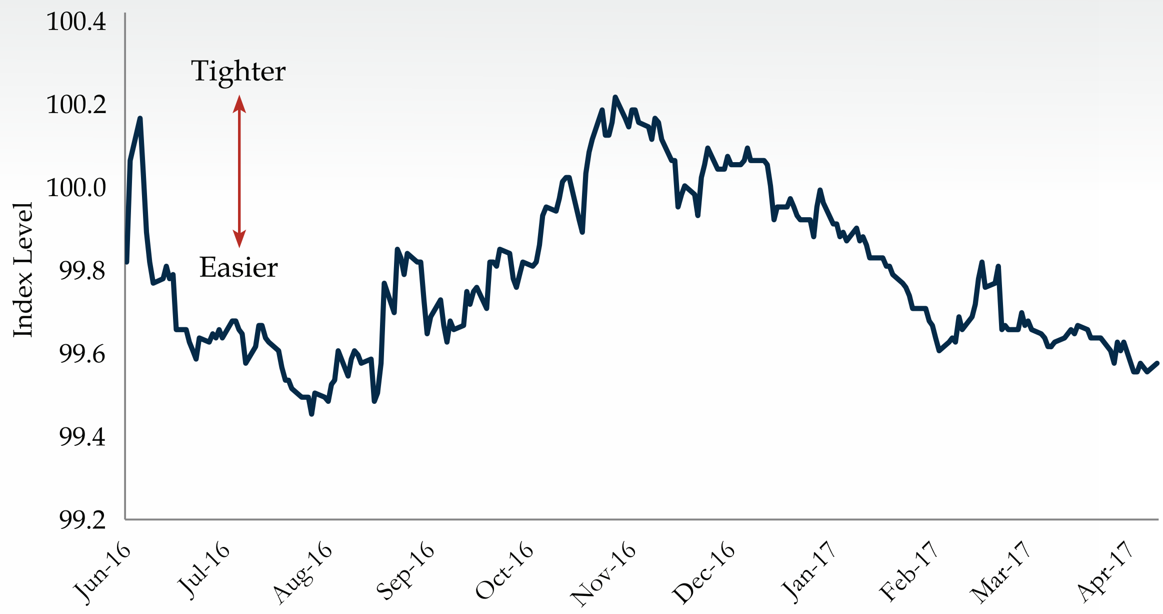
Goldman Sachs Financial Conditions



Source: Bloomberg

Part of the Fed's reasoning may lie in the fact that, counterintuitively, financial/ lending conditions (as represented above by the Goldman Sachs Financial Conditions Index) have actually eased since they began tightening. Judging by some of their recent public comments and meeting notes, the Fed is becoming increasingly worried about overly lax credit standards and frothy market valuations. If that is the real motivation behind their latest thinking, then they may well continue raising interest rates until financial conditions materially tighten. Said differently, the Fed may continue tightening until the market reacts negatively.

There is also the "dry powder" argument. In recent easing cycles, the Fed has needed to cut interest rates by over 500 basis points (i.e., 5%) to help pull the U.S. economy out of a downturn. In other words, the Fed would need to raise interest rates by 25 basis points every quarter for the next four years just to give themselves enough room above zero (i.e., "dry powder") to combat the average recession. Given that this is already the second longest economic recovery on record, we may be closer to the next recession than many people believe. Furthermore, given that this is also the weakest economic recovery on record, if the Fed did try to raise interest rates by 25 basis points every quarter for the next four years, they would likely cause the next recession before they were done. All of this is to say that the Fed will likely be forced to fight the next economic downturn with a more limited toolkit than ever before, but perhaps that is all the more reason for them to start preparing now.

Dates of Recent Easing Cycles	Fed Funds Rate at Start (%)	Fed Funds Rate at End (%)	Fed Funds Rate Difference (%)
9/84-8/86	11.75	5.88	5.87
5/89-9/92	9.75	3.00	6.75
12/00-6/03	6.50	1.00	5.50
8/07-12/08	5.25	0.25	5.00
Average	-	-	**5.78**

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Fed Balance Sheet Reduction

Since the onset of the Global Financial Crisis (GFC), the Fed has expanded its balance sheet from roughly $1 trillion to roughly $4.5 trillion by buying long-term Treasuries and mortgage-backed securities directly from U.S. and non U.S. commercial banks (i.e., "Quantitative Easing"). While the Fed stopped expanding their balance sheet in October 2014 with the end of their third round of Quantitative Easing (QE3), as their bonds have matured they have reinvested the proceeds in similar securities to maintain the current $4.5 trillion level. Thus, while the Fed has not been implementing a formal QE program for a few years now, in reality they have continued buying bonds and injecting liquidity into markets ever since. But this is all coming to an end. While still short on details, the Fed has announced that it will begin to unwind its balance sheet in the near future (perhaps as early as September). While the initial stages of this process are likely to be gradual and executed through a lack of reinvestment rather than the outright sale of existing securities, this will nonetheless mark a watershed moment in the post-GFC central bank stimulus era.

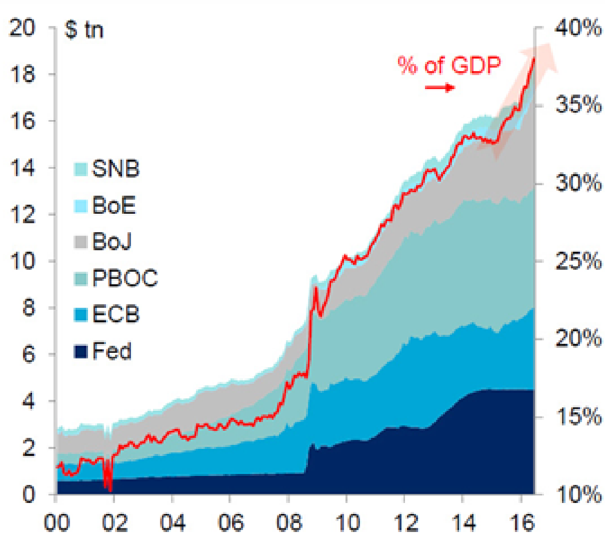
As for the market's potential reaction, much will depend on how this transition is perceived. Will it be perceived as a gradual removal of emergency liquidity measures that are no longer needed? Or, will it be perceived as the beginning of the end of explicit central bank support for financial markets? In our opinion, the odds of the former would be higher if the Fed were acting in isolation. Unfortunately, the other major central banks around the world are also planning their own exits from their respective stimulus programs, which makes the latter an uncomfortably high probability.

The Global Unwind

As mentioned before, the Fed ended QE3 almost three years ago now. In the meantime, however, other central banks around the world have gone into overdrive. As shown in the chart below, the aggregate global central bank stimulus is higher today (almost nine years after the crisis supposedly ended) than it's ever been.

More and more and more!

(Aggregate balance sheet of large central banks, $tn & % of GDP)



Source: Citi Research, Haver

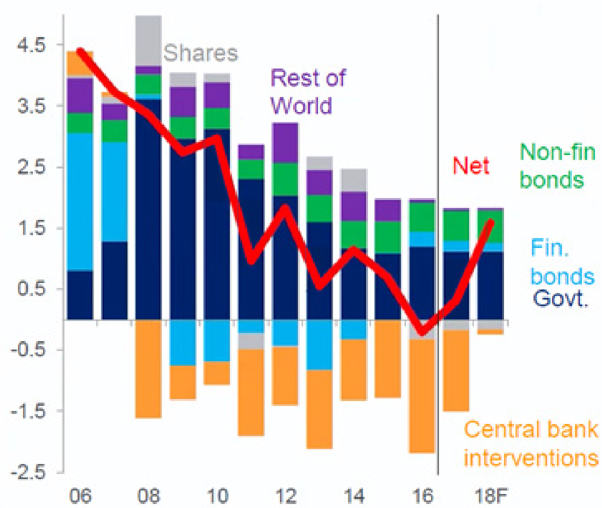
At close to $20 trillion and almost 40% of global GDP, an unwinding of the collective global central bank balance sheet would be exceedingly tricky. But that now appears to be the road ahead. In recent weeks, the European Central Bank, Bank of Japan, and Bank of England have all addressed, in one way or another, their intentions to begin removing stimulus in the relatively near future. While we are still likely months away from someone other than the Fed actually tightening, it is becoming abundantly clear that we have reached the peak of central bank stimulus (at least for this cycle).

What does that mean for interest rates? That depends on the extent to which central bank purchases have artificially suppressed them in recent years. While reasonable minds can differ on the magnitude of interest rate manipulation (i.e., how much lower interest rates are than they otherwise would be), it is clear that central bank bond purchases have had some effect. Purely from a supply and demand perspective, the potential impact is significant.

As illustrated in the following chart, the issuance of new bonds in the developed world net of central bank purchases has declined significantly as central banks ramped up their bond-buying programs, and was actually negative last year. In other words, in 2016 developed world central banks actually bought more bonds than were issued!

...just stand by for $1tn more in net issuance

Net issuance in developed* markets after central bank purchases, $tn



Source: Citi Research, Haver, Fed, BoE, ECB, SNB, BoJ. *Covers US, Eurozone, Japan, UK & Switzerland.

As also shown in the chart, however, the picture begins to change dramatically as we move into 2018. With the Fed in full tightening mode and other central banks at least taking their feet off the gas, a significant source of demand for bonds will soon be removed from the equation. Who steps in to fill that demand gap? And how much do interest rates need to rise to entice them to do so? How does an equity market whose valuations increasingly only make sense in the context of perpetually low interest rates react?

Economic Strength = Market Weakness?

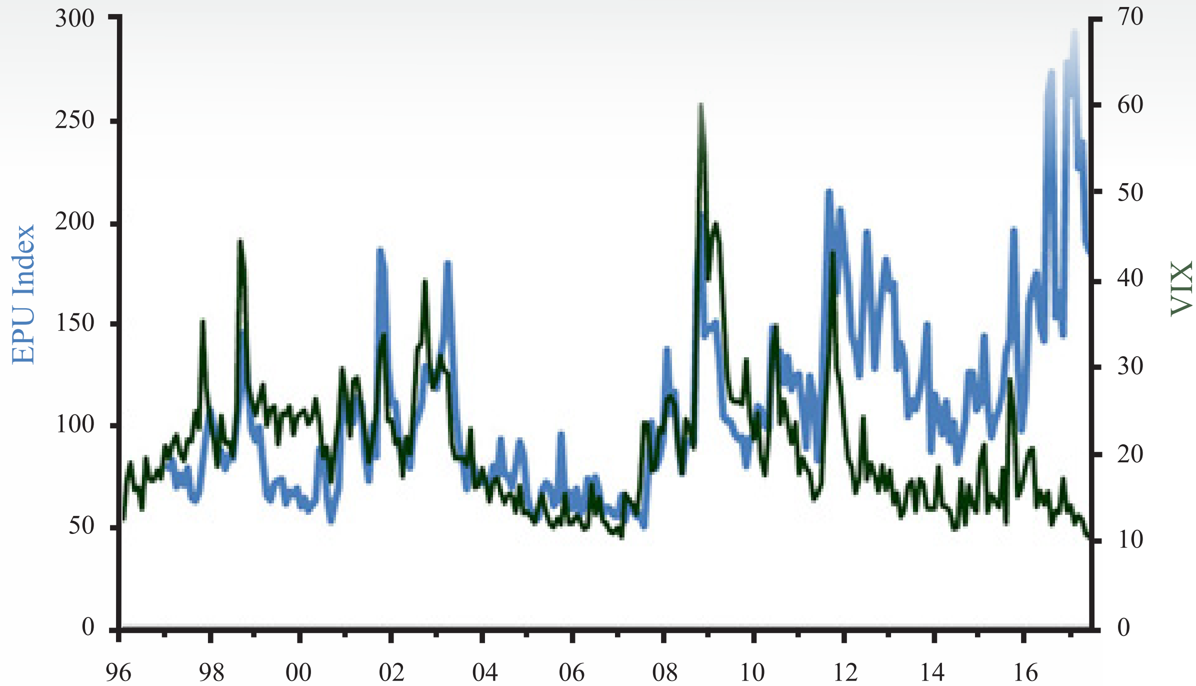
For years the relentless rise in risky assets has confounded macroeconomic strategists and investors alike who believed that economic weakness and uncertainty would surely put a dent in "animal spirits" and risk appetite at some point. We must confess that the market's continued willingness to ignore just about any and all potential risk factors has surprised us as well. With the benefit of hindsight, however, it becomes clearer that central banks' implicit or explicit support for financial markets was the one factor that trumped all others.

After all, if these entities who can literally print money out of thin air, are buying trillions of dollars' worth of financial assets with zero sensitivity to their price, what could go wrong? This is otherwise known as the "central bank put."

This created a very counterintuitive environment where bad news was good news. If economic weakness meant more monetary stimulus to support asset markets, then disappointing fundamentals were a reason to buy rather than sell. But if bad news is good news, what if the opposite is also true? While the global economy is hardly booming, it has apparently been growing fast enough and long enough for global central banks to declare victory, pat themselves on the back for a job well done, and start to close up shop. But if the continuous flow of central bank liquidity was the most important factor in driving up financial assets in recent years, then the removal of that liquidity, ironically due to relative economic strength, may lead to some nasty surprises for a market that has seemingly reached all-time levels of complacency.

Needless to say, we will continue to watch this dynamic very closely as central bank liquidity is one of a small handful of factors that are truly "systemic" (i.e., that impact all asset classes around the world).

Economic Policy Uncertainty index and VIX



Source: Bloomberg Finance LP

Conclusion

Injecting trillions of dollars of monetary stimulus was the easy part. Removing it was always going to be the real test. We are truly in uncharted territory. As such, we do not pretend to know exactly how this will play out, but neither should central bankers. To be clear, we do not foresee an imminent risk from this stimulus unwind as the process will be intentionally deliberate. Furthermore, recent history tells us that central banks that talk tough about tightening liquidity quickly back off once the market expresses its displeasure, and that may well be the case again. But the unwinding of global central bank stimulus has the potential to be the defining market narrative over the coming months and quarters and therefore, warrants significant attention.

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