

# Central Banks Step Up Equity Buying—Should Investors Care?

As markets consider the consequences of the Federal Reserve ending its bond purchases and the possible beginning of quantitative easing in the Eurozone, recent news reports have focused investor attention on another dimension of central bank activity: their purchases of equities. Though opaque financial reporting makes detailed accounts of central bank equity holdings difficult to come by, informed observers seem to agree that central banks in aggregate have become important players in global equity markets. Indeed, last year Central Banking Publications and the Royal Bank of Scotland Group Plc conducted a survey of 60 central bankers, overseeing a combined $6.7 trillion, which revealed that 14 had already invested in equities or would do so within five years.

With intervention in fixed income markets—the traditional domain of central bankers—already at exceptional levels, the prospect of an increase in central bank–driven equity purchases has invited speculation about the consequences of such activity. In June, for instance, one columnist at the *Financial Times* enumerated the risks of central bankers moving their portfolios into listed equities: buying at "overheated" prices and thus encouraging others to follow; favoring, whether intentionally or not, the shares of particular companies, industries, or economies; facing political backlash if a period of high volatility leads to portfolio losses; and, perhaps first and foremost, muddying the line between traditional monetary policy and other investment activities.[1]

[1] Ralph Atkins, "Beware Central Banks' Share-Buying Sprees," *Financial Times* (June 19, 2014).

Investors should remember that central banks are merely one of three major types of public investor. Central banks, which hold approximately $13 trillion globally on their balance sheets (roughly four times what they held a decade ago), manage domestic monetary policy and are the stewards of foreign exchange reserves that can be used to intervene in the market for a country's own currency. They have traditionally held fixed income assets like government debt that can be sold easily if funds are needed for open market operations or currency intervention, although they have expanded this mandate in recent years to include a much broader swath of securities. Public pension funds hold about $9.5 trillion and are largely invested in domestic currency assets to match domestic currency liabilities. Sovereign wealth funds, which manage $6.5 trillion, typically invest foreign exchange assets in excess of reserve requirements with an eye toward maximizing returns or fulfilling other political goals, often by holding equities. All told, these three types of public investors account for around 20% of cross-border asset holdings.[2]

For central banks, the move to diversify away from traditional fixed income holdings has been driven primarily by what seems to be an ever-expanding mandate to "manage" economic activity. As Ben Bernanke opined in a 2010 essay, "Easier financial conditions will promote economic growth. For example, lower mortgage rates will make housing more affordable and allow more homeowners to refinance. Lower corporate bond rates will encourage investment. **And higher stock prices will boost consumer wealth and help increase confidence, which can also spur spending.** Increased spending will lead to higher incomes and profits that, in a virtuous circle, will further support economic expansion." (Emphasis added.) The idea that boosting equity prices will lead to economic growth flips traditional economics on its head—equity prices are no longer market-determined gauges of corporate value, but rather pawns to be manipulated to boost economic growth.

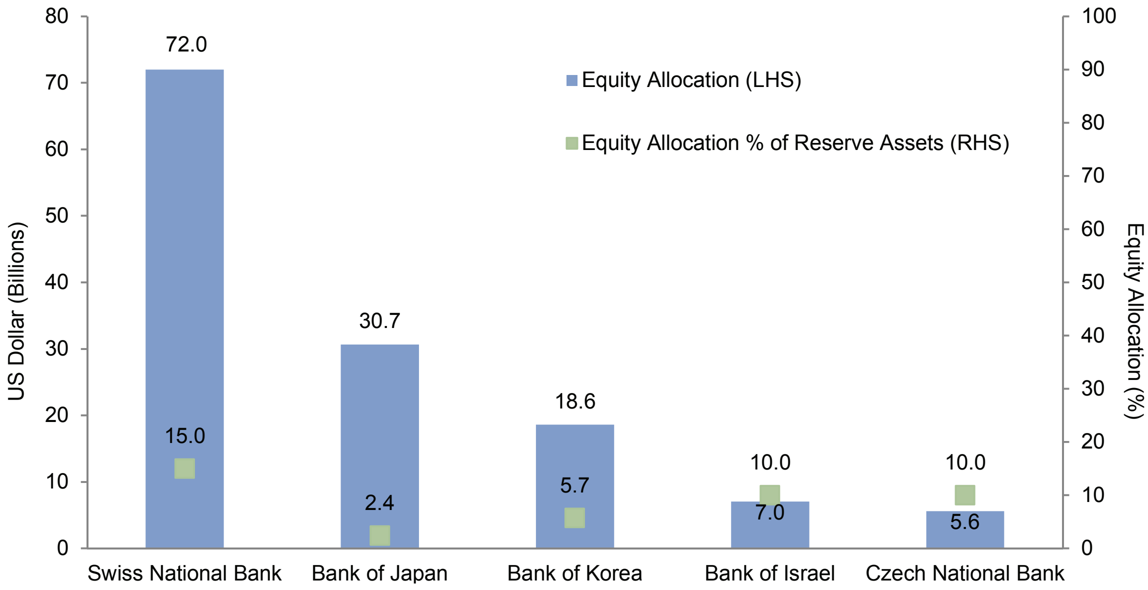
## Which "Buying" Do You Mean?

Given the scale of central bank holdings, the very idea of their buying equities stokes some observers' fears of monetary policy running amok. Investors should distinguish, however, between two types of stock buying when considering what might truly be a market-moving development.

The first, and less noteworthy, variety occurs when banks invest foreign exchange assets in excess of reserve requirements in global equities to diversify existing holdings or to preserve the real value of their portfolios. The Swiss National Bank's 15% allocation to passive equity holdings across the cap spectrum in its $480 billion foreign exchange reserve portfolio is an example of such buying. In the past three years, Switzerland's

[2] Official Monetary and Financial Institutions Forum, *Global Public Investor 2014* (June 2014).

Selected Central Bank Equity Allocations
As of December 31, 2013




FX reserves have more than doubled as the bank has defended a ceiling on the franc's exchange rate against the euro. As the SNB's portfolio grew, the bank diversified it broadly, adding equities, corporate bonds, and inflation-linked securities to its holdings, and also including new currencies in its investment strategy, such as the Australian dollar, the Korean won, the Swedish krona, and the Singapore dollar.

The Bank of Israel's program of buying US equities, which began in March 2012, can be viewed in a similar light. A senior adviser to then-Governor Stanley Fischer, who now sits on the US Federal Reserve Board, noted that the bank was buying equities to diversify, reduce risk, and deliver better performance. Yet another example is the Bank of Korea's portfolio diversification. In response to "the inevitability of low returns," the BOK is "breaking away from rigid fixation on bonds of the highest credit ratings" and committing part of its reserve portfolio to foreign equities. While this type of stock buying is generally viewed as relatively innocuous, it may beg the question of why central banks—which, as their own currency issuers, cannot go broke—should be concerned with improving returns.

A second type of buying occurs when central banks buy equities as part of unconventional monetary policy operations or as intervention to support investor confidence. The Bank of Japan's recent purchases of domestic equity ETFs fall into this category, as the BOJ has explicitly linked its buying program to a stimulus effort to



reflate the Japanese economy. Driving this point home is speculation from traders that the BOJ is following a "1% rule" in which it buys after the TOPIX index falls around 1% in early trading. Regardless of the truth of such rumors, it is not the first time the BOJ or other Asian central banks have engaged in such interventions. The BOJ bought equities several times in the 1990s in the name of "financial stability"—its so-called price keeping operations—and again in 2009. During the 1998 Asian financial crisis, the Hong Kong Monetary Authority spent about $15 billion buying domestic equities to squeeze short sellers—and ended up making a profit. While such actions may provide the equivalent of a shot of adrenaline to navigate a period of stress, their long-term value is an open question. Many credit central banks' aggressive actions with staving off "another Great Depression" in 2009, but even if true, the moral hazard engendered by such operations may magnify markets' ultimate denouement.

## Where Are We Now?

A question on many investors' minds is what might happen if another major central bank—e.g., the Bank of England, European Central Bank, or the Federal Reserve—embarks on an equity purchase program and/or makes explicit the notion of the "~~Greenspan Bernanke~~ Yellen/Draghi put." While one is tempted to believe markets would respond positively, particularly in the short term, it is also possible investors could "sell the news." Indeed, threats of action are often more effective than action itself, since people tend to overestimate the effects of actions, in both positive and negative directions. Mario Draghi's 2012 pronouncement that he would do "whatever it takes" is a perfect example—rates have come down across European debt markets without the ECB doing much of anything. Of course, such pronouncements must be credible to have this effect. Thus, investors implicitly assume central banks actually have the power to "manage" markets; a worst-case scenario would be one in which they took action but markets reacted *negatively*, feeding a narrative that central banks had lost control.

## The Bottom Line

The consequences of stepped-up central bank buying of equities are difficult to predict. While markets might react positively to such actions, at least initially, the risks are substantial if market participants come to view such purchases negatively in the long run and decline to follow the central banks' lead. Further, all such activities are by definition short-term palliatives rather than long-term solutions, and in fact tend to exacerbate underlying tensions (to take one obvious example, the ECB's success in talking down peripheral bond yields has eased pressure on such countries to get their fiscal houses in order, with the result that little progress has been made) that will make any future downturn in economies or markets that much more problematic. ■




# Contributors

**Eric Winig, Managing Director**
Ramin Sobhany, Investment Associate

# Exhibit Notes

**Selected Central Equity Bank Allocations**
Sources: Central Banking Publications and Official Monetary and Financial Institutions Forum.
Notes: Bank of Korea, Bank of Israel, and Czech National Bank data are as of June 2013. Data are based on self-reported surveys of the respective banks.