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# The end of quantitative easing: Implications for the global economy and investors

*Speech by Dr Raphael Arndt, Chief Investment Officer, at the i3 Luncheon Melbourne, Victoria*

***Check against delivery***

## Introduction

Good afternoon, and thank you for the opportunity to speak to you.

Just over ten years ago the world entered what became known as the Global Financial Crisis as the US housing bubble burst.

The resulting collapse in asset values led to a series of financial sector insolvencies and an unprecedented withdrawal of liquidity from the global financial system.

Central banks around the world responded by easing interest rates rapidly and adopting unconventional monetary policy designed to force liquidity back into the financial system.

Today I will discuss the impact that this "quantitative easing" has had on markets over the last decade.

In a nutshell, its influence on markets has been profound, far reaching and ultimately, something that will end.

Quantitative Easing has been a tailwind for a decade, pushing down the cost of borrowing for governments, corporates and individuals, while inflating asset prices.

The challenge ahead of us is that the end of quantitative easing and shrinking of central bank balance sheets will not only see the loss of this tailwind, but will effectively introduce a headwind.

Today I will briefly look back on the last decade and outline how we at the Future Fund are positioning our portfolio in this environment.

## Context

Let's start by looking back at the events of ten years ago – the Global Financial Crisis.

At this time, many institutions which had been around for decades collapsed, including Bear Stearns and Lehman Brothers, as well as Babcock and Brown and Allco here in Australia.

Drastic times called for drastic action.

Coordinated action by Governments and central banks saved the world from a repeat of the Great Depression.

In just over six months between September 2008 and April 2009 the RBA slashed the cash rate from 7.25% to 3%.

It has since been forgotten by many that the RBA did embark on a series of rate rises, increasing the cash rate from 3% to 4.75% over twelve months in 2009/10, before progressively reducing it from late 2011 to its current level of 1.5%.

I mention this just to provide context and a reminder as to what has occurred over a relatively short timeframe – the last decade.

Sometimes asset owners have short memories and extrapolate the current situation or the very recent past into perpetuity when making investment decisions or valuing assets, and it is dangerous to extrapolate current historically low rates into perpetuity.

Relative to a decade ago, there are some positives worth mentioning:

- The world's banks are much less levered now;
- The corporate sector has paid down debt over the last decade;
- Regulation has been strengthened, and linkages across the financial system recognised; and
- Poor incentives have, to a great extent, been corrected.

So the global financial system is in a better place today.

However, let's not forget that global debt remains at all-time highs.

While households in the US took advantage of the low interest rate environment to reduce their debt levels, here in Australia we were cushioned by China's stimulus and kept borrowing. We now have among the most levered households in the world.

More debt means less resilience to interest rate rises. Put simply, when you need to pay more to service your mortgage, you spend less at the shops.

And Governments across the world collectively now carry a larger debt burden than a decade ago.

Global demographics and an ageing population will increasingly be a headwind to growth and will also add to the burden on governments through pension and healthcare costs.

At least most governments have the ability to print money or levy taxes, so governments have options to manage their balance sheets that banks, corporates and individuals don't.

Although I make the point that Europe's monetary union reduces the ability for a nation state in the Euro Zone to manage its national balance sheet in this way.

And after a decade of anaemic performance, the real economy is slowly returning to normal levels of growth.

However, it has taken the biggest ever stimulus in history, and a decade, to get global growth to a normal level.

And the stimulus has had side effects – most notably, spill over effects from QE have stimulated markets and asset prices.

The tailwind of cheap money has seen asset prices and investors' appetite for risk both increase – and in many cases led to risk being mis-priced as investors bid up prices of risky assets on a wing and a prayer that the good times will roll on forever, or if not forever, at least until they can on-sell the asset to someone else.

The bifurcation between the performance of the real economy –which has been ok, but nothing more – and asset prices – which has been strong, is now being reflected in the politics of populism and protectionism that we see when we look out across the world.

Low interest rates inflated the wealth of those who were already wealthy, but did little for the wealth of those who work for a living and who had no starting asset base and increasingly no opportunity to build one.

Populist politics is the price of that policy.

The extreme low interest rate era will come to an end at some point, perhaps quite soon. The world's economies have recovered sufficiently to come off the low interest rate drug which kept them alive through the recovery phase.

A period where central banks shrink their balance sheets will unwind the tailwind of quantitative easing that has led to an unstoppable increase in asset prices, reduction in volatility, and increased risk appetite.

## What is an investor to do?

So in this environment, what is an investor to do?

It is important for investors to think about risks, and not just returns.

This means asking what are the risks in your portfolio?

And asking what would happen:

- If growth stumbles?
- If interest rates rise more than expected?
- Or if debt suddenly becomes less available?

Unless you have a crystal ball the only real protection is diversification.

Even after the recent selloff, equities remain expensive by historic standards and valuations are susceptible to bouts of volatility.

Risks like rising protectionism and trade disputes have the potential to spook markets and impact fundamental value.

While equities have served investors well over recent decades it doesn't pay to put all your eggs in that basket.

Hence, a response is to diversify by:

- geography;
- asset class; and
- drivers of performance.

By drivers of performance I mean that it isn't prudent to hold a portfolio that is entirely dependent on economic growth continuing or interest rates falling further or staying at historic lows.

In thinking about diversification it is important to understand the relationship between different asset classes.

In the past for instance, equities and bonds often provided good diversification – meaning that when one performed poorly, good performance in the other asset class provided something of an offsetting effect.

The flood of liquidity from QE has seen this relationship break down – and it no longer holds that equities and bonds will provide diversification from each other in all scenarios.

It is for these reasons that the Future Fund doesn't have significant holdings of bonds, but does hold assets such as venture capital, hedge funds and has a diversified global portfolio including significant exposure to currencies other than the Australian dollar.

And we hold tens of billions of dollars in aggregate in these asset classes because they provide diversification away from equities.

In addition to diversification, it is important to maintain flexibility. This is as true for those investing for the long term as for anyone else.

By this I mean holding cash and assets that can be liquidated at short notice.

The reasons for doing so are two-fold:

- Firstly, to avoid being a forced seller of illiquid assets into a down market if there is a liquidity squeeze; and
- Secondly, having the ability to invest into a down market when conditions permit and forward-looking returns look attractive.

To that end, over the last six months the Future Fund has taken a conscious decision to sell around $5bn of illiquid assets, across a number of asset classes.

Markets are robust, valuations remain full and, in our view the risks I have mentioned have not been fully priced by markets. A long term investor should be prepared to sell at times like this and step back into the market when the outlook is more attractive or, at least, less uncertain.

This is not the first time the Future Fund has taken a position on how much risk to have in the portfolio, and doing so has added around 1.3% pa to our returns over the last decade compared to holding a static portfolio.

## Conclusion

In concluding I will come back to the title of my speech – namely, the end of Quantitative Easing.

While the coordinated actions of central banks averted a repeat of the Great Depression, the impact of Quantitative Easing and unconventional monetary policy was most keenly felt in markets – and asset prices experienced a decade of turbocharged performance.

It is therefore reasonable to expect a bumpy ride ahead in markets as we see the unwinding of what was trillions of dollars of liquidity that was introduced into global economies.

In such an environment, diversification, flexibility and consideration of risk are particularly important for investors.

It is therefore prudent to think about different scenarios, and consider the portfolio implications as the tailwind of quantitative easing ceases and becomes the headwind of shrinking central bank balance sheets and rising interest rates.

Thank you.