

# fund strategy

INVESTMENT INSIGHT FOR FUND SELECTORS

## Growing pains

Getting to the root of why central bank policy is failing - 26



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# What is the impact of central bank policy?

Our experts give their views on the consequences of central bank policies such as QE and negative interest rates, and ask: what should they do now?

## COMMITTEE CHAIRMAN



**Laura Suter**

Editor,  
Fund Strategy

Central bankers have been throwing all they can at markets in an attempt to stimulate growth, stabilise the markets and allay investor fears.

The European Central Bank has most recently expanded its quantitative easing programme by an additional €20bn to €80bn a month.

The latest move sees corporate bonds included in the bank's bond buying programme as it continues to try to boost the eurozone's economy and inflation.

However, many fear moves such as implementing negative interest rate policies are a sign that banks are running out of ammunition.

Both Japan and Europe have moved to negative interest rates. The idea is that they encourage portfolio shifts to other asset classes and will discourage savings, with savers effectively paying to hold money in bank accounts. Many would argue that holding negative cash and bonds can hardly be termed investing as it is guaranteeing losses.

So what's on the horizon? There is growing talk of 'helicopter money', where central banks try to inject money printed by circumventing the banking system and putting it directly into households and the private sector via tax cuts and public spending. Many see this as a logical step by policymakers, but it has been dubbed a desperate last resort by others.

Another option that has been floated is greater coordination of monetary policy between global central banks, but the level of coordination required would make this truly a last resort.



**James Calder**

Head of research  
City Asset Management

History will judge the success or failure of QE but those of us living through it have little choice but to accept it. I doubt QE's architects would have envisaged the results so far but they would probably not be too unhappy with them.

The results of QE so far have been largely a matter of timing. The US and UK were first out of the traps and have benefited most without having to overreach into unorthodox policy. Europe and Japan waited longer and have had to reach further for lesser results, bringing in negative interest rates.

The positive impact has been asset price inflation but we have only recently seen signs that the average person on the street is seeing any improvement (I judge this on wage inflation).

So where does this leave us? QE should still benefit the Japanese and European markets but the impact of each successive move will diminish.

In the UK, rates have been consistently pushed out but one would hope this trend reverses. I would suggest the next stimulative in the UK should be fiscal, but I believe the current chancellor is too fixated on one part of the equation.



**Jonathan Davis**

Managing director  
Jonathan Davis Wealth Mgmt

Isn't it interesting that with the greatest central bank stimuli ever, the global economy is slowing down? Multiple tranches of QE, tried in Japan and failed, are being tried again – and failing.

Buying by central banks of anything that moves is not raising prices. Meanwhile, Help To Buy in the UK is seeing the effects wearing off, rapidly. Zero interest rate policy, or indeed negative interest rate policy, are obviously deflationary as people will hoard cash rather than spend it.

How is it possible all this could result in no sustained improvement in the UK and global economy? The answer is extremely simple.

We are a global society racked with enormous debt and no amount of stimulus can unburden that. Ask the Japanese. They tried it from the 1990s until recently and they had no growth and no inflation for 20 years, as well as an 80 per cent fall in stock prices and a 65 per cent fall in house prices.

The next time we have a recession, central banks will do vastly more QE, 'for the people', and move to more negative interest rates, and they still won't help. Invest accordingly.



**Peter Lowman**

CIO  
Investment Quorum

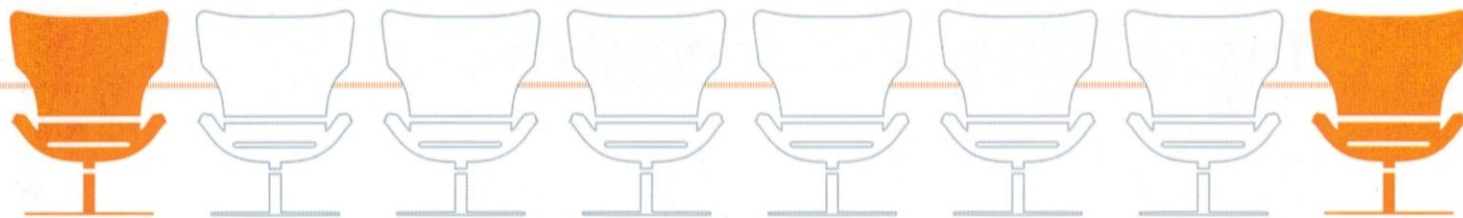
Since the collapse of Lehman Brothers and Bear Stearns in 2008, central bankers have had to act to halt a total financial meltdown.

Rising unemployment, ailing economic growth, falling inflation rates, a collapse in commodity prices, a slowing Chinese economy and the Eurozone crisis all followed, giving central banks very little choice but to act aggressively.

At first, the US and UK applied measures such as QE and cutting interest rates. Japan and the eurozone soon followed, adding further monetary tools, such as zero or negative interest rates.

These actions have stimulated the financial markets, leading to an eight-year bull market in equities. We have also seen government bond yields and interest rates fall to all-time lows and a period of 'currency wars' as loose monetary policies created a race to the bottom.

We will soon need to normalise western interest rate policy but the world still suffers from the threat of deflation, recession and lower GDP forecasts, which is likely to keep central bank policy dovish for the foreseeable future.



### Mike Deverell

Investment manager  
Equilibrium Asset Mgmt

Central bank policy continues to move markets. Despite the Fed's recent rate increase, the global trend is for lower rates, with moves into negative territory in Japan, Switzerland and Europe. In the UK, the markets are now pricing in no rise until at least 2020.

This has hit the bond market, with long-term yields falling to record low levels, which in turn has had a knock-on effect on banks.

Banks make money from borrowing over the short term and lending out for the long term at a higher rate. As long term rates come down, this margin is squeezed, hurting profits. For example, the rate on HSBC's standard unsecured person loan is 3.3 per cent a year. Three years ago it was 6.5 per cent. Base rates have remained at 0.5 per cent but the rate HSBC charges on loans has almost halved.

It is hard to see how HSBC makes a decent profit on that rate, or how it is compensated for default risk. During the credit crisis, the delinquency rate on US loans exceeded 7 per cent. Policy actions can have major unintended consequences.



### Tim Cockerill

Investment director  
Rowan Dartington

Ten years ago, central banks imagined that by now we'd all be back to interest rates of 4 to 5 per cent. But those days are gone – probably forever. The need for negative interest rates in Japan and Europe shows that central banks have failed to stimulate economic growth.

For investors, any bond paying a coupon becomes more attractive as negative rates bite – even bonds with a zero coupon. It also forces investors into other asset classes, such as equities, where the risks are probably much higher than many of those investors want to take.

Bonds and equities have become costly, but any setback in the markets has been quickly reversed as investors snatch a bit more yield and a perceived bargain. The backdrop to all this is a slowing global economy, falling profits and massive global debt. But with central banks having flooded the world with cheap money, it has to go somewhere. The result is likely to be permanently higher asset prices and more volatility.

The deeper we go into unknown economic territory, the more nervous investor sentiment becomes. They fear the black swan.



### John Husselbee

Head of multi-asset  
Liontrust Asset Management

Central bank policy remains in uncharted waters, with the sea of public debt rising daily. Since the global financial crisis, central banks have been right, left and centre stage of investor sentiment and are unlikely to make an exit soon.

Deflation remains a challenge, not helped by the oil price halving twice in 18 months. This has forced the major central banks once again to act. The world's economy is not as in sync as it was believed to be.

The US is further down the economic cycle than Europe and Japan, which are ahead of emerging market economies such as Brazil and Russia. However, the Federal Reserve has signalled a more dovish approach to future rate hikes, whereas Europe and Japan have moved to negative rates. In the short term this supports government bonds and extends the currency wars in a game of pass the parcel.

Regions where there is easing will continue to be favoured, provided this is supported by further currency devaluation. In the longer term, it remains to be seen how central banks navigate themselves without drowning in debt.

## INDEPENDENT VIEW



### Larry Hatheway

Group chief economist  
at GAM

Extraordinary monetary policies are supposed to promote growth and lift inflation via several channels. First, low or negative interest rates should promote borrowing and spending. Second, they should discourage savings and lift consumption. Third, they encourage purchase of risky assets, such as corporate debt and equities. That, in turn, should boost business spending and, via wealth effects, household expenditure.

Yet, like all things in economics, monetary policy is subject to diminishing returns. Borrowing rates have already fallen and asset prices have already appreciated. Incremental moves from here won't deliver as much growth or lift markets as much as earlier steps did.

And the benefits are small compared to the audacity of the policies. As Keynes noted, faced with uncertainty, firms won't lift investment even if the cost of capital falls. Instead, they squirrel away the savings or pass them along to shareholders via dividends and buybacks. Perversely, negative interest rates may increase the need to save for those reliant on interest income. Bank earnings also suffer, potentially stunting credit growth.

Those are a few reasons why investors have not warmed to negative interest rates in Japan and the eurozone. It is also why some economists and a few former central bankers are pondering the need for 'helicopter money'.

In short, monetary policy is no longer as effective as it was at lifting either growth or asset prices. Investors and policymakers alike would be wise to search for new courses of action.