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GLOBAL PERSPECTIVE

Central-bank dominance in key advanced economies: Scaling new heights

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The direct intervention of key central banks to fulfil economic objectives is structurally altering global financial markets. The legacy of the crisis that began in 2007-08 remains, and our projection is for sustained global disinflation/deflation in the major economic centres of the world going forward. As such, direct intervention by central banks is likely to continue to increase. Indeed, central banks are now policymakers, asset owners and regulators in a completely revamped financial system. The printing press and negative interest rates have now become the key forces shaping both the nature and size of all global risk premia.

But what does this increased intervention mean for savers and investors? By keeping risk-free rates very low, central banks force investors to take more risk, which generates a wealth effect (also called the "portfolio rebalancing" effect). In the case of economic centres such as the eurozone and Japan, there is a powerful FX channel effect as well (via interest-rate differentials). The key aim of this policy from a central-bank perspective is to influence output growth and inflation via more liquidity, lower borrowing costs, FX depreciation and rising asset prices.

Central banks currently hold on average around 20 to 30% of all outstanding government debt in key economies. They hold more in the eurozone and Japan; the BoJ holds 30% of current JGBs stock and the ECB is forecast to hold 34% of total German public-sector debt securities by end-2017. This is compared to almost zero pre-2008. This means that traditional global fixed-income investors have to adapt to the structural reality of a very dominant player being present in the market, whose final objective has nothing to do with earning fixed income risk premia. This affects shape and nature of fixed-income duration, and now credit (in the case of ECB) risk compensation available to investors.

The thrust of easy monetary policy is easy to understand (i.e. it is meant to stimulate growth and inflation). However, the current era of central-bank dominance creates significant tail risks in the form of the credibility of these unorthodox policies. The best example of this tail risk is in the eurozone. Here, it is well known that the ECB's governing council is not unanimous when it comes to deploying of QE/negative interest rate programmes.

State influence on the banking sector likely to grow further

Direct central-bank intervention in debt markets is only part of the story. New banking sector regulations such as Basel III, Dodd Frank and the Volcker rule are rewiring the entire financial system. They are doing this by changing the scope and usage of what is considered risk-free collateral.

Moreover, the strong pressure seen on the European financial sector (especially on Deutsche Bank) in early February brings a new dimension to the fore. This is because, despite all of the capital and liquidity backstops, markets dominated by the private sector still attacked key banks' debt markets on the back of essentially profitability related concerns.

Here, our line of questioning is simple. Suppose a very large bank is unprofitable, driving its equity price to almost zero, and its debt (both senior and junior) is ring-fenced by the central bank. Who, then, is the ultimate beneficial owner of the bank? Indeed, growth is still anaemic and pure monetary-policy tools appear to have reached their limits (in terms of both actual size and political resistance). Thus, central banks using the commercial banking sector as a growth tool and inflation-enhancing policy is not an entirely forgone conclusion, in our view.

Challenges facing global fixed income investors: Back to basics with buy and hold

Our expectation of sustained disinflation and low economic growth implies that investors/savers will continue to be forced to look for yield. However, given the above backdrop and evolving structure of financial markets (specifically fixed income), investors need to appreciate the new dimensions of this Brave New World.

A key unforeseen consequence of central-bank dominance via QE has been "herding", or increased commonality in investment positions. This has occurred as investors are forced into fixed income, which is then accessed predominantly via market-cap-based allocation schemes. In addition, tightening regulations have damaged the banking sector's financial-intermediation capability. This has led corporate and EM bond inventories to fall sharply, which in essence implies a very narrow exit door and a much bigger crowd. The result is bond-market liquidity being seriously undermined, and large investors' losing confidence that they can convert their bonds into cash at will in a frictionless manner.

However, in a world of disinflation, in order to meet investment objectives from both a return and diversification perspective, investors still need to access fixed income premia. Here, we recommend a prudent search for yield, prudence being firstly to navigate the potential tail risks (emanating from central-bank dominance) and secondly to appreciate the fractured liquidity situation. Specifically, we believe that investors need to consider a buy-and-hold approach to fixed income, treating the bond as intended – i.e. to generate coupon income and to be held to maturity. This is in order to mitigate both duration (or the risk of higher rates) and liquidity (the need to access markets) risks.

However, we believe firmly that under a buy-and-hold framework, the status quo of using market-cap allocation which is engineered to reward leverage is ill-equipped to deal with the new realities. Indeed, we believe that global fixed income investors need to consider a trade-off between liquidity and credit risk. We believe that they should focus on the latter by emphasising the role of fundamentals in portfolio construction (especially as they traverse the riskier fixed-income segments in search of yield). This would be in order to mitigate default risk and utilise the limited degrees of freedom which the current environment affords.

All in all, we believe that the essence of both safety and liquidity, especially when it comes to fixed-income investing, needs to be reassessed. We recommend a "back to basics" approach as the Western economic and financial system begins to face an era of "unbounded" uncertainty.

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