QE INFINITY and the Monetary End Game

A few weeks ago, I found myself in a rather interesting situation. I was sitting in a large conference room in one of the nicest skyscraper office towers in Century City. By the way, this beautiful office was an absolute ghost town—a story for another day perhaps. Around the table were some of the most powerful business leaders and civic activists in Los Angeles and then there was me. The topic of discussion? How to create a coalition of business leaders in the region to change the negative narratives around business and advance a practical, progressive and pro-economic development agenda. No small task, right?

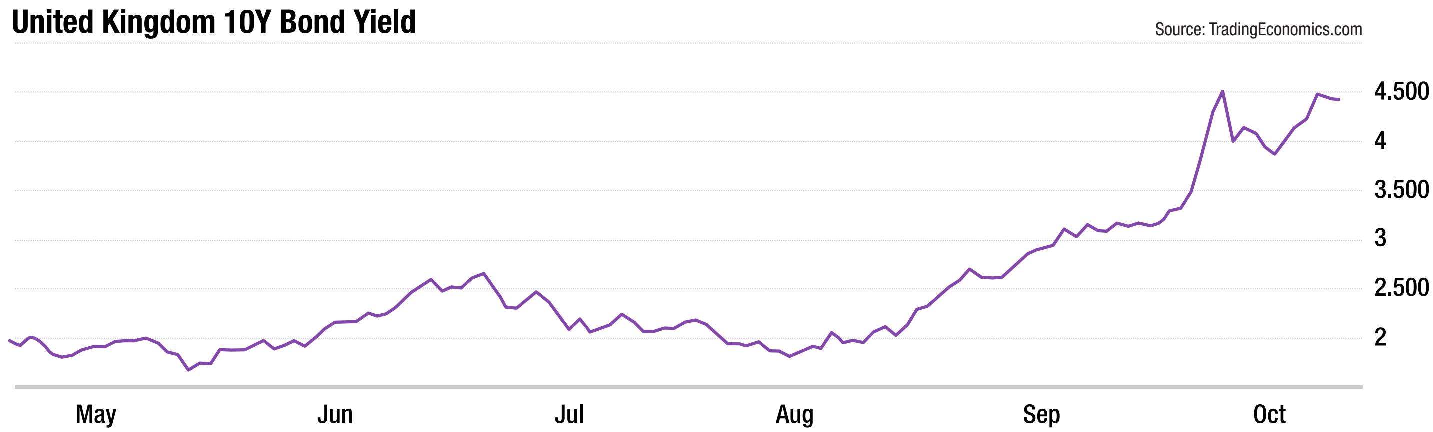
Anyway, my brilliant friend, Jonathan, a Profit reader of course and one of the most prolific McKinsey partners in the world, lead the meeting. Something he said in his opening remarks really struck me. He was trying to frame up the challenge of the Los Angeles region within the broader context of what's going-on in the rest of the world. He talked about things like the demographic cliff in the developed world, rising Asia, AI and climate change. He ended with a discussion about asset prices that I think is really important for the conversation we've been having here in these pages.

His point was very simple but compelling: high asset prices are here to stay. Why? Because governments and central banks around the world simply cannot allow them to be otherwise. Lower asset prices are essentially an existential threat to the established order. It comes down to a question of credibility. If asset markets were to crash and stay low for an extended period of time, it wouldn't be long before governments would start defaulting on all the promises they have made to citizens—e.g. pensions, social security programs, health care, anti-poverty subsidies and transfer payments…etc. And, if that happens, well, all bets are off!

I had been stewing on this idea for a few weeks when the UK's mini-currency crisis erupted. And as things evolved there, I realized that the policy response absolutely confirms Jonathan's point.

Let me explain. Like everywhere else in the world, the UK has an inflation problem, exacerbated, as we discussed last month, by a rapidly declining Pound. So, the BOE comes out, rather predictably, with a 50bp rate hike and announces some Quantitative Tapering (i.e. selling off UK bonds from the BOE Balance Sheet). Nothing surprising or crazy here. This is exactly what we've been doing here in the US. Then newly elected Prime Minister Truss comes out firing with a tax cut package aimed at stimulating the economy. Immediately, both the Pound and UK Government Bonds start falling like a knife.

2. British Pound Sterling to US Dollar Exchange Rate (I:BPSUSDER) % Change



After just a few days of this, the BOE comes out and announces that not only are they reversing course on QT, but also that they are going to engage in unlimited QE to stabilize the situation. Wait, what? Didn't the BOE want to raise rates to fight inflation? Wasn't the market was just giving an extra helping hand here by selling of the bonds?

Well, to truly understand the situation we need to introduce another player into the drama—the UK Pension system. I don't want to get into all the intricate details here but apparently the pensions had entered into a bunch of interest rate swap deals in recent years. These swaps, created by Wall Street banks, were designed to help pensions improve their actuarial picture in the face of historically low interest rates and nominal yields. These swaps work fine except in extreme situations, which is exactly what happened after Truss's tax cut announcement. The way the swaps were structured created this self-reinforcing reflexive dynamic where as UK Gilts decreased in value the pensions had to sell more and more of them to meet their contractual obligations on the swaps, which made the price go down ever more and so on and so on. Apparently, things got so bad, so quickly that the pensions were withing a few days of total collapse.

Obviously, the BOE (and the UK government) cannot let that happen! Just imagine what kind of conversation they would have to have with pensioners.

> *"I know you worked the better part of your life based upon the promise of this pension. But…um… well we're sorry to report this but we have lost all our money in the market and your pension is gone. Not temporarily but forever."*
>
> ***"Excuse me, what?"***
>
> *"Yeah, um, the money is gone. We won't be able to pay out your pension anymore. Thanks for all your years of service though."*
>
> ***"WTF! What do you mean you lost the money? Who has it?"***
>
> *"Well technically, the Wall Street banks that sold us the swaps."*

Thankfully, the BOE, armed with the magical and immense power of QE, was able to stabilize the situation and avert this rather awkward political disaster. If you are interested in a good laugh, check out this "And Its Gone" clip from a famous South Park episode that imagines a very similar situation and conversation.

Ultimately, this is no laughing matter. We're talking about real people here with real economic needs. On the bright side though, I think we have learned something extremely important from this little incident. First of all, my friend Jonathan was absolutely right. High asset prices are here to stay. The go-forward playbook is just so obvious. Central banks are going to intervene to protect markets, especially when market action threatens sensitive political promises. I think we also learned what the future is going to look like for the US. Basically, we just got a sneak peak of the monetary policy end game. What happened in the UK is exactly what's going to happen here. For now, the Fed is going to continue along in its rate hiking cycle and try to break inflation with a combination of higher rates and a slowing economy. But the minute things in asset markets get too crazy, they are going to fire up the digital printing presses and engage in QE, potentially on a massive scale. The Fed put is alive and well.

If I am right about this, we are on the verge of the era of QE infinity. Perhaps this is a good thing. Look, if the Fed is really willing to engage in QE whenever markets wobble, maybe we really can have our cake and eat it too. QE basically solves the problem of market crashes, which are all about liquidity. But what are the ultimate consequences of QE? Can we really say that QE doesn't cause inflation? Do we really believe what we're seeing today is really just a result of the pandemic and has nothing to do with the trillions of dollars created by the Fed and other central banks over the last decade? What breaks if asset prices just keep going up and up and up? These are some of the ultimate questions of our age and I suspect we're about to see some answers. Buckle Up! ▫