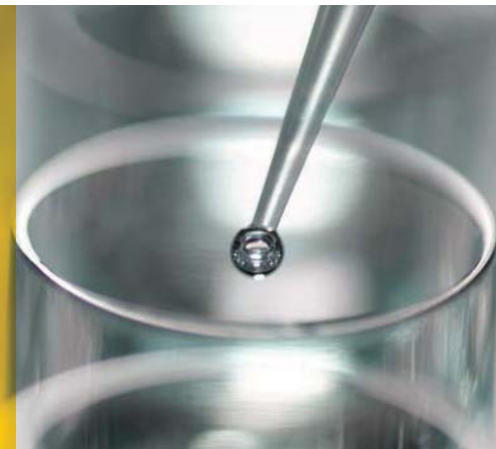

Diminishing Returns for QE and Asset Bubble Risks

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Quantitative easing (QE) seems to be exhibiting diminishing returns when it comes to generating real economic activity.

EXECUTIVE SUMMARY

- The Fed has expressed concern that a prolonged period of low interest rates may encourage a "reach for yield" by investors.
- Setting Treasury valuations aside, we do not see evidence of imminent overheating in U.S. fixed income markets today.
- However, certain trends bear watching including the easing in financing terms and the rising share of issuance being used to fund special dividends and share buybacks.
- We are closely monitoring these trends and avoiding areas of the market where we do not believe we are being compensated for the associated risks.

"It is reasonable to ask whether systemic risks can in fact be reliably identified in advance; after all, neither the Federal Reserve nor economists in general predicted the past crisis."

—Ben Bernanke

CENTRAL BANK POLICY AND FINANCIAL STABILITY

The flood of liquidity from the global central banks has lowered systemic risk and fueled a rally in world capital markets. However, quantitative easing (QE) seems to be exhibiting diminishing returns when it comes to generating real economic activity. Furthermore, there are growing concerns that such policies may have long-term consequences, which could increase financial instability in the future.

Indeed, Federal Reserve Chairman Ben Bernanke[1] recently cautioned that a prolonged period of low interest rates may encourage a "reach for yield" by investors. This yield-seeking behavior can push asset prices beyond their fundamental value and create bubbles in financial markets. Ironically, U.S. Treasuries are probably the furthest from fundamental value of any major asset class due to Fed intervention. Yet, the Fed views this as a necessary by-product of its efforts to support aggregate demand.

1 Ben S. Bernanke, "Monitoring the Financial System," The 49th Annual Bank Structure Competition sponsored by the Federal Reserve Bank of Chicago, May 10, 2013.

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Setting Treasury valuations aside, we do not see evidence of imminent overheating in the broader fixed income markets today. Despite the absolute low levels of yields, our models suggest that investment grade and high yield spreads versus U.S. Treasuries are fair based on current fundamentals. Nevertheless, certain trends bear watching including the easing in financing terms and the rising share of issuance being used to fund special dividends and share buybacks, which are detrimental to bond holders. We are closely monitoring these trends and avoiding areas of the market where we do not believe we are being compensated for the associated risks.

Setting Treasury valuations aside, we do not see evidence of imminent overheating in the broader fixed income markets today.

JUDGING THE SUCCESS OF UNCONVENTIONAL MEASURES

The Fed has pursued three rounds of QE since the onset of the financial crisis in 2008. The first round of QE, which ran from October 2008 to March 2010, was largely successful at restoring market functioning and reducing tail risks especially during the most acute phase of the crisis. There is also evidence that QE1 brought down long-term Treasury yields, which supported U.S. economic growth and staved off the threat of deflation. Indeed, by the time the first round of asset purchases was completed, the U.S. economy had emerged from recession and was expanding 2.1% year-to-year.

However, the economic benefits of the second and third rounds of Fed asset purchases are more ambiguous. Despite further declines in U.S. Treasury yields, U.S. economic growth remains stuck at around 2%. Although home value and stock prices have risen since the implementation of QE3 in September 2012, there is little evidence that this has translated into a faster pace of consumer or business spending. In fact, year-to-year growth in retail sales and new orders for durable goods has actually slowed over the past nine months.

Some of this may be due to the lags associated with monetary policy or the external factors such as the deterioration in the European economy and the U.S. fiscal drag. Indeed, it is difficult to prove what might have happened without central bank intervention. Nevertheless, the economic numbers generally suggest diminishing returns to QE.

At the same time, the potential costs of QE may be increasing as central bank balance sheets expand globally. Increased liquidity may raise credit risks by compromising bank underwriting standards or discouraging necessary balance sheet repair and deleveraging as we have seen in Europe.[2] Low interest rates may also encourage a reach for yield as portfolio managers dissatisfied with low returns take on more credit risk, duration risk, or leverage.

Several Fed officials have recently spent time discussing yield-seeking behavior and how best to address potential credit market overheating[3] should it emerge. Fed Governor Jeremy Stein has been the most vocal arguing that annualized rates of payment in kind and covenant-lite issuance in the high yield market are evidence of a fairly significant pattern of reaching for yield.

From Stein's perspective, the Fed should be open to using its macroprudential supervisory and regulatory tools as well as monetary policy to address potential overheating. However, it is not clear how much support this view has from the rest of his colleagues at the Fed. Traditionally, monetary policy has restricted its attention to the dual mandate of price stability and maximum employment.

2 World Economic Outlook April 2013, "Chapter 3: Do Central Bank Policies Since the Crisis Carry Risks to Financial Stability?" The International Monetary Fund.

3 Jeremy Stein, "Overheating in Credit Markets: Origins, Measurement, and Policy Responses," Research Symposium sponsored by the Federal Reserve Bank of St. Louis, February 7, 2013.

What is clear from recent communications is that Fed officials are thinking more about the risk of asset bubbles and their role in propagating them. This may be why Fed officials have indicated that the end of QE is unlikely to be the steady and uniform process like their approach from 2003-2006 when they raised short-term interest rates in a series of 25 basis point increments over 17 straight meetings. That methodical approach has been partly blamed for fueling the housing bubble which eventually led to the 2008 financial crisis.

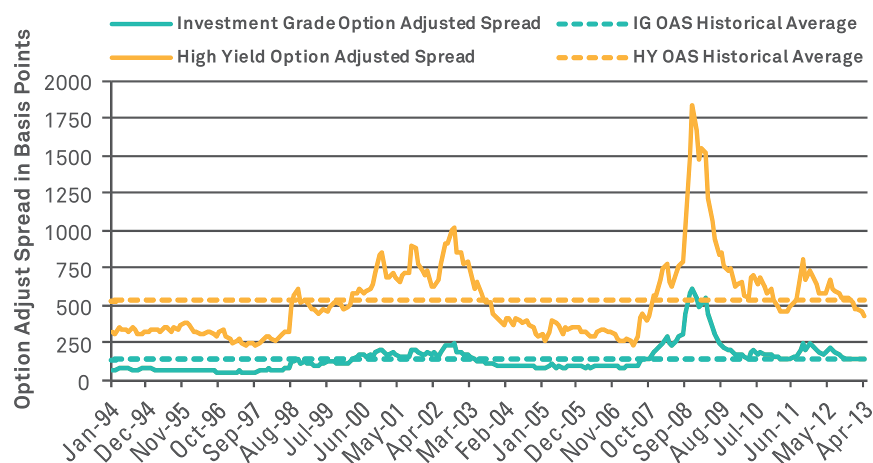
FEW SIGNS OF OVERHEATING IN U.S. CREDIT MARKETS

Nevertheless, we do not see signs of an imminent overheating in U.S. credit markets today. While the absolute level of yields is low due to the Fed's manipulation of the U.S. Treasury market, investment grade credit spreads remain in line with their historical averages at around 140 basis points and they are significantly above the tights of the last two cycles. High yield spreads do look a little rich compared to historical averages, but they are still well above the troughs in the 250 basis range experienced over the last two economic cycles.

In addition to valuations, we also consider trends related to the investor behavior, the quality of issuance, and financial leverage when assessing whether the markets have run too far. According to our analysis, issuance quality has deteriorated at the margin, but nearly two-thirds of funds raised in the high yield market are still being used for refinancing existing debt at lower interest rates or fund capital expenditures, which is generally positive. And it would be a stretch to say there is irrational exuberance in the bond market given the near universal scorn investors heap on the diminutive yields in the fixed income markets. Leverage is beginning to make a comeback, but it is nowhere near the levels we witnessed in 2007. One reason is tighter regulation has constrained the balance sheets of banks and broker-dealers.

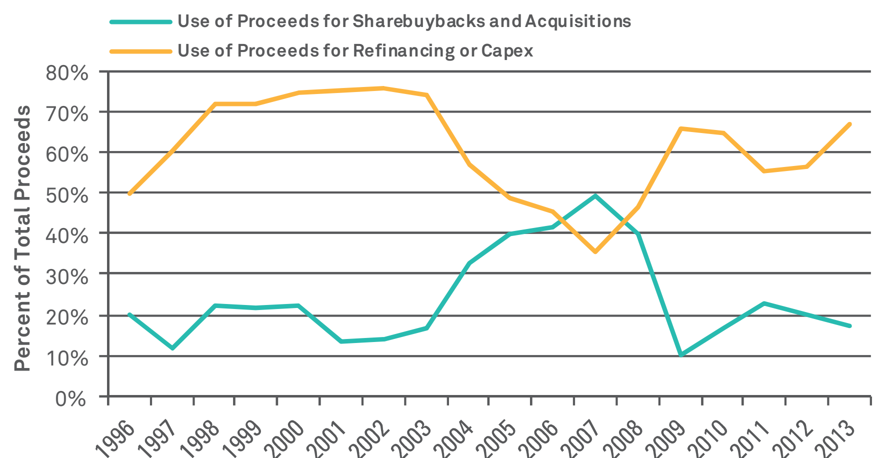
Even so, we expect the debate over the efficacy of QE to intensify and this may weigh on risk assets especially given the rally we have seen since the latter half of 2012. Unfortunately, as the 2001 technology bubble and the 2007 housing bubble demonstrate, the Fed has a poor track record when it comes to identifying and addressing asset bubbles. Moreover, even if they can develop an early warning system, there seems to be disagreement amongst the Board of Governors about the appropriate policy prescriptions that would follow. In our opinion, traditional monetary policy is a rather blunt instrument for countering excesses in financial markets. Instead, increased surveillance and macroprudential oversight are better suited to cooling overheating markets.

Exhibit 1 – Credit Spreads Are Fair to Somewhat Rich by Historical Standards



Source: Barclays as of May 2013; data is from January 1994 to April 2013.

Exhibit 2 – High Yield Issuance Proceeds Are Mostly Used for Positive Purposes



Source: Barclays as of May 2013; data is from April 1996 to April 2013.

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