The Bank with a Soul

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mBaer Necessities

Melancholic economies - QE addicted and QT intolerant

Markets and governments feel entitled to central banks' support in suppressing market volatility and keeping interest rates low.

These are legitimate and justified expectations in light of central banks' massive interventions since the 2008 crisis and the central bankers' assessment of these policies, exemplarily summarized by ECB Ms Schnabel: "the success of our interventions has been overwhelming. PEPP [ECB's asset purchase program during the pandemics] prevented the financial system's collapse." With a little creativity, Ms Schnabel's hyperbole sounds like a pharmaceutical company CEO's assessment of its little blue pills.

For starters, quantitative easing (QE) had the effect of inflating asset prices artificially and contributed to increasing wealth inequalities as it benefited disproportionately financial assets' owners. As the macro environment is changing rapidly, a more impartial assessment of the effects of central banks' QE policies will be carried out when they will eventually be removed. In fact, as inflation rose dramatically last year and is still exceptionally high in many countries, it appears inevitable that central banks will remove their support by rising interest rates and reversing their massive bond-buying programs, resulting in significant downside risks for markets and in the deterioration of public finances driven by rising interest rates.

In this environment, central banks' QE policies are likely to be reversed as several central banks announced the reduction of balance sheets, a policy called quantitative tightening (QT), and a series of interest rates increases in the attempt to bring inflation under control.

Though the details of QE are myriad and nuanced, the extent of its size is clear simply by looking at the growth of central banks' balance sheets: as of April 2022, the total balance sheets of Fed, ECB, Bank of Japan and Bank of China has reached the staggering size of USD 31 trillion. Trying to make sense of this amount echoes the child's admonishment to Saint Augustine that the Mystery of the Holy Trinity cannot be fathomed with the smallness of the human mind (some hagiographists believe the child was, in fact, an angel.)

The Fed appears to be committed to reducing its balance sheet by nearly USD 100bn per month starting next month and, at the same time, hiking interest rates several times this year. Other central banks signalled similar QT policies, for current inflation rates are significantly higher than most central banks' targets.

We believe that the Fed will engineer a recession in the following months by sharply rising interest rates and implementing an aggressive QT policy.

The reason is that the Fed's - and most central banks' - assessment of inflation risks proved to be wrong last year.
In the US, the Fed considered the inflation to be *transitory*; the numerous signals from the real economy, including generous fiscal policies, tight labor markets, increasing and accelerating wage inflation and supply-chain disruptions, were underestimated; even the standard monetary policy rules that prescribed to increase interest rates were ignored.
Add to these factors that inflation expectations have been rising and, second, that commodity prices surged due to the war in Ukraine. Hence, the result is a persistently high level of inflation in many countries.

The good news is that, compared to similar inflationary periods, like the 1974 and 1983 episodes in the US, central banks can now count on solid credibility and a large arsenal of policy instruments to reduce inflation.

As we wrote in February last year, the question is rather whether central banks will keep their focus on inflation and will not be *distracted* by the conflicting mandates of managing the economy, restoring full employment, keeping inflation low, safeguarding financial stability and, possibly, also fight against climate change.

Assuming the Fed is truly committed to bringing inflation close to its 2% target, a recession in the US appears inevitable.
Start with the transition to higher interest rates.

After the 0.25% rate increase in March, MIT Prof. Mankiw asked, *"Imagine going 3 years back in time and asking any Fed official what they would do if CPI inflation was 7.9% (and core CPI inflation 6.4%). Does "We will raise rates by 25bp" sound plausible?"* The answer is that the current value of the Fed rate at 0.375% is far below even the generously low level of interest rate prescribed by the Taylor rule, 3.5%, estimated by Fed Mr Bullard. Interest rates in the US will have to reach levels of at least 3.5 per cent for inflation to be brought under control.

This is an aggressive interest rates path that has been partially priced in by fixed income markets. When fully executed, it will likely result in further increasing costs for indebted governments, leveraged investors and mortgage borrowers.

Since the introduction of QE policies, no central bank has managed successfully to reverse QE, ending up exacerbating the challenges in unwinding the policy, represented by markets' and governments' QE-addiction, and partially due to the central bankers' overconfidence in QE as a tool for stabilizing markets and foster economic growth.

As central banks appear to be committed to changing their mindset by transitioning from QE to QT, investors should be prepared to change their paradigm and assumptions about central banks' support. The risk is for some of the investors to metamorphose from QE-addicted Wolfs of Wall Street to QT-intolerant Chihuahuas of Bahnhofstrasse.

Francesco Mandalà, PhD
Chief Investment Officer

Investment Office Team

Francesco Mandalà, CIO, joined MBaer Merchant Bank in February 2021. His background is in Economics and Financial Engineering, and his competencies are portfolio management, fixed income modelling, macro strategy, risk management and fund analysis. Previously, Francesco worked at UBS and Julius Baer in various roles. Earlier, he was a Statistician at the European Central Bank (ECB) in Frankfurt and an Analyst at the Committee of European Banking Supervisors (CEBS) in London. He currently collaborates with the Swiss Finance Institute (SFI) and co-leads some Master Classes together with SFI Academics. Francesco holds a Certificate in Financial Engineering & Risk Management (Columbia University), a Certificate in Investment Management with Python and Machine Learning (EDHEC Risk Institute), a PhD in Economics (Pavia University), an MSc in Economics & Econometrics (Southampton University), a BA in Economics (Bocconi University, Marks: 110/110). Francesco is fluent in Italian and English.

Patrick Quensel joined MBaer Merchant Bank in October 2021 as **Investment Advisor**. With more than 10+ years of experience, he has gained broad insights within the financial services industry, focusing on multi-asset portfolio management, risk management, systematic investing, and global macro. Previously, Patrick worked for an investment management boutique as Head Investment Advisory and Senior Portfolio Manager. Among others, he managed two award-winning investment strategies and was responsible for the cross-asset investment framework.

Patrick holds an MBA from Insead and a Bachelor and Master's in Banking & Finance from the University of Zurich. Patrick is fluent in German and English.

Thomas Büren joined MBaer Merchant Bank in July 2021 as **Investment Specialist**. Before joining MBaer Merchant Bank, Thomas developed corporate finance and financial markets skills and knowledge. He gained experience as a trainee in various countries and financial departments; investment banking (Commerzbank, London), asset management (Salm-Salm & Partners, Frankfurt), deal advisory (KPMG, Paris & Mauritius) and wealth management (BNP Paribas, Paris).

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