October 2009

Racing for the exit

As the world continues the tentative recovery phase from the Global Financial Crisis (GFC), investors are shifting focus to the exit strategy from the myriad policies put into place to bring us back from the brink of financial and economic collapse.

Interest rates at record lows

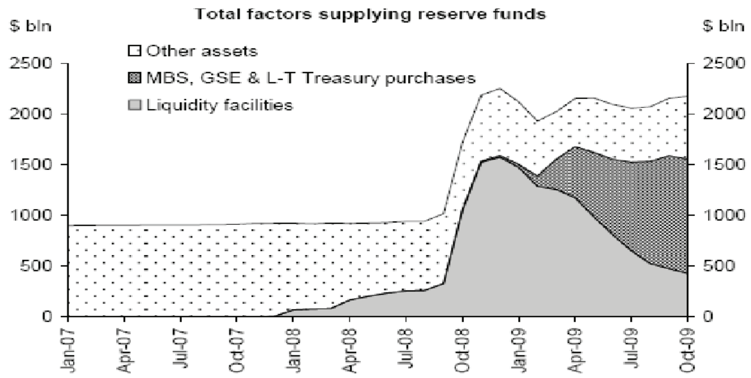
The drastic reduction of interest rates was the linchpin of official response to the crisis in most countries. Central bankers around the world eased monetary policy aggressively to record low levels (nearly zero in the US, UK, Europe and Japan). The Federal Reserve Bank in the U.S. was one of the earliest banks to lower rates, for a total cut of nearly 500bps. It also implemented a range of liquidity facilities and 'credit easing' programs aimed at lowering longer term rates and getting the flow of funds moving again.

Balance sheet expansion

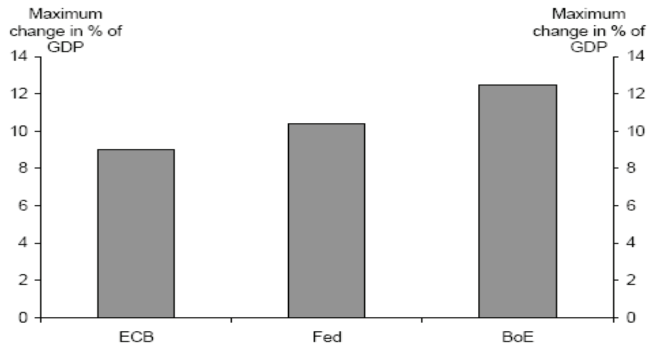
The central bankers (mainly in the US and UK) also boosted their balance sheets dramatically by buying assets to ease the credit crunch. The U.S. Federal Reserve alone expanded its balance sheet from less than USD 1 trillion to more than USD 2 trillion. By the time it completes its program, the figure could be well north of USD 2.5 trillion!

Most Governments, whether their budgets were balanced or not, embarked on a massive fiscal stimulus program, providing its citizens with plenty of cash in the form of direct payments or infrastructure spending to create jobs. As the graph below depicts, in addition to slashing interest rates to record lows, central banks expanded their balance sheets by anywhere from 8 to 12% of their total GDP.

The timely actions of the central banks and the governments not only helped fend off a downward spiral in debt deflation and a repeat of the Great Depression but also managed to light a fire under risk assets. Equity markets surged, commodities soared on demand from China and India, oil prices skyrocketed as consumption started to resume. It looks as if the reset button has been pushed and the world has forgotten the feeling of standing on the edge of the abyss, in just less than a year's time.



Source: FRB, DB Global Markets Research



Source: Haver, DB Global Markets Research

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Australia's Reserve Bank Governor Glenn Stevens was the first central banker in the G-20 to start normalising interest rates post-GFC. The RBA raised its overnight funding rates by 25bps twice (to 3.50%) on October 2, & November 3rd 2009 after having lowered them from 7.25% to 3% between September 2008 and October 2009. In his speech, Mr Stevens warned that the current level of interest rates in Australia were at 'emergency' levels. Now that equity markets and risk assets have had a significant bounce (60% of the lows in March), the impetus to keep rates at emergency levels has passed. Similar comments were echoed by the RBNZ and the Bank of England governors.

The RBA and the Australian economy were either very lucky or very smart as they did not have to embark upon the various programs that their brethren did around the world. This is largely due to their stronger economic circumstances at the beginning of the crisis. Therefore, the steps necessary to remove the 'emergency' rates and to start normalising interest rates were quite simple. Start by raising the overnight rate and the flow-on effect on the population is almost instantaneous. For the US it is a different story.

The  Process

The Fed should start the process of normalising rates only when it is satisfied that the economic expansion has enough momentum to withstand the potential backup in yields that will occur when the exit becomes imminent.

- GDP growth will have to have risen significantly above trend.
- Unemployment will need to have declined noticeably from its peak, with the prospect of getting lower.
- Core inflation will show signs of stabilising.
- The Fed should be comfortable with its projections for the period ahead.

Additionally, the Fed has to start contemplating the following:

- Actively pursue the contraction of its balance sheet.
- Significantly write down the value of many of the remaining assets on its balance sheet.
- Exit asset purchase programs gradually (in some programs, such as mortgage-backed securities, it is in for the long haul).
- Start normalising interest rates from 'emergency' levels.
- Start the process of reducing liquidity facilities. Most of these will run down passively, and in fact many already have (see graph below).

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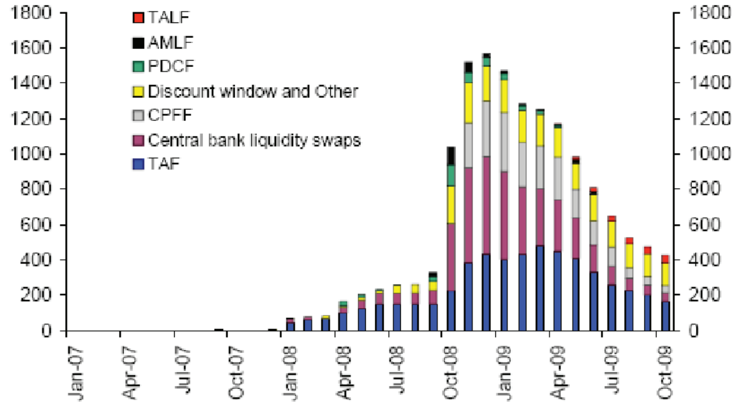
As Malcolm Muggeridge, author and British Journalist, so aptly put it, ‘few men of action have been able to make a graceful exit at the appropriate time’. The timing of the Fed’s exit strategy will be critical to its long term success. The Fed must therefore ensure that macroeconomic conditions (growth and inflation) are stable before embarking on normalising rates. Leave the exit policy for too long, risk higher inflation; exit too soon, risk another downturn in the economy.



Source: FRB, DB Global Markets Research

The Fed would like to cause as little disruption as possible to the mortgage market as it terminates asset purchases. A gradual approach is necessary. Similarly, the Fed will want to give the market ample warning through verbal warnings, to manage market expectations.

The Results of 

Most central banks endeavour to keep rates about 2% above inflation in a normal economic environment. This is similar to being on auto-pilot for central banks in stable economic environments. If we assume long term inflation of around 3%, it is safe to assume that central banks attempting to normalise rates would target rates of around 5% for the RBA,and 3-4% for the Fed and the ECB.

In his wisdom, English Playright, Tom Stoppard noted that ‘Every exit is an entry somewhere else’. So, what happens when the central banks start normalising rates? Where does this ‘exit’ lead in the short-term?

In terms of market response, we expect bond markets to sell off substantially when the exit plans are in place. This applies mainly in the US, as Australia has already sold off in anticipation of more RBA rate hikes. The need for capital protection will be reduced, and due in part to the massive supply of debt, the normalisation of rates will cause bonds to significantly underperform. Continued outperformance of equity markets is also questionable when the cost of borrowing for the economy is rising. It is therefore important for the Fed to engage in this action of normalising rates only after it is confident of the sustainability of the economic recovery.

One thing is certain: increased market volatility is in the offing as an exit has very rarely been orchestrated in a clean manner to satisfy all market participants.