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# 2022 Roadmap: QE, Tapering and Zero Cash Rates

Our weekly view on asset allocation.

13 September 2021

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# Central Banks Still in no Hurry to Take Away the Punch Bowl

Last week's RBA September meeting flagged a tapering of bond purchases. In something of a surprise to the consensus view, the RBA announced a reduction in the pace of its asset purchases to A$4 billion a week from the previous A$5 billion.

The RBA foresees a sharp economic rebound once NSW and VIC begin to exit lockdowns, with its base case being positive economic growth in Q421 and solid growth through next year. Thus, the RBA believes emergency policy settings can be phased out gradually. The decision to maintain the $4 billion/ week pace of bond purchases until at least mid-February is seen by the RBA as an appropriate buffer against near-term economic risks.

Just a week earlier, at its US Jackson Hole conference, the US Fed hinted at a likely tapering of its bond purchasing program before year-end, although it left the exact timing open-ended. So, what exactly are the implications of a winding down of QE and will it spell trouble for the stock market?

## Avoiding a Taper Tantrum

Tapering refers to the winding back of the monthly pace of bond buying (QE). This slower pace of purchases is the central bank's QE exit strategy. Importantly tapering is not really a tightening of policy but a shift to a less loose policy stance.

### Fed and RBA singing from the same songbook

Importantly, in its recent Jackson hole comments the Fed was at pains to separate the decision to taper from the decision to lift the cash rate. This is to avoid a repeat of the infamous 2013 "taper tantrum" when markets (temporarily) panicked about a perceived quick withdrawal of policy stimulus.

Last week the RBA was also resolute in its guidance that it does not expect to lift the cash rate until at least 2024. So, the clear message is that investors should expect zero cash rates for some considerable time to come.

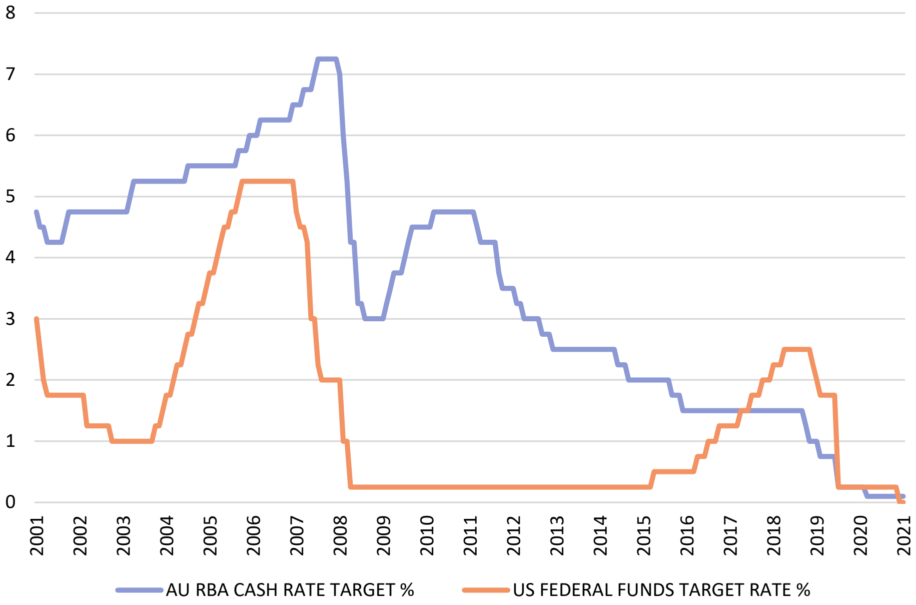
> *"The timing and pace of the coming reduction in asset purchases will not be intended to carry a direct signal regarding the time of interest rate lift-off, for which we have articulated a different and substantially more stringent test."*
>
> Jerome Powell - Fed Chairman - Jackson Hole Symposium

### Taper tantrum unlikely this time around

While this dovish forward guidance around the cash rate from both the Fed and the RBA should avoid a bond market "taper tantrum", it does not mean bond yields will not rise over the coming year, and it does not mean cash rates cannot ultimately rise faster than currently flagged.

Market pricing for the first cash rate hike is still a fair way in the distance (around the end of 2022), but it is already ahead of Fed and RBA guidance, and there is still scope for expectations to shift further.

**Exhibit 1: QE is a function of central banks hitting the lower bound on cash rates**



Source: Refinitiv, Wilsons.

# We Remain Cautious on the 12-month Bond Market Outlook

Long-term bond yields reflect an expectation of both the pace of central bank rate rises and a view of where the cash rate will settle several years from now i.e. the equilibrium or neutral policy rate. These expectations can shift significantly over time. Longer-term bond yields also contain an assessment of inflation risk, which remain fairly subdued despite the recent spike in inflation. This can also change.

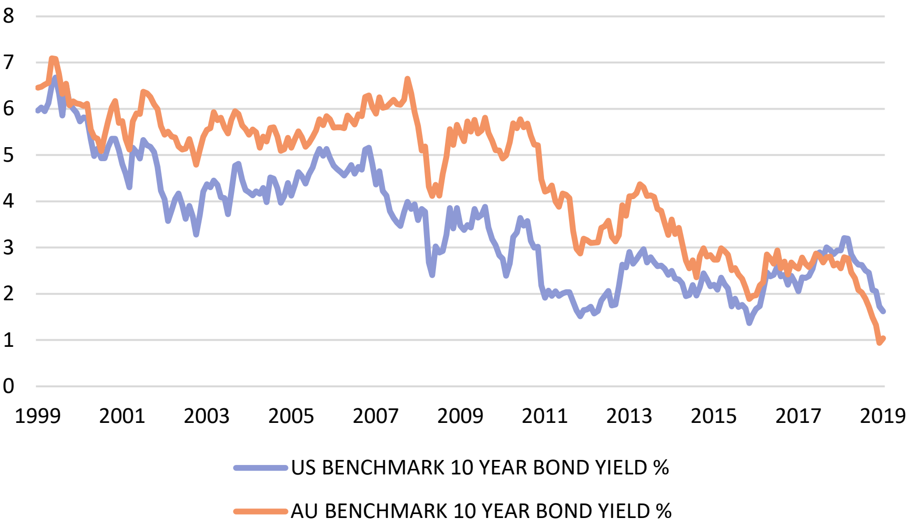
Bond market performance is also a function of supply and demand for bonds. Importantly, there will be less demand for government bonds as QE purchases wide down. Therefore, a key support for bonds is likely to fade over the coming 6-12 months.

Working out the future path of bond yields is, therefore, quite a complex problem. The tapering of bond purchases and the eventual end of QE will, all things equal, put some upward pressure on bond yields by removing a major buyer (the central bank). Still, the path of growth and employment, as well as the path of inflation, are likely to be even more important.

Strong growth and a falling unemployment rate would bring forward expectations for Fed rate hikes (unemployment or indeed full employment is now a key Fed target). Strong growth and higher than expected inflation would bring forward expectations for rate normalisation even faster.

In contrast, disappointing growth and/or lower than expected inflation would see bond yields mark time or even fall from current levels.

**Exhibit 2: QE has helped depress rates at the long rate of the curve but yields should rise as QE fades**



Source: Refinitiv, Wilsons.

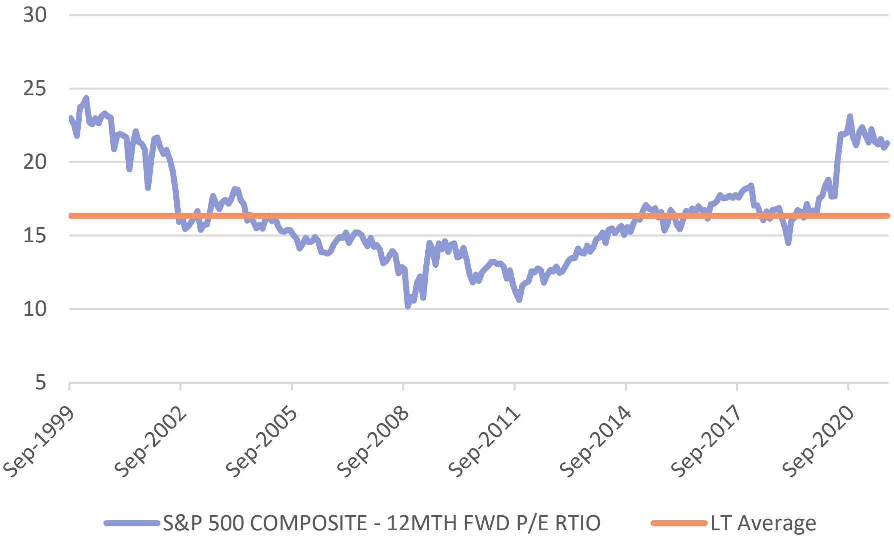
Our inclination is to expect bond yields to move up over the coming year as:

1. They are very low in the context of history and versus the "expected" inflation rate (real rates are significantly negative on virtually all plausible inflation scenarios).
2. We believe economic and employment outcomes over the next 12 months should be relatively strong as pent-up demand is released, so markets should increasingly price the winding back of the current "emergency" policy stance.

## Equities can Cope with “Gradually” Higher Bond Yields

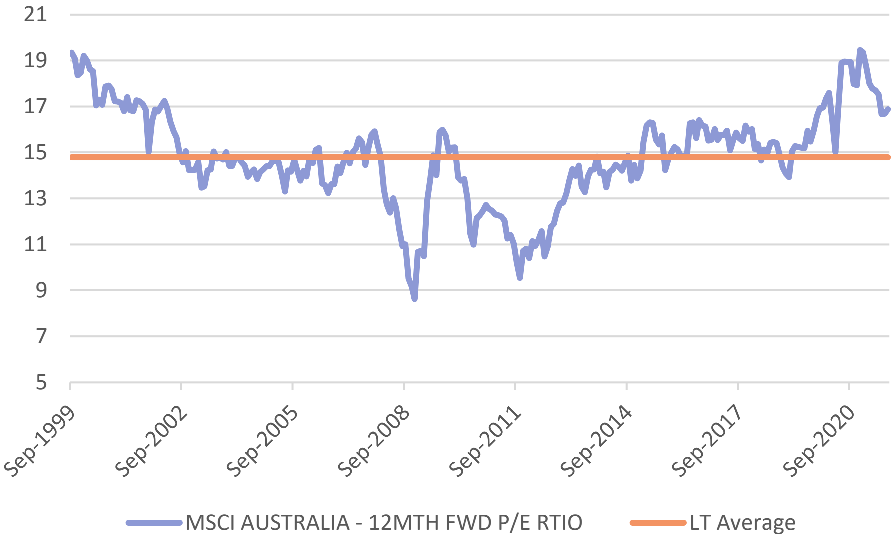
If bond yields indeed move up over the next 12 months, say by 50bp to 100bp, this need not be a disaster for stocks. Equities can cope with gradually higher bond yields if profits continue to rise at a decent pace (as we expect). Importantly, we are a long way from approaching a neutral, let alone a restrictive cash rate, which has typically been the tipping point for the stockmarket.

**Exhibit 3: US equities look expensive on a conventional PE measure**



Source: Refinitiv, Wilsons.

**Exhibit 4: Australian equities also look expensive on a conventional PE measure**

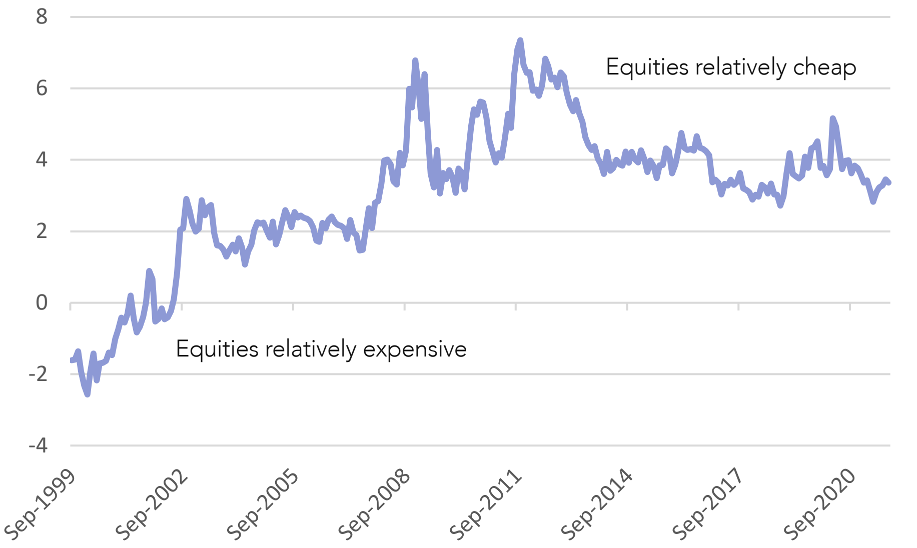


Source: Refinitiv, Wilsons.

Equity valuations are elevated in an absolute sense, but equities still look good relative value versus interest rates even if bond yields were to push 100bp higher. In short, stocks do not appear to be valued off the current ultra-low level of bond yields, so a moderate rise in yields should not be a major problem for equities, albeit it could prompt higher volatility and further market style rotation.

Read The Value vs Growth Debate: Where to From Here?

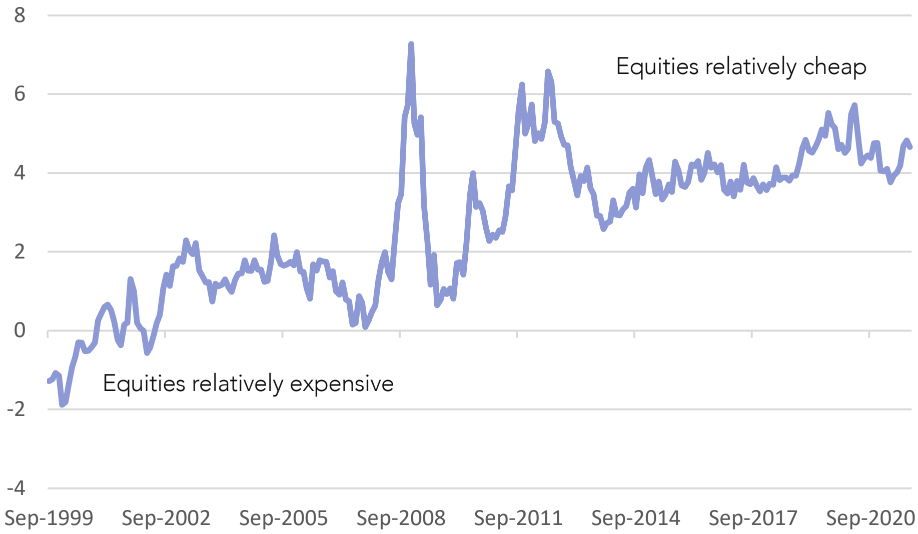
**Exhibit 5: US equities still look relatively good value versus bonds**



* US Earnings Yield to 10 Year Bond Yield

Source: Refinitiv, Wilsons.

**Exhibit 6: Australian equities also still look relatively good value versus bonds**



* Aust Earnings Yield to 10 Year Bond Yield

Source: Refinitiv, Wilsons.

## Is Quantitative Easing Money Printing?

Normally central banks implement monetary policy by changing the overnight cash interest rate (which serves as a reference rate for a lot of borrowing). In scenarios when short-term interest rates have already fallen to zero, central banks have been buying government (and sometimes corporate) bonds to provide additional support to the economy.

This technically boosts the quantity of money in the system (hence the term quantitative easing), but in practice, its main impact is to lower the rate of interest further along the yield curve.

This is potentially quite stimulatory in an economy like the US with a lot of long-dated fixed-rate borrowing e.g. the US mortgage market. In the case of Australia, the impact is likely to be felt more through the impact on the currency and via the indirect (dovish) signalling QE proves in respect of the likely path of conventional (cash) policy rates.

### Isn’t this still printing money and therefore inflationary?

Sort of, but not quite when you dig into the detail. Currently, central bank bond buying involves the central bank using electronically created (printed) money to buy existing government bonds in the secondary market (e.g. from banks, super funds and foreign investors).

So, it is not directly injecting money into the economy nor providing the money directly to the government to spend. Because of these distinctions, we do not see QE as inherently inflationary, though it does produce something of a moral hazard by indirectly assisting governments in running up very large deficits.

One important distinction to full blown money printing is that the bonds bought by the central bank must (at least according to current conventions) still be paid back (by the issuer) when they mature. RBA Governor Lowe has been at pains to emphasise this distinction that QE is not a completely free lunch for the government.

### A Note on Modern Monetary Theory

> *"In theory, there is no difference between theory and practice – but in practice there is,"*
>
> Yogi Berra, Professional Baseball Catcher

**Modern Monetary Theory** (MMT) has received a fair amount of attention in this current COVID-inspired QE phase. MMT argues that genuine money printing or “debt monetisation” is a valid policy option. A government borrowing in its own currency cannot technically default if it is willing to use the printing press. The only theoretical constraint is the amount of inflation such a policy may generate.

When inflation is very low and demand very weak there is technically nothing wrong with using money printing to directly finance large amounts of government spending, which can be used to boost the economy as needed.

While this may be technically correct, the trouble is that politicians (who already have a propensity to spend too much) would be at great risk of becoming addicted to this flow of central bank money, resulting in a steady stream of wasteful government spending and ever-rising deficits. Unlike the current form of QE, this would likely result in runaway inflation – so we think the logic of MMT falls over in the real world. As a result, central banks are wary of endorsing this version of QE. Having to pay back the debt, or at least stabilise the level of debt relative to the size of the economy, keeps at least a veneer of fiscal discipline in a QE world.

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