Viewpoint

The end of QE

With QE over in the US and interest rate rises on the horizon, we asked the EIE editorial panel how investors should protect themselves **By Tjibbe Hoekstra**

Defence mechanisms

When the Fed cautiously started to talk about tapering in the summer of 2013, there was what seemed to be an allergic reaction from the markets. Fixed income investors sold off their higher-risk debt and emerging market debt indices dropped by 6% in a matter of days.

This was not good: if that is how the markets reacted to the beginning of a discussion about slowing the rate of QE, how would they react when talk turned into action? And, even more terrifying, what would happen when QE stopped completely?

Well, not much, it turns out. The Fed started to taper its bond purchasing programme in December 2013 and in October 2014, QE came to an end. Markets barely noticed.

More printing than ever

"The market behaviour in the summer of 2013 was born out of fear and driven by the idea that liquidity would be cut back by the Fed," says Tristan Delaunay, general director at Athymis Gestion in Paris. "But this time, I'm not as pessimistic as some of the commentators because the Bank of Japan and the ECB have replaced the liquidity that will be taken out of the system by the Fed in the year to come."

In fact, global liquidity is now higher than at any point in history, stresses Claes Roepstorff, who heads Nordea's balanced and alternative products department in Denmark.

"Even with the Fed tapering, there is a lot of liquidity left in the market which needs to be placed somewhere. On a global scale, there is even more QE now than a couple of months ago," he says.

According to data from the Bank of International Settlements (BIS), the combined balance sheets of central banks in Europe, the US and Japan amount to more than €11trn, more than double the figure at the end of 2008 (see chart).

Staying loose

Notwithstanding the ongoing balance sheet growth of the ECB and the Bank of Japan, there are several compelling reasons to assume that the Fed will not raise interest rates until late next year.

Roepstorff says: "The Fed has a long way to go when it comes to bringing down unemployment, or increasing employment, so they are taking it slow. I think a rate rise is most likely to happen in the summer of 2015 or even later."

The Fed does not have an incentive anyway to increase interest rates, considering inflation is well below the 2% target rate now, according to Tim Peeters of Belgian wealth manager Portolani.

"The Fed wants to create inflation in order to ease government debt and create growth," he remarks.

In its autumn monetary policy statement, the Fed said it considers it "appropriate to maintain the 0% to 0.25% target range for the federal funds rate for a considerable time (...) especially if projected inflation continues to run below the Committee's 2% longer-run goal."

Considering inflation is now running at 1.7% – and with the oil price down by about 20% compared to a year ago – it would not be a particularly risky bet to say inflation will stay below target for the foreseeable future, notwithstanding surprisingly strong real GDP growth of 3.9% in the third quarter of 2014.

Braced for the worst

So, if interest rate risk remains muted for some time to come, what are the implications for asset allocation? Although an aggressive rate hike seems pretty far off even in the US, European fund selectors already have taken refuge. As yields are expected to rise first in the US, some have withdrawn from dollar-based bonds altogether, while there is

US QE Timeline

Aug '07	The Fed's federal funds rate stands at 5.25%
Dec '08	The Fed's federal funds rate is lowered to 0%, and QE 1, involving the purchase of up to $600bn (€486bn) in mortgage-backed securities (MBS)
Mar '09	QE 1 is expanded to include the purchase of an additional $750bn of MBS and $300bn in longer-dated Treasuries
Mar '10	QE 1 comes to an end
Nov '10	The Fed initiates QE 2, involving the purchase of $600bn in longer-dated Treasuries
Jun '11	QE 2 comes to an end
Autumn '12	The Fed embarks on QE 3, involving monthly purchases of $40bn in MBS and $40bn in longer-dated Treasuries
Dec '13	The Fed announces the start of QE tapering, reducing the total level of purchases by $10bn at each meeting
Oct '14	QE 3 comes to and end. Since the beginning of QE 1 until now, the Fed's balance sheet has grown from roughly $2trn to $4.5trn