Armageddon: When failed QE and falling asset prices collide

By Emma Cusworth

In their desperate scramble for growth, the Fed and ECB have finally revealed they are willing to print unlimited amounts of money. Yet, there is growing recognition among the investment community that quantitative easing (QE) on its own cannot and will not be enough to generate economic growth. It does, however, artificially inflate asset prices and worsen institutions' funding levels.

Meanwhile, politicians are continually failing to do their bit to help address the mounting debt problems or find a workable solution to the eurozone crisis. When it becomes clear that QE is going to fail if it does not receive the necessary political support, asset prices will correct downwards

sharply. This presents institutions with a double-whammy as asset values fall when investors can least afford it.

Easing makes life harder

The irony of QE is that it makes life significantly harder for institutional investors. With the Fed and ECB ready to undertake unlimited amounts of easing in their attempts to shore up their economies and generate growth, the picture for UK institutions also deteriorates markedly.

In a world where no country can afford to become less competitive, the pressure on the Bank of England (BoE) to follow suit will likely prove harder to resist. Consensus among experts is increasingly pointing towards further intervention in the UK.

Stewart Richardson, chief investment officer at RMG Wealth Management, says he expects to see another £50bn added to the asset purchase programme come November's meeting, taking the total to £425bn and, according to Sandra Crowl, who sits on the investment committee at Carmignac Gestion: "The growth rate in the UK continues to be disappointing so I expect the Bank of England won't have a problem expanding its balance sheet further."

The problem of further easing in the UK is it has a direct, often detrimental impact on institutions' funding status. A further extension of the asset purchase programme would, therefore, likely leave them in a more precarious position heading into next year. While QE provides support for risk assets, helping offset the increase in liabilities, that is only any good if the impact on both assets and liabilities occurs over the same timespan. That is unlikely to be the case.

Pension Corporation calculates, using the BoE's own assumptions on the impact of QE, that every basis point yield drop across the gilt curve increases liabilities for defined benefit pension funds by around £2bn. On 4 March 2009, the day before the first round of QE, the yield on the 30-year gilt was 4.3%. By 2 October this year, the 30-year gilt yield had fallen 120 basis points to 3.1%, equivalent to a £240bn increase in liabilities *(see*

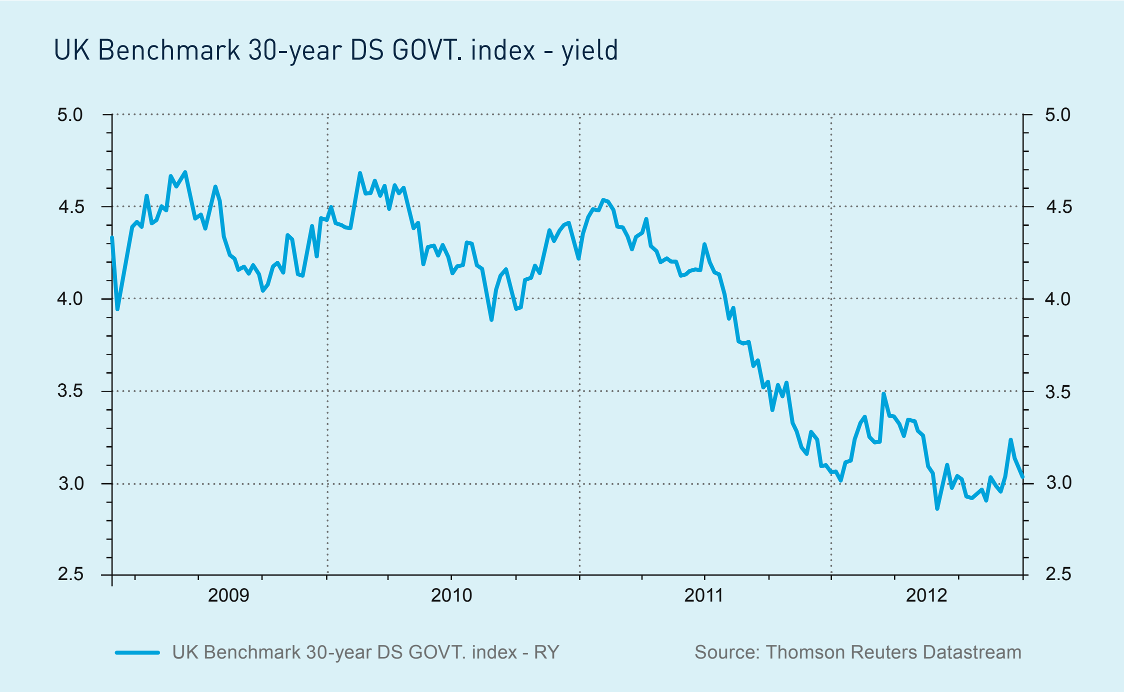

chart above). While QE is not the only factor affecting yield movements, its impact is certainly very significant and another extension of the asset purchase programme is widely expected to help push yields lower.

However, the effectiveness of QE is dying off with each new round of easing. As Mark Gull, co-head of asset and liability management at Pension Corporation, says: "When QE started in 2009, it was a broadly good thing given the concerns over inflation, gilt yields of around 4.3% at the time and the Bank of England's focus on the longer end of the yield curve. It has subsequently become less effective and the side effects are coming more into focus. The BoE now owns 40% of the gilt market. How much more can they do without creating an even bigger distortion?"

The deterioration of funding levels has also led to the 15% hike in the Pension Protection Fund levy for 2013 with further 10% increases expected in 2014 and 2015, but the impact does not stop there. Widening deficits also limit companies' ability to generate the growth and employment QE is designed to stimulate by diverting money that could otherwise be used to invest in companies or return to investors. Smiths Group chief executive Philip Bowman, warned the BoE in September that the £375bn bond-buying scheme was forcing companies to plug widening holes in their pension funds rather than investing in those businesses or increasing dividends. Smiths has pumped £378m into its pension scheme over the last five years to try and tackle its growing deficit, which more than trebled in the last financial year from £199m to £620m. Bowman pointed to the asset purchase programme driving yields down as a major factor in the jump in deficit. The deficit would lower if bonds yields rose but, even if that meant the scheme became over-funded, the company would be unable to recoup the money for investment at a later date.

QE and asset prices

Funding levels are not the only factor affected by QE for institutional investors. It also has a very significant impact on the asset side of the equation, which, despite providing short-term support for prices, could mean a sharp downward correction in the coming months. "Quantitative easing creates a short-term sugar rush for risk assets," says RMG's Richardson, "but little momentum is given to the economy. Structural changes are needed to build the economy. When markets realise QE is not working, the price will have to be paid as assets have been pushed above where they should be. That, in turn, ensures future returns are depressed as markets recalibrate downwards."

Many experts believe that correction could come as early as 2013.

2013: Armageddon?

Nouriel Roubini, dubbed "Dr Doom" after correctly predicting the global financial crisis, has stuck to his forecast of a "perfect storm" of events in 2013, which would lead the global economy into a protracted recession over several years. The storm would arise where the eurozone and other officials are unable to manage the exit of Greece and other peripheral countries such as Portugal and Spain, while Chinese officials are unable to provide sufficient bailouts to banks to avoid a collapse in output and economic tensions. Should these events coincide, along with a recession in the US, a protracted recession would follow, the risks of which are raised by policy mistakes and the unwillingness of developed market authorities to use policy tools, which further delays rebalancing, leading to a sharp slowdown of global growth.

Despite the short-term 'sugar-rush' created by QE, as Richardson calls it, the fundamental picture is already reverting back to where it was earlier this year. Peter O'Flanagan, head of FX dealing at Clear Currency says: "Doubt over the eurozone rescue measures, concerns over the US fiscal cliff which is looming, and growing belief that current stimulus measures have peaked are all justifiable reasons for the sell-off in risk, but these are all old issues."

Ultimately, the question remains whether QE is simply a plaster on the longer-term problems caused by continued Western deleveraging and a global economic slowdown as corporate profit margins are off their highs, and there is synchronised stalling in the US, European and Chinese economies.

"The Fed and ECB have gone all in in the face of an economy that is coming off its peak, but there is nothing they can do to stop a global recession," says Humayun Shahryar, chief executive of hedge fund Auvest. "There is nothing anybody can do to stop a global economic collapse in the coming months, which will likely strike when it is least expected. The economy is simply too big for these guys to control. The tailwind is not with the Fed, corporate profits have peaked and we believe the US is already in recession, which we expect the data to support in the coming days and weeks. Once the markets realise the US is already in recession, the wind will be knocked out of their sails.

Quantitative easing creates a short-term sugar rush for risk assets.

Stewart Richardson

"Markets are currently being set up for a collapse that will make 2008 look like child's play," Shahryar continues. "The crisis is not just about greed and leverage. We are going through a massive change in the global economy. Four out of five of the main global economic drivers of the last three decades are turning negative, but sovereign debt has ballooned over the last five years. We will see a collapse as soon as that borrowing stops. Half the global financial system will be nationalised and 2015 will see the rise of a new monetary system."

With deficits already mounting and more QE to come, the outlook for institutional investors in 2013 is potentially very gloomy. If the limited ability of QE to generate real economic growth becomes clear, economic fundamentals continue to deteriorate across the globe and politicians fail to act, institutions will need to focus on downside protection to avoid the double-whammy that QE has already created by inflating asset prices, setting markets up for a fall as institutions can least afford it.

Picture: Shutterstock

European QE – lame duck?

In order for the ECB's latest efforts in quantitative easing (QE) to be effective, governments are going to have to be responsible in asking for bailouts and accepting the conditions. However, with social unrest on the rise in two of the main countries of concern, the political will and ability to act responsibly is already under threat in countries most in need of the ECB's Outright Monetary Transactions (OMT) facility. Ongoing strikes in Greece continue as the population protests against further policy measures Prime Minister Antonis Samaras and the coalition government are trying to impose. New strikes also bring new market slumps and a rise in yields on the debt of affected countries. Meanwhile, social unrest in Spain is already making it politically more difficult for the government to seek help from the ECB. However, according to Moody's Investor Services, the country's banks face a capital shortfall that could climb to €105bn, almost double the government's estimate of €53.7bn. With Europe's two largest economies no longer able to make up the growth deficit in the region, political inertia could undermine the ECB's latest attempts at QE before it has even begun.

Sandra Crowl, who sits on the investment committee at Carmignac Gestion, says: "The ECB's measures have worked in the interim to increase confidence, but that will be short-lived if countries who are having difficulty financing themselves also become less able to implement austerity measures and are unable to get beyond the stigma of seeking the ECB's help."