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THE GREAT UNWINDING

Incredibly, one of the most important economic announcements of 2018 has been completely overshadowed by the near-continuous flow of bombast from Donald Trump.

In any normal year, the European Central Bank (ECB) announcing that it will reduce and ultimately end its massive quantitative easing (QE) program after roughly 10 years of aggressive asset purchases would be the biggest story of the year—recall the 'taper tantrum' that occurred after the US Federal Reserve made a similar announcement in 2013—however, because of the seemingly endless Trump distractions, markets have barely noticed.

But the ECB announcement, we believe, is extremely consequential. Specifically, the ECB announced that it will begin tapering its buying of monthly assets (mainly bonds) from EUR30 billion to only EUR15 billion after September and finally end the purchases completely by the end of the year. Throughout the ongoing QE process, the ECB's collective balance sheet has ballooned to an extraordinary EUR4.5 trillion and all of this asset buying and suppression of bond yields has done an admirable job of propping up European equity markets. So, an important question emerges: what happens when the ECB stimulus stops?

Background

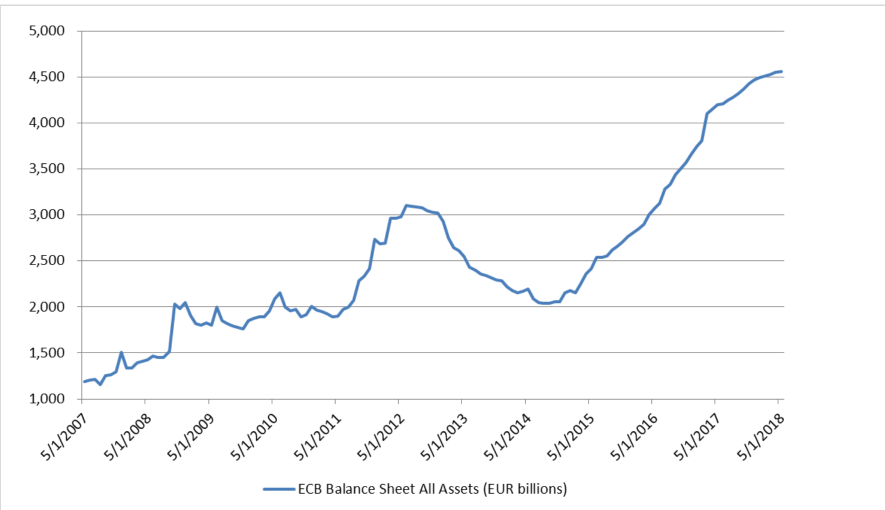
Most major central banks took exceptional measures during the 2008–09 financial crisis to save economies and salvage equity markets. This included, of course, lowering their benchmark interest rates to record- or near-record-low levels, but it also involved massive asset purchase programs, which essentially allowed central bank balance sheets to become a prominent instrument of monetary policy. The central banks of virtually all the major developed economies have adopted this approach at some point over the past decade—the ECB, the US Federal Reserve, the Bank of Japan and the Bank of England, for example.

Ultimately, these stimulus strategies worked, and developed-world economies slowly began to expand and equity markets, as evidenced by the current seven-year global equity bull market, began to recover.

Why Is the ECB Ending QE?

The ECB clearly felt that the European economy was now strong enough to no longer need stimulus. And there is ample evidence to suggest it's correct. The Eurozone has averaged better than 2% annual GDP growth over the past three years including 2.4% growth last year—its best growth rate in more than 10 years. European equity markets have stabilized and have been performing just fine with the STOXX Europe 600 Index averaging 6.5% annually over the past 10 years on a total return basis and an even more impressive 9.4% annually over the past five years. Inflation, which the ECB has struggled to increase, has spiked recently, currently sitting at close to 2%. And even Greece, which, of course, has been a major destabilizing force in Europe, has shown progress, recently unlocking the next EUR1 billion of its bailout program, having satisfied its lenders that it's meeting its targets.

Current Level ECB Balance Sheet



Source: Bloomberg

Europe, naturally, is not without its risks, with the messy March election in Italy being a good example, but the ECB clearly felt that this year was the appropriate time to end QE and we agree.

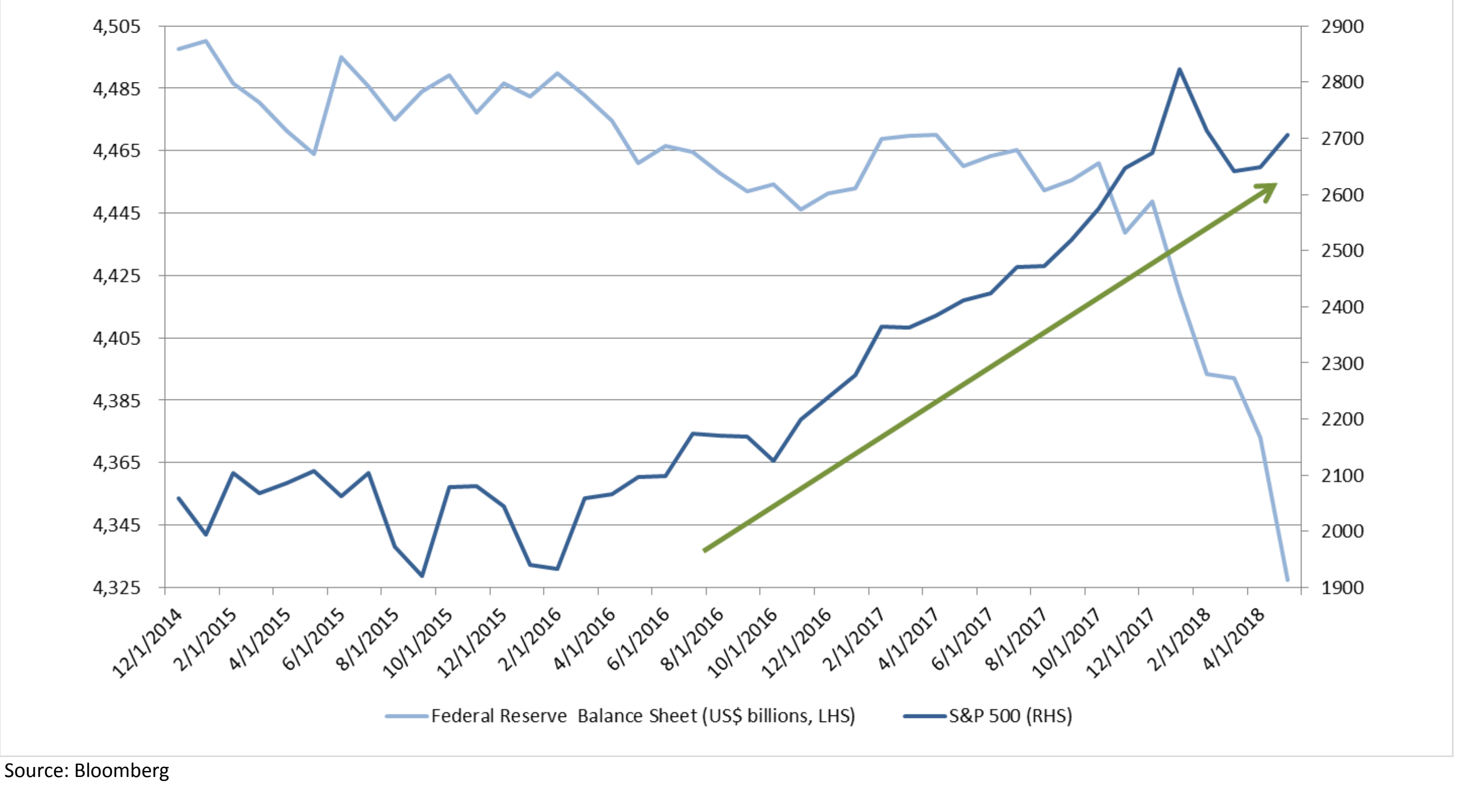
QE Is Ending: Are European Equity Markets Prepared?

Given that the global financial crisis was unprecedented and that the collective central bank response was also unprecedented, we don't know with certainty how the removal of QE will play out long term. To be blunt, massive QE and historically low interest rates are a kind of grand experiment with unknown outcomes.

But, there is one significant precedent for the ECB and that's the actions already taken by the US Federal Reserve. Like the ECB, the Fed enlarged its balance sheet to levels measured in trillions of dollars and took steps, albeit a few years earlier, to scale back and then eliminate its asset buying. More recently, the Fed announced that it will actually be steadily reducing its holdings of Treasuries and mortgage backed securities and thus we've seen the Fed's balance sheet fall from a peak of US$4.5 trillion in January 2015 to US$4.3 trillion currently. Clearly, the Fed's actions suggest its continued confidence in the US economy.

So, how have US equity markets reacted? Quite well. Since the Fed's balance sheet peaked in January 2015, the S&P 500 has advanced more than 46% on a total return basis, equivalent to 11.7% annual growth (see chart). A combination of a strong US economy and gradual Fed measures have calmed US equity markets and allowed them to advance.

Removal of QE and a Shrinking Fed Balance Sheet Have Not Hurt US Equity Markets One Bit



Source: Bloomberg

A SLOW AND STEADY SHIFT

What we're now witnessing is central banks beginning to ease the pressure on their balance sheets with the ultimate intention of achieving more normalized interest-rate policies (the Bank of Japan, admittedly, is a notable exception as it continues to forge ahead with asset buying). Central bank balance sheets couldn't continue to expand indefinitely and, at least so far, the methodical and well-telegraphed process of slowly eliminating QE programs has not derailed the global equity bull market. Further, in order to cushion the blow of ending QE, the ECB announced that interest rates will remain unchanged until the back-half of 2019 ("at least through the summer of 2019"). In other words, the ECB is taking gradual baby-steps. Central banks moving slowly is always appreciated by equity markets.

We'll continue to monitor the Fed and ECB, but, so far, so good.

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