How much should we worry about the end of monetary stimulus?

Since the last Federal Open Market Committee (FOMC) meeting on June 12th and 13th, we have read and heard from analysts that appear to be extremely concerned about the effects that the withdrawal of the stimulus will have on the economy and, particularly, on the stock market. In this piece we would like to argue against that pessimistic narrative: the Fed's receding stimulus is an orderly and transparent process that should not weigh down on markets.

Concerns

There is no doubt that the so-called quantitative easing (QE) program the Fed embarked on in 2008 was a major factor of subsequent stock-market performance. At the very least, it boosted confidence. Therefore, concerns regarding its rolling back are reasonable. But will this mark the beginning of new era for financial markets? We believe this would be a hasty conclusion given what we have seen so far.

First, we have witnessed some analysts talking about the withdrawal of monetary stimulus in a way that gives the impression that central banks are about to pull the plug swiftly and abruptly, leaving markets devoid of liquidity and, basically, on their own. The reality is very different. While we acknowledge that (1) the level of central-bank stimulus in the aftermath of the 2008 financial crisis was unprecedented (in the US, the UK, the EU, and Japan); and (2) that this stimulus was paramount in helping the economy recover after the crash, a recovery which we are still enjoying to this day, it is also necessary to mention that the effect of the program on the economy is far from a settled issue. Many analysts have stated that the Fed pushed assets' prices higher, but few have made an effort to quantify the effect. The consequences of QE continue to be a matter of both academic and practitioners' debate; it is far from a settled issue. For example, many predicted out-of-control inflation as a consequence of QE, and yet ten years after the first round this fear has still not materialized (only recently the US has edged close to its 2% target, while the euro area and Japan still lag behind). Another example comes from the effect on unemployment: a research paper by Wu and Xia (2016) estimates the reduction in unemployment in the US due to QE to be just 0.13%. Overall, there is broad agreement that QE was the right policy at the right time, but the magnitude of the effects on the stock market are still contested. Additionally, a big chunk of the funds provided by the Fed were kept by the banks as reserves within the Fed, therefore not increasing the money supply. This would help explain why inflation did not rise.

The truth about the end of stimulus

Regarding the Fed and its unwinding of the stimulus program, the rate at which the central bank is shrinking its balance sheet is very slow; the Fed still holds more than $4 trillion in assets, whereas 10 years ago it did not even have $1 trillion. The Fed is not selling assets, but rather not rolling over part of the proceeds from maturing bonds. This process is being conducted very gradually and very transparently, with the specific aim of avoiding any surprises. In fact, the process started last year: in September the central bank announced that, starting in October, it would begin reducing its balance sheet, which back then stood at approximately $4.5 trillion. The change in policy was widely expected; the Fed had taken careful steps to prevent another "taper tantrum." (At the end of May of 2013, the Fed's chairman announced that the QE program would be slowly tapered back. Markets reacted negatively, pushing yields up by 140 basis points for ten-year treasuries between May and September of that year.) The new policy was not a radical departure from QE. It dictated that the amount reinvested would be cut by up to $10 billion per month, a small amount, signaling that the Fed was in no hurry to get back to normal. Cuts would rise gradually over the course of 2018 ($10 billion increase every 3 months). A key element of the Fed's announcement was that the final balance-sheet size it would target was not revealed (although the Fed stated it would probably be higher than what it was before the crisis).

Europe and Japan

As for the ECB program, it was started much later (2015) and for different reasons (the debt crises in some euro-area countries). It also achieved a larger scale than the Fed's effort. While the central bank in the US had a balance sheet

roughly equal to 25% of GDP at its peak, the ECB was close to 40% (and the Bank of Japan close to 95%). The ECB will only stop purchasing assets in December of 2018, an announcement made following strong – though still not completely satisfying – economic data. But there is an important caveat: it will keep rates at very low levels. And make no mistake about it: if the need arises, they will start buying assets again (e.g., the bonds of a government that suddenly needs help). On the other hand, the Bank of Japan is still buying large amounts of government debt, ETFs, and other securities. Their aim is to keep short-term interest rates negative, and long-term interest rates at zero. Overall, international central banks (and governments) remain cautious about the health of the economy, and will continue using monetary and fiscal policy to support them as they see fit.

Conclusion

Summing up, there is no consensus that QE caused massive inflation in stock and real-estate prices (i.e., "bubbles"). In fact, inflation rates have been stubbornly low in the US, the EU, and Japan, despite the efforts from all three central banks to boost prices. As an example, a study by McKinsey (2014) analyzed the effects of QE on stock prices and concluded that "effects on equity prices might not be significant." Two things are important to remember: first, central banks will intervene again if they need to; second, the risk premium today is significantly lower than after the crisis erupted, which (all else equal) is good for stocks. Regarding US interest rates, analysts should keep an eye on variables like unemployment and growth, but also on the level of debt issued by the Treasury and the amount of money being pumped by central banks overseas. Looking forward, we don't see an important and immediate risk for the world's equity markets coming from the stimulus reduction in the US and the EU.

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