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PERSPECTIVES

The Turning Tide

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The Turning Tide

After close to a decade of extreme accommodation from central banks, we are beginning to see signs of a monetary policy pivot. For the first time since 2010, the global economy has been enjoying synchronized cyclical economic growth, which has led some central banks to begin moving the monetary policy dial from emergency to neutral. While there is not yet synchronized tightening, a number of central banks have been hinting that they would like to begin reducing the extraordinary levels of accommodation currently in place, and in North America, the U.S. Federal Reserve (Fed) and Bank of Canada (BoC) have already begun modestly tightening their policies.

This by no means signals the end of an era; conditions remain very accommodative: capital is abundant and cheap, and the environment is generally supportive of financial assets. However, the tide is turning and the trend is no longer toward increasing accommodation, but rather toward a slow normalization of policies.

Because the level of monetary accommodation deployed following the financial crisis was unprecedented, so too is its unwinding. While there is no roadmap (and partially because there is no roadmap), we believe that central banks will proceed carefully. In this article I look at how central banks may move forward and the potential side effects for financial assets.

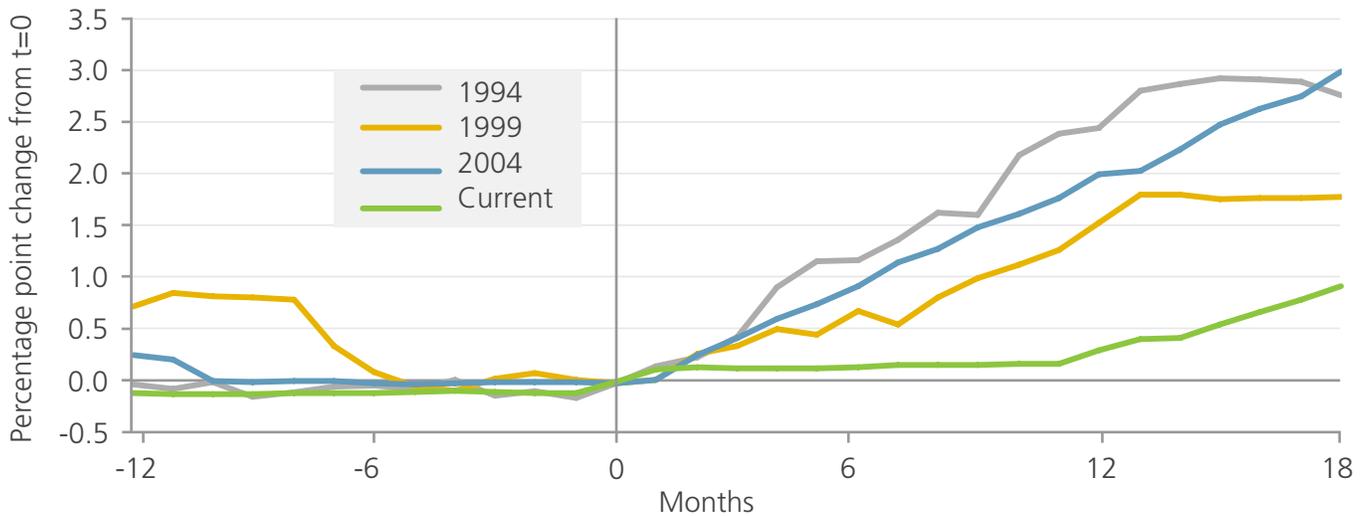
Rising Rates: Higher does not mean high

Since fixed income yields hit their historical lows, there has been a lot of discussion about interest rates increasing and what that might mean for investors. While yields have moved up from their lows, it's important to keep in mind that they are by no means high. For example, 50% of global sovereign debt currently yields less than 1% and 27% yields less than 0%.

That said, both the BoC and the Fed have begun modestly increasing their key rates. In Canada, the BoC has raised rates twice this year, which caused short-term rates to move higher. However, so far it has only removed the additional stimulus it provided following the collapse in the price of oil; by maintaining the rate at 1%, it continues to provide the same significant level of accommodation as it has since the financial crisis. Therefore, I'll focus this discussion on the Fed, which is further along in its tightening journey.

After holding it steady for seven years, the Fed began increasing the federal funds rate in December 2015. Since then it has raised the rate three more times. It has advised that it plans to carefully review relevant economic data before making further adjustments, and we expect it to continue moving slowly and cautiously. In fact, we anticipate that this will be the loosest tightening cycle in Fed history. For context, consider that since 1983 the average Fed tightening cycle has lasted 18 months and the federal funds rate has risen 300 basis points during that time. The current tightening cycle has been underway for more than 20 months and the federal funds rate has only risen 125 basis points. The following chart illustrates how shallow this cycle is versus previous ones.

Current cycle is different from the past tightening periods



Sources: Bloomberg Finance L.P., Haver Analytics.

As of June 2017.

Notes: $t=0$ refers to the start of U.S. monetary policy tightening cycles. Percentage point change from $t=0$ in monthly effective federal funds rates. The graph refers to tightening cycles beginning in January 1994, June 1999 and June 2004, with the current cycle beginning in December 2015.

The lack of precedent for removing this level of stimulus is one of the reasons the Fed is moving cautiously. Another is that the economic backdrop, while improved, is solid rather than outstanding. Global economic growth is expected to be in the range of 3.5% over the next two years, which is still below the pace that preceded the financial crisis. In addition, both price and wage inflation remain lacklustre, with price inflation consistently coming in below central bank targets. There are three main factors restraining inflation:

Debt: Elevated levels of debt mean that consumers have less money to spend on goods and services as more of their income goes toward servicing debt.

Demographics: The global population is aging, and consumption tends to decline with age.

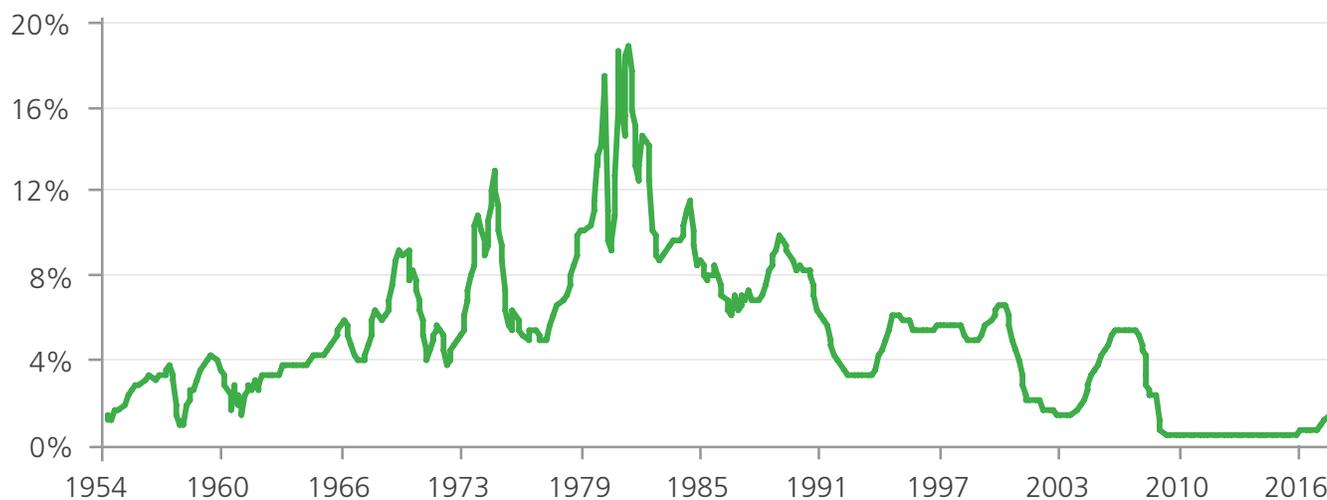
Technology: Technological advances are making goods cheaper.
(For more on this, see the Tethered by Technology sidebar.)

We do not expect these factors to abate in the near term. In fact, even modest increases in interest rates would exacerbate the first factor. The World Bank, International Monetary Fund, European Central Bank (ECB) and Fed also see headwinds for inflation and recently lowered their inflation outlooks. We believe inflation will remain low for some time to come.

Implications

As long-term interest rates are driven by expectations for economic growth and inflation, this low inflation environment is unlikely to spur long-term rates significantly higher. In terms of short-term rates, keeping inflation in check is one of central banks' core mandates, and since it is already well contained, there is no need to raise rates materially to control it. However, central banks are also interested in maintaining financial stability, so high debt levels are a concern for them. Keeping rates exceptionally low could make the problem worse as it may encourage people to continue borrowing. Weighing moderate economic growth, low inflation and high debt levels, we anticipate that the Fed will raise the federal funds rate slightly with an eye on preventing financial instability, but will not raise it meaningfully. We believe it will keep its key rate low versus historical norms; in fact, Fed policymakers' central tendency forecast is for a federal funds rate of 1.625% at the end of 2018, which is well below the historical average of almost 5%.¹

Federal Fund Rate (July 1954 – October 2017)



Source: Board of Governors of the Federal Reserve System.

As at October 2017.

While rates may rise modestly, the situation for fixed income investors is not as dire as some had predicted. We do not anticipate a dramatic sell-off in bonds, but rather a continuation of the lower-for-longer environment. For equity investors, this environment is likely to be positive as low yields should support higher valuation multiples and positive economic growth will help to strengthen earnings.

Tethered by Technology

Conditions should be ripe for inflation to gain momentum, yet it remains stubbornly low globally. This is partially due to demographic trends and high debt levels, but another key factor is technology.

For companies, technology is making it cheaper to manufacture and distribute goods, which is positive for corporate margins and bottom lines but negative for inflation. For example, Amazon's use of robots in its fulfillment centres has allowed it to decrease cycle time from 60 minutes to about 15 minutes, reduce the average human intervention per order down to 1 minute and increase its space utilization by 50%. Other companies are taking advantage of software advances that allow them to access real-time information when creating detailed end-to-end planning, which can result in less wasted inventory. Technology is also creating opportunities where none existed before, such as with shale oil. Advancements in drilling technology mean that previously inaccessible oil can now be extracted, and the resulting additional supply contributed to the substantial decline in oil prices during 2014 and 2015, which has been a significant headwind for inflation.

Technological developments are also having a direct effect on consumers' lives. The number of devices people need has shrunk dramatically since the invention of the smart phone. People have less need for watches, day planners, cameras, music players, pagers and laptops. Almost everything they need is now available in the palm of their hand. Needing fewer devices reduces consumption, which has a disinflationary effect. In addition, the mobile internet has empowered consumers by providing easy access to product and pricing details. Information about the best and lowest priced items is just a few clicks away, enabling them to make better, more informed purchasing decisions and reducing the asymmetry between producers and consumers. And in some cases, the internet has revolutionized entire industries, allowing consumers to obtain a similar or better product for less money. For example, we've witnessed Netflix, Uber and Airbnb all disrupt their respective industries and force existing companies to reduce prices in order to compete, which obviously has a deflationary impact on the economy.

Considering Moore's Law, which states that computing power doubles every two years, there's no reason to suspect that the technology headwind for inflation will dissipate in the foreseeable future.

Paradigm Shift: Transitioning from QE to QT

As the after effects of the financial crisis became more firmly entrenched, lowering key interest rates didn't appear to be providing enough stimulus, so a number of central banks launched asset purchase programs known as quantitative easing (QE). Through its program, the Fed purchased Treasury bonds and mortgage-backed securities in an effort to provide support for the financial system and to stimulate the economy by lowering longer-term interest rates and encouraging lending. The program was enormous and increased the size of the Fed's balance sheet from \$867 billion in mid-September 2007 to more than \$4.4 trillion in mid-September 2017.

U.S. Federal Reserve Balance Sheet



Source: Bloomberg Finance L.P. As at September 2017.

In October of this year, the Fed began tapering these purchases in what is being referred to as quantitative tightening (QT). The Fed has outlined its initial plans for QT, and it appears to be taking a gradual path, reducing its balance sheet by \$300 billion over the first year. In addition, the Fed has indicated that it plans to remain flexible and will adjust as conditions warrant. So its approach to QT will be similar to its approach to interest rate increases – careful and well communicated. This is key because the reaction of market participants could lead to significant yield volatility. Taking a careful approach to QT should help to moderate overreactions and, therefore, volatility.

Implications

Of course, it is difficult to predict the outcome and side effects of QT because of the lack of precedent. However, since QE eased financial conditions by repricing assets, it's reasonable to assume that QT will do the reverse. As we consider possible implications for investors, it's useful to understand how QE affected financial assets. Essentially, with the Fed buying large quantities of Treasuries, there were fewer Treasuries for investors to buy, and those that were available became more expensive, so investors were forced to buy other assets, such as corporate bonds, foreign bonds, high yield bonds and stocks. As demand for these other investments increased, their prices rose as well.

As the Fed reduces its Treasury purchases, the supply of Treasuries available to investors will increase. This means those who altered the composition of their portfolios in response to the lack of Treasuries will have an opportunity to rebalance and reduce some of their risk by increasing their Treasury holdings. This may lead to lower returns for other assets; if demand for them wanes, prices may decline in response.

All else being equal, QT is likely to lead to somewhat higher yields and wider credit spreads, which would be negative for bond returns. QT may also mean more modest equity returns. However, we believe the effects of QT will be moderate, for at least the first year of the program. While the U.S. is engaging in QT, other regions, such as Europe, continue to purchase assets through QE programs, which will restrain yields and provide support for equities there. Should there be synchronized QT in the future, such as if the ECB were to end its purchases, the effects on financial assets could well be more pronounced.

Our View

While the monetary policy tide is turning, we expect this tightening cycle to be very long as central banks remove some of their stimulus while maintaining a focus on their core mandates – fostering maximum employment and keeping inflation in check. We expect they will also closely monitor financial stability. The course that they follow is likely to be well communicated as they are aware that surprises could materially affect volatility and yields.

It appears that the Fed's rate hike cycle and QT program will have differing impacts on investors. While QT should increase yields, low inflation, moderate economic growth and incremental increases in the federal funds rate are likely to contribute to a continuation of the lower-for-longer yield environment. Overall, our expectation is that short-term rates will rise somewhat, with real rates moving from negative to zero, but long-term rates are unlikely to rise meaningfully given low inflation. Our outlook is for fixed income to deliver coupon-like returns. In terms of equities, the ongoing lower-for-longer yield environment should be supportive of higher valuations, but QT may moderate returns as investors shift some of their equity holdings back to Treasuries. On balance, we believe equities will deliver positive returns in the mid-single digits. Investors should be aware that returns from both fixed income and equities may not be as high as they have been over the past several years.

With this backdrop, we continue to favour a diversified portfolio that includes:

1. High quality equities that have the ability to increase their earnings and dividends in a moderate growth environment and thereby protect the real value of investors' savings.
2. An allocation to cash to provide stability and safety of capital.
3. An allocation to high quality domestic government bonds and investment-grade corporate bonds to provide some income, diversification and stability.

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About TD Asset Management

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All data sourced from Bloomberg Finance L.P. unless otherwise stated.

¹ U.S. Federal Open Market Committee

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