The Implications of Easing

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Just as the US Federal Reserve (Fed) announced the conclusion of its long-running quantitative easing (QE) program, the Bank of Japan surprised markets by announcing the expansion of its own easing regime. Mark Mobius, Executive Chairman, Templeton Emerging Markets Group, and Michael Hasenstab, Chief Investment Officer, Global Bonds, Franklin Templeton Fixed Income Group®, weigh in on the implications of these central bank actions, as well as current European Central Bank (ECB) policy, and what they could mean for investors on both the equity and fixed income side. First, some background on quantitative easing from Dr. Mobius.

One of the most talked about subjects among global investors over the past couple of years is actually somewhat of a misnomer and typical of the euphemisms common in financial circles: the US Federal Reserve's (Fed's) "quantitative easing (QE)" program. "Easing" really isn't an accurate description—in actuality, it is about expanding rather than easing. There was QE1, then QE2, and finally QE3, the last version of the Fed's moneycreation program. QE1 started in late 2008 in response to the US sub-prime financial crisis, in the form of a program to purchase government debt, mortgage-based securities and other assets primarily from banks which were suffering from the decline of the value of those assets. The original program was set at US$600 billion, but the expected economic recovery and ending of tight credit did not materialize as expected. Hence, QE2 was launched in 2010, and then two years later, QE3, as policy makers became more and more desperate to create the required economic stimulus.

In total, more than US$4 trillion (close to the size of China's foreign exchange reserves) was spent, about six times the original plan. The result was a three-fold expansion of the Fed's balance sheet. In my view, what's most important to note is that the United States was not the only country to launch such a program during these years. In the United Kingdom, a £75 billion (about US$120 billion) program was launched in 2009, and that program was gradually expanded to £375 billion (about US$600 billion). The Bank of England's balance sheet expanded four-fold; the government was using new money to buy back its own debt.

Subsequently, the European Central Bank (ECB) found itself with the same problem of failing banks. So the same solution has been applied, and the ECB's balance sheet also has expanded as more and more assets are purchased from European banks.

Of course the Chinese, Japanese and other central banks have launched monetary expansion programs of their own, allowing banks in many respects to be sheltered from having to make tough decisions regarding their bad investments. Meanwhile, much of the money has remained on the banks' balance sheets, much to chagrin of the central bankers who wanted the banks to initiate lending so the economies would revive. Some of the money has also been diverted into the equity markets as well as property and other tangible assets such as commodities.

The low interest rates we see globally in many markets now disadvantage regular bank deposit savers and pensioners, while the equity holders have generally benefitted as the surviving banks have grown bigger, and perhaps are now in the "too big to fail" territory. The savers who have suffered with low interest rates could be hit with another problem of high inflation down the road. Although inflation has generally remained low in the markets where central banks have been engaging in easing measures, many—including me—believe that once the banks gain the confidence to begin lending aggressively again, inflation will likely rise. This, of course is a double-edged sword. Countries battling deflationary forces, including Japan and the eurozone—would welcome inflation. But the flip side is that inflation can quickly spiral out of control, and it can hit emerging market economies particularly hard, as a higher proportion of their consumers' budgets go to basics like food and fuel.

For now, we believe the most recent easing efforts of Japan and the ECB should offset concerns about the end of the Fed's QE programs and that these efforts will continue to provide liquidity to the markets. But, we'll be watching for any unwelcome aftershocks.

Central bank policy has been a major driver of global asset prices over the past few years. In October, the Fed concluded its QE program and that was pretty well telegraphed, so it was not a surprise. Meanwhile, Europe clearly struggles internally with conflicting dynamics and conflicting political agendas between Northern Europe and Southern Europe, particularly some economic disparity between Germany and other parts of Europe. It seems clear to us that the general trend is for the ECB to adopt a more easy policy, although we haven't yet seen it play out to the same magnitude as the Bank of Japan (BOJ)'s efforts.

The BOJ recently announced a massive expansion in its asset purchases from ¥50 trillion to ¥80 trillion a year. Basically, it equates to a similar magnitude of what the Fed was doing; the BOJ has expanded the type of assets that it can purchase to include exchange traded funds (ETFs) and real estate investment trusts (REITs) and expanded the tenor of what it is buying in Japanese government bonds, moving out past seven-year maturities. The BOJ has also made the asset-purchasing unbounded in terms of the time frames.

I think the BOJ's actions are indicative of not only how important QE is to both Japanese Prime Minister Shinzo Abe's "Abenomics" policy and his political legitimacy, but also as a driver of Japan's domestic economy. QE facilitates two major dynamics: First, it funds massive government indebtedness. Basically, the Bank of Japan is now directly financing the government, which is important in Japan because the government is running massive fiscal deficits on top of a huge debt stock. At the same time, the pool of assets domestically from the private sector is shrinking because the current account has moved basically from massive surpluses to flat-like deficits at times, while at the same time the population has been aging. So we believe another source of financing is needed. This is critical, in our view, and Japan's policy motivation is very different from the motivation of QE in the United States or the motivation of QE in Europe, which are not really about explicit debt financing. Japan's debt dynamics are more of an explicit debt financing.

The other component of QE that we believe is critical in Japan's case is that it facilitates pension fund reform. Pension fund reform is important because changes in the Japanese Government Investment Pension Fund's asset allocation mix toward more domestic equities, global equities and global bonds should allow the return on the global pension fund to increase, which is important to help offset the higher inflation that retirees are likely going to face. In the past, retirees enjoyed deflation because their cost of living kept going down, but QE and Abenomics are engineered to create reflation. That is politically very unpopular for an older population. In order to compensate in some measure for the negative effects of inflation, a boost to investors' asset prices would help mitigate those effects. It also provides short-term political legitimacy to Abenomics. Abe faces the same problem that most politicians face, which is that long-term goals and the right reforms usually create short-term pain. Without some short-term incentive, it's really almost impossible for any country to bridge that gap.

Providing a boost to Japanese asset prices through QE and through pension reform could give a boost of confidence to the domestic economy and give support to Abe. We believe that can provide him a window of opportunity to potentially push through the harder structural reforms that are generally more unpopular.

The implication of QE for domestic asset prices is quite clear to us. Pumping money into the economy and changing the asset allocation mix of a trillion-dollar pension scheme has had an impact on Japan's domestic asset prices. Globally, it's also very supportive, in our view, because money is fungible. Money that is printed in Japan doesn't just stay in Japan; it flows into other markets. So we think Japan's QE program is very positive for global risk assets but will be unambiguously negative for the yen.

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