

In no sense is this QE!

During an investment conference, I recently was asked the question what I consider to be the most important event of the year 2019 in capital markets. I answered that it was the surprising 180° turnabout of the U.S. Federal Reserve (the Fed) and its resumption of massive treasury bond purchases, as a result of which the Fed's balance sheet began again to grow rapidly. In my opinion, this event is not fully appreciated by the markets but nevertheless it sends an important signal about future development.

During the global financial crisis of 2008, the Fed took a step that had been unusual up until that time by initiating massive purchases of treasury bonds. This involved truly large sums of money. The Fed's balance sheet gradually expanded from USD 900 billion in September 2008 to USD 4.5 trillion by the end of 2014. The term quantitative easing (QE) came into daily use to describe these purchases. To criticism that this is nothing other than monetisation of the government debt by printing new money, the Fed's representatives used to reply that this was a temporary issue and that, when the time would right, the Fed would sell again the bonds it had purchased.

At the beginning of 2018, the Fed's balance sheet really did start gradually to contract. By September 2019 the Fed's balance sheet was only USD 3.7 trillion and it seemed that we were on the way to normalisation. After that, however, the interbank market saw a sharp increase in rates caused by a lack of liquidity. The Fed reacted instantly and began pumping liquidity into the market by buying up treasury

bonds. Fed chairman Jerome Powell proclaimed that "in no sense is this QE"!

The reality, however, is such that by the end of January 2020, the Fed's balance sheet had expanded to USD 4.15 trillion and so in only one-third of a year the Fed had purchased treasury bonds in the value of USD 450 billion. I think more important than what this step is to be called are the reasons behind it and the signal it sends for the future. In our analysis, the Fed was forced to purchase new treasury bonds because of an imbalance between the supply of and demand for those bonds.

The US federal budget is running a high deficit despite that economic growth is currently solid. The annual deficit now exceeds USD 1 trillion. At this pace, the United States must issue new T-bonds in order to cover the deficit. New bonds valued at USD 1 trillion are coming into the market each year and somebody has to buy them.

If we simplify this, we can differentiate between foreign and domestic buyers. In recent years, foreign investors have been very restrained in their purchases of US bonds. Their net purchases between 2014 and 2019 were minimal. It could be that the dollar had become gradually more and more expensive, and that that made buying of US bonds more risky. (As a point of information, the US dollar index has risen from the level of about 85 in the years 2012–2013 to the current 102.) The cumulative US federal budget deficit for the years 2014–2019 came to USD 4 trillion and during the

same period the debt increased by USD 6 trillion.

In essence, it has been up to domestic investors to absorb this sum. Their capacities, however, are not unlimited either, and they were virtually exhausted by September 2019. So the Fed was the only buyer capable to take up the superfluous supply of Treasury bonds, and essentially it remains the sole buyer up to today. Since the middle of September, it has been buying about 80% of newly issued treasury bonds and so in fact it is almost fully monetising the new federal debt.

For the years 2020–2021, the estimated US federal budget deficit is USD 2.2 trillion and the federal debt should increase by USD 2.5 trillion. This is the volume of new treasury bonds that must be issued, and it is not at all probable that their sale will be possible without significant contribution from the Fed.

So, what can we expected for the future?

1. It is not at all probable that the US federal budget will transform to any regime other than one of high deficits.
2. It is likely that the market will be under constant pressure from new issuance of treasury bonds in increasing volumes.
3. The buying capacity of domestic investors will grow at a rather slower pace than will the supply of bonds.
4. The Fed and potentially foreign investors will remain the main buyers.
5. Foreign investors will be reluctant to buy US debt, however, so long as they will consider the dollar to be expensive.

Daniel Gladiš, February 2020

6. So, it can be expected that the M2 money supply in the United States will grow significantly due to the Fed's massive purchases of treasury bonds. The money supply in the United States grew by 6% annually in the past ten years, and in the past half year even at about a 9% annual pace.
7. This new round of QE will probably be long-term in nature, if not even a permanent state of affairs, and it will push the dollar down. In combination with the low interest rates set by the Fed, very low or even negative real interest rates are to be expected.

Investment implication number 1:

Investors should pay greater attention to currency hedging of the US dollar. The triple combination of budget deficit, trade deficit, and debt monetisation is to be taken seriously.

Investment implication number 2:

If we find ourselves in an environment where debt is monetised on a long-term basis and this is accompanied by artificially low real interest rates, then it is better to avoid debt securities and direct the majority of investments into property assets that have a certain ability to compensate for decline in the purchasing power of money. Stocks generally fall into that category.

This conclusion is by no means new, we have talked about it already for years and macroeconomic development indicates that it is valid today more than ever.

Invest with care !



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