

Beware Quantitative Tightening!

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Quantitative Tightening (QT), the unwinding of Quantitative Easing (QE), is jangling the nerves of investors around the world. And fair enough, too. It's unprecedented and so no-one knows for sure exactly how it will play out. QE unleashed a massive amount of bond buying by central banks suppressing bond yields to record low levels. When that central bank buying turns to selling, will bond yields soar, bringing an end to the great bond bull market and equity bull markets as well? And what will be the impact of all that liquidity being withdrawn from the system? Be defensive!

There are a few issues with this narrative. Yes, QT is unprecedented - but we can make some educated guesses by thinking about the mechanics of QE and QT, the scale of what is being proposed, and the behaviour of markets.

Firstly, in the case of the US - where the data is readily accessible - one of the direct consequences of QE has been that commercial banks' excess deposits with the Fed have soared. This is because when the Fed creates cash to buy bonds as part of the QE process, that cash is deposited by the bond sellers with the commercial banks who then place it on deposit with the Fed. These deposits are described as excess deposits because they are just that. They are not needed by the banks. Or anyone else. So, what does QT do? It simply takes that excess liquidity out of the system. That is not a problem. In fact, it will barely be noticed.

Secondly, QT is effectively a sale of bonds by the government so, in effect, it will increase the amount of new bond issuance that needs to be absorbed by the markets. We need to put that impact into context. The amount of QT expected in the coming year is approximately 1% to 2% of developed world GDP. It's a big deal, but perhaps not that big.

As has been the case so many times since the GFC, a good point of reference is the Japanese experience from 1990 to 2002. During this time, Japanese government debt rose from 70% to 170% of GDP. That's the equivalent of 8% of GDP in new debt issuance every year for 12 years. Over that time, Japanese bond yields fell steadily from above 6% to below 2%, one of the great bond bull markets in history. This scale of bond sales was well in excess of anything contemplated by QT. This is not to suggest that QT will be good for bonds, but just that there are many other things going on that will be more important. Markets seem to be able to take huge levels of bond issuance in their stride.

Finally, the narrative assumes that no one in the bond markets realises that any of this is happening. Markets are not stupid (even if individual participants often are). Markets have known for some time that this is coming. US bond yields have already risen 1.5% from their lows. Maybe most, if not all, of the impact has already been factored into prices.

All the evidence points to QT being a non-event. There are plenty of things to worry about. But worrying about QT? It's nuts and you can clearly see it's nuts!



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