



# Life After QE

## WHAT'S NEXT FOR INVESTORS AFTER THE FED ENDS QUANTITATIVE EASING?

By BNY Mellon Investment Management

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“It’s not really the end of QE, but the start of monetary policy divergence.”

Since the global financial crisis, the Federal Reserve’s quantitative easing (QE) policy has helped nurture the recovering US economy by keeping markets awash in liquidity while interest rates have remained low. Ahead of the planned end of the Fed’s unprecedented QE program in October, investors are concerned about the implications for market liquidity and volatility. For the portfolio managers and strategists from BNY Mellon Investment Management and its affiliates whom we recently interviewed, the conclusion of QE presents both opportunities and risks.

For Jack Malvey, Chief Global Markets Strategist at BNY Mellon Investment Management, the end of QE heralds the start of the gradual normalization of US monetary policy. But both Malvey and Paul Brain, Head of Fixed Income at Newton, point out that the end of QE from the Fed does not mean the end of QE policies by other central banks in developed markets. “There’s a lot of extra stimulus coming from the European Central Bank, and the Bank of Japan is still pumping money into the system quite rapidly,” Brain says. “The Fed’s action is not really the end of QE, but the start of monetary policy divergence and a shift in central bank support for global markets away from the Fed to these other large central banks. This divergence means fixed income investors may want to seek markets in which rates are unlikely to rise, consider corporate bonds and increase flexibility about how much duration risk they take and where they take it. There may also be a number of diverging currency trends that investors with a flexible global approach can seek out and use to their advantage.”

Sinead Colton, Global Investment Strategist with Mellon Capital Management, also emphasizes divergence as a key characteristic of life after Fed QE. “There’s a huge amount of uncertainty around the normalization of interest rates across the globe. Central banks are at very different positions in how loose they need their monetary



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policy to be and whether or not there is an additional boost coming through from the fiscal side,” she says. “With those varying levels of economic growth, there’s also a lot of uncertainty about inflation. Interest rates have been so low for such a long time that it’s not impossible that we could see inflation increase considerably. At the other end of the spectrum, we have the eurozone, which seems poised to move into deflation.”

While the Fed says it intends to follow a gradual path to normalization, Brain believes the extent to which it succeeds depends partly on whether markets accurately understand the central bank’s communications about the timing of future rises in interest rates. “We know what they’re going to do, but now the market will be looking for hints in the Fed’s forward guidance about when they’ll start to raise rates. Everyone will be looking for changes in the wording of the Fed’s communications. At Newton, we expect that as we gradually approach the middle of next year, we should see interest rate increases. We believe that the Fed is focusing on an inflation rate of about 2 percent and on unemployment dropping to about 5.5 percent by June of next year.”

Malvey also stresses the importance of forward guidance and praises the directness with which Fed Chair Janet Yellen has explained the central bank’s plans to end QE and raise interest rates. “At the September Fed meeting, it couldn’t have been made clearer. It’s all there. Next year they’ll start raising rates on a gradual path to full normalization. But Dave Leduc, Chief Investment Officer at Standish Mellon Asset Management, points out that the Fed needs to stay on its game in that respect. “Withdrawing huge amounts of liquidity without panicking the markets will require the extremely careful choreography of policy changes and communication by the Fed. With risk premiums at such low levels, investors are not being compensated for the potential increase in volatility that would come with a policy mistake.”

All of our experts see new opportunities but also challenges for investors in this coming era of normalization in the US and continuing QE elsewhere. Leduc expects continuing uncertainty and believes that policy normalization is not fully priced into the fixed income market. “Right now, the forward curve is not properly pricing interest rate rises, which we at Standish expect to begin in the second quarter of 2015,” he says. He also expects increased volatility as QE ends. “Liquidity papers over a lot of volatility and blunts the impact of events that might otherwise cause shocks,” he notes.

Colton points out that the new opportunities and risks may require new approaches on the part of investors. “It’s important for institutional investors to have a lot of flexibility around asset allocation, not just at the asset class level, but also within asset classes,” she says.

“Being unconstrained in how you can allocate across different asset classes as well as within asset classes, across different categories of fixed income, for example is important and institutional investors should consider whether their current governance structures allow them to make the timely decisions that are characteristic of flexible multi-asset strategies.”

All of our experts believe the time is right for the Fed to move away from its “unconventional” monetary policy. “We’re constructive on the US economy. We believe the recovery is real,” says Leduc. Dave Daglio, head of The Boston Company’s Opportunistic Equity Team shares a similar conviction about the strength of the US economy. “While many investors remain focused on the Fed,” he says, “we don’t believe the central bank is the key story line. We believe the US economy is stronger than it is currently being portrayed by Fed Chair Janet Yellen, and that the Fed appears slightly behind the curve in its assessment. When QE ends, we expect to see wage growth pick up, capital spending rise and inflation expectations accelerate. Against this backdrop, we will seek to identify the distortions in capital allocation that were caused by abnormally low real rates, and we expect to see the prime beneficiaries of those low rates, such as emerging markets and makers of long-tailed assets like airplanes, tractors and farm machinery, get squeezed.”

Steve Kolano, Investment Strategist with BNY Mellon’s Investment Strategy & Solutions Group also agrees that the US economy is ready to thrive even as the Fed ends QE. “We believe that fundamentals in relation to expectations will replace concerns about Fed policy as the main focus for investors.” But he is keeping an eye on the potential for turbulence as central bank policies diverge. “Some of the most interesting times in capital markets have occurred when conditions that have prevailed for a considerable time change. Policy normalization and interest rate hikes from the Fed could strengthen the dollar for at least the next several years, so we’re watching global capital flows very closely, especially flows into and out of emerging markets in Latin America, South Africa, and parts of Asia. China’s investment and export-driven economy has been fueled in part by capital flowing into the country and it may slow as the dollar strengthens. Slowing growth and capital outflows from China and other developing markets could potentially slow global growth, too.”

Overall, our experts see a world after Fed QE characterized by slow growth in Europe and Japan while a US recovery takes shape on a solid footing that it can sustain for a longer-than-usual period of time. As Malvey puts it, “The case can be made that the next recession in the US is many years away.”

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“We’re watching global capital flows very closely.”

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