Quantitative Easing: Welcome to the Hotel California

by Bill Campbell

In their iconic song, "Hotel California," the Eagles sum up the trap of living to excess with the paradoxical finish: "You can check out any time you like, but you can never leave." That couplet captures the dilemma facing the G4 central banks. The Federal Reserve (Fed), Bank of England (BOE), European Central Bank (ECB) and Bank of Japan (BOJ) are trying to reverse decade-long "Quantitative Easing" policies which staved off the global credit crisis but, if left too long in place, risk a global currency crisis. They recognize the need to unwind their asset purchases and restore policy to a normal setting. Unfortunately, the next recession may derail this overdue normalization, forcing the banks to resume asset purchases. Such an outcome could lead to a crisis of confidence in the G4 currencies as a store of value.

In times of recession or economic shock, central bankers implement counter-cyclical monetary policy to support the economy. The conventional means to accomplish this is a lowering of short-term interest rates. Historically, this approach has been limited to taking short-term rates no lower than zero. But what if the severity of a crisis requires stimulus beyond the zero bound? In a 2002 paper, Ben Bernanke, then a governor of the Fed, presented a blueprint for the extraordinary monetary policies which central bankers, including Bernanke as Fed chairman, would use to fight deflation in the wake of the credit meltdown.

The expanded policy tools included asset purchases (in the case of the Fed, U.S. Treasuries and Agency mortgage-backed securities), which came to be called Quantitative Easing (QE), and negative rates, practiced by BOJ and briefly by the ECB. The BOJ is the farthest along in this experiment. Confronted with deflation a decade earlier than the U.S. and Europe, the BOJ has expanded its policy toolkit to use asset purchases, including even equities, negative interest rates and other extraordinary measures.

The large-scale asset purchases artificially reduced interest rates on government securities. This starved investors out of low-risk government debt and into higher-yielding but riskier assets. To the extent this market intervention supported employment and held deflation at bay, QE could be termed an interim success. The problem is that no one has a second half of the Bernanke blueprint. How do we exit these extraordinary policies before they do more harm than good?

The acute phase of the credit crisis ended years ago, giving way to nearly a decade of global economic growth. The central banks, however, have lacked the courage to unwind QE.

During congressional testimony in May 2013, then-Fed Chairman Bernanke ignited what came to be called the "taper tantrum" when he appeared to telegraph a reversal of QE. Government yields jumped, prompting sell-offs in risk assets as well. The result: the Fed blinked, and postponed cutting back on its $85 billion of monthly bond purchases.

In June 2017, ECB President Mario Draghi gave a speech at the Portuguese resort of Sintra in which he stated that "all signs now point to a strengthening and broadening recovery in the euro area." The markets took those words as a nod to removing extraordinary stimulus. Yields on European government bonds backed up as market participants tried to find a new clearing price which discounted the new reality. Like the Fed, the ECB blinked, walking back talk of QE exit.

Both the Fed and ECB kept "livin' it up at the Hotel California" – missing a window to start unwinding their asset purchases.

Unfortunately, history has shown us that central bankers only become comfortable enough to start tightening at the end of a recovery or late in a cycle, when growth is strong and asset valuations are lofty. But at this point in the cycle, we often see a reduction in expected future returns of risky assets as yields and spreads have already compressed significantly. At this point in the cycle, central banks raise policy rates, which increases the discount rate used to value assets, reducing their valuations.

In "Hotel California," the late Glenn Frey has said that he and fellow Eagles member Don Henley "wanted to write a song that was sort of like an episode of the Twilight Zone." Today, many investors find themselves in a central bank-produced twilight zone of distorted asset prices. Thus, they are making the logical decision to buy the relatively high-yielding safe assets and reduce holdings of richly valued risk assets. This behavior is flattening yield curves, frustrating central bank efforts to normalize rates.

By waiting so late in the business cycle to begin normalization, the G4 central banks may run out of time to complete this process before the next economic contraction. If so, the next recession will likely compel policymakers to reverse course and resume asset purchases despite their swollen balance sheets. We may even see the Fed and BOE imitate their Japanese and European counterparts in acquiring assets further down the risk spectrum. The BOJ already owns a significant portion of the outstanding ETF market. The ECB has purchased corporate as well as government debt. To paraphrase Frey and Henley, the G4 bankers are all just prisoners here, of their own device. ■

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Definitions of Terms Used

Yield Curve - A line that plots the interest rates, at a set point in time, of bonds having equal credit quality but differing maturity dates.

Normalization - The standardization of data obtained from different sources at different periods, through peer review or comparison against the objectives of data collection.

G4 Central Banks—The Bank of England (BOE), the Bank of Japan (BOJ), the Federal Reserve (FED), and the European Central Bank (ECB)

Exchange-Traded Fund (ETF) - A marketable security that tracks a stock index, a commodity, bonds, or a basket of assets.

Quantitative Easing (QE)— An unconventional monetary policy in which a central bank purchases government securities or other securities from the market in order to lower interest rates and increase the money supply.

Taper Tantrum - Term used for the 2013 surge in U.S. Treasury yields, which resulted from the Federal Reserve's use of tapering to gradually reduce the amount of money it was feeding into the economy.

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