INVESTMENT PUBLICATIONS HIGHLIGHTS

‘QUANTITATIVE TIGHTENING’ AND BOND YIELDS

Francesco Garzarelli, *Global Markets Daily*, Goldman Sachs Economic Research, September 21, 2017

Goldman Sachs determined that the Federal Reserve’s plan to incrementally reduce its balance sheet will have a limited impact on US and global government bond yields. However, the trajectory of government bond yields will continue to be heavily dependent on macroeconomic factors, such as inflation.

According to Goldman Sachs, the initial impact of quantitative tightening (QT) on yields will be minimal, because a large portion of maturing Treasury securities will continue to be reinvested over the next 10–12 months based on the Fed’s timetable to unwind its balance sheet. When the Fed’s balance sheet reaches pre-quantitative easing (QE) levels, Goldman Sachs estimates that the overall impact of QT on US Treasuries will be a 50 basis point increase in ten-year yields and a flattening of the yield curve.

Although Goldman Sachs is confident in its estimates of QT’s impact, it is less confident in the rate at which yields will change because their assumptions are heavily dependent on macroeconomic conditions. For example, if low inflation were to persist or the probability of a recession were to increase, any increase in ten-year Treasury yields in the near term as a result of QT would likely be restrained due to an increase in private sector demand for US Treasuries.

Spill-over effects from global monetary policy further complicate the effect of QT on US Treasuries. Currently, the European Central Bank (ECB), the Bank of England, and the Bank of Japan (BOJ) are still actively implementing policies aimed at easing monetary conditions. Based on previous analysis conducted by Goldman Sachs on the relationship between international monetary policy and domestic government bond yields, international government bond markets should also exert downward pressure on ten-year US Treasury yields, flattening the yield curve.

The Fed’s QT should also work to limit efforts by the United Kingdom, Eurozone, and Japan to ease, given that higher US Treasury yields will increase selling pressure internationally. As a result, Goldman Sachs expects to see US and global government bond yields converge as the Fed reduces its balance sheet, all else equal.

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FLOWS & LIQUIDITY: GLOBAL LIQUIDITY TO REMAIN ABUNDANT DESPITE THE FED

Nikolaos Panigirtzoglou et al., *Global Asset Allocation*, J.P. Morgan, September 22, 2017

The authors believe that the Federal Reserve's plan to shrink its balance sheet will have little impact on global liquidity, given that other central banks are predicted to continue easing policies over the next three to four years.

Quantitative easing (QE) impacts markets by changing both the demand and the supply of bonds, as well as financial institutions' stock of bonds and cash. As the Fed shrinks its balance sheet, the private sector will have to absorb the additional supply of Treasuries and mortgage-backed securities, potentially exerting upward pressure on yields. This pressure could account for as much as $900 billion, if coupled with tapering by the ECB and BOJ. But given current monetary policies, J.P. Morgan estimates that the impact will be closer to $500 billion, an amount not likely to impact global liquidity materially.

The authors contend that the absorption of Treasuries and mortgage-backed securities will also impact the relative pricing of various forms of collateral. During the Fed's QE, the shortage of government bonds versus cash encouraged private companies to replace government bonds with cash reserves, impacting pricing. As the Fed shrinks its balance sheet, this will revert. To measure this, the authors look at the ratio of excess reserves divided by the stock of government securities held outside of central banks and predict that by 2020 this will reach around 25%, a level slightly above current levels.

Broadening beyond financial institutions, the Fed's impact on liquidity can be measured by the global aggregate money supply and demand. In examining both, the authors find little reason to think the overall impact on broader liquidity will be significant. In short, they expect liquidity to remain abundant.

FIVE MYSTERIES SURROUNDING LOW AND NEGATIVE INTEREST RATES

Laurence B. Siegel and Stephen C. Sexauer, *The Journal of Portfolio Management*, vol 43, no 3 (Spring 2017): 77–86

The authors address questions regarding the unprecedented monetary policies following the global financial crisis (GFC). They conclude that asset returns are likely to be low, growth equities will be highly valued, and factors other than monetary policy will determine the path of labor productivity and economic growth.

The authors first consider why QE did not spark extreme inflation. Although QE grew the monetary base substantially, growth in the M2 money supply, which is closely tied to inflation, was slow and stable. The authors also suggest that technological innovation disrupted the nature of money, changing the relationship between traditional monetary aggregates and prices.

The authors then question if low interest rates are a product of the Fed's unconventional monetary policy or the supply and demand for capital. Since the GFC, and largely because of it, savings are up and investment is down. These dynamics imply low market-clearing interest rates. The authors argue that shifts in the supply and demand for capital account for two-thirds of the drop in real interest rates since 1980, with long-term growth expectations accounting for much of the rest, but central bank action was so extraordinary that it's clear the Fed's aim was to keep rates low.

The authors admit that unconventional monetary policy during the GFC likely staved off an economic depression, but does not produce long-term economic benefits. Economic growth is a product of only two dynamics: labor force growth and labor productivity.

What low rates do produce are low returns to capital, at least from a neoclassical perspective. It is difficult to determine, however, if factors contributing to lower equilibrium interest rates are transitory or permanent. Lags in innovation make it difficult to know how technological disruption today will shape markets in the future. While the authors believe the principles of portfolio management still apply, they argue that low expected returns will push investors to favor growth equities. Further, they suggest that low interest rates will limit the effectiveness of monetary policy in shaping the direction of the economy.

The biggest beneficiaries of low rates are sovereign borrowers, while savers bear the cost. In fact, sovereign borrowers increased debt levels but actually reduced debt service costs as a result of low rates. Although the beneficiaries of low interest rates are clear, the economic benefits are less so. The authors do suggest that low and negative rates likely helped to limit the severity of the crisis. ■