What the Feds QE4 means for Australian investors

Developments of the past two months reinforce that we're likely to witness a classic bull rally leading into US presidential elections in November 2020.

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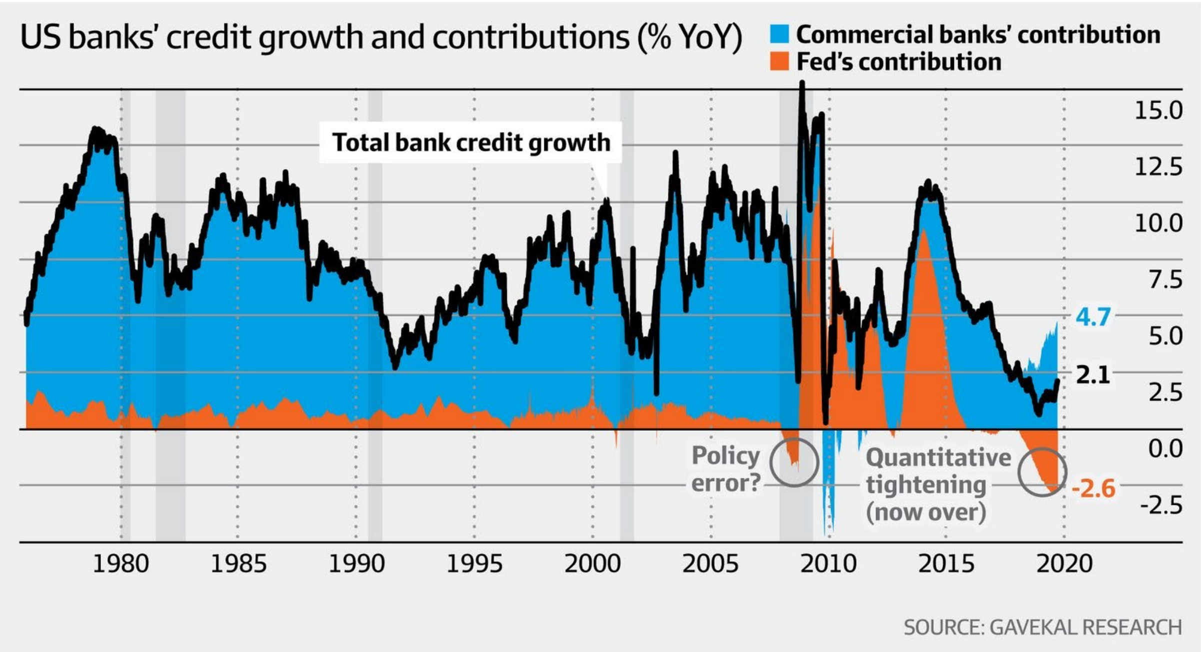
For ultra-wealthy Australian investors, there's an ever-present need to modulate the amount of accepted risk and wariness surrounding contagion.

Simplified. this is known as "risk-on" and "risk-off".

As we asserted in this column in early September, contrary to the hoopla about recession (even though recessions are an economic phenomenon and not a financial markets impulse), we're likely to witness a classic bull rally leading into the US presidential elections in November 2020.

Developments of the past two months reinforce this.



The graphic illustrates a powerful phenomenon that caused the total bank credit supply in the aggregate US monetary system to contract three weeks before the Bear Stearns crisis – triggering the Great Recession – and again in a more sizeable way this August.

Why this is material to the conversation about risk-on or off is because this large downward force was confused for another portent – the infamous inverted US yield curve.

The inference is that if such forces in 2008 tipped us into the Great Recession and an even larger magnitude hit and passed this August without spilling us into recession, then the base case for risk-off dissipates quickly.

Inversely, last week the US Federal Reserve expanded its balance sheet, so much so that it should be considered quantitative easing round four (QE4).

Unlike previous QE open market operations, the nature of these purchases and the commitments made by the Federal Reserve this time round are quite distinct.

Balance sheet expansion

This veiled form of QE has been via a balance sheet expansion, beginning with an initial $US60 billion ($87 billion) monthly purchase rate of Treasury bills, which echoes the $US75 billion adopted during QE2 (2010-2011) and the $US85 billion for QE3 (2012-2013).

The difference between this balance sheet expansion and previous open-market operations is that these purchases do not look to manipulate longer-term treasuries but instead are buying up shorter-dated securities – meaning that repricing will probably occur in the term premium component.

Such nuanced operations will not directly cut the supply of bonds. But they will crowd out the private sector and afford the Federal Reserve flexibility in terms of size and time frames, with latitude to adjust purchase amounts each month.

The motivations are obvious – to continue stimulating the US capital base and to "clean house" after February and March’s messy and corrosive emergency repo operations, which were feared to be triggers for a broader market collapse.

Global yields have bounced off their early October lows and the relatively steady hard data in the US and talk of fiscal stimulus in the European Union are additional factors supporting a drift higher in yields.

Further evidence that risk-on is in play can be seen via the steepening of the US VIX (Volatility) curve, with near-term VIX futures relaxed while early 2020 futures increased over the past month.

Traditionally the VIX futures curve steepens, with implied volatility falling across maturities. Over the past few weeks, there has been an unusual steepening, with VIX futures expiring in early 2020 rising, despite short-dated futures falling.

Put simply, while the market expects less volatility in the fourth quarter than it did a month ago, it expects more volatility in early 2020.

Risk appetite

With renewed optimism on Brexit progress and an easing of the US-Sino trade fracas, risk appetite recovered sharply in October. Cross-asset risk appetites have caused the greenback to hold relatively strongly, the flagship S&P 500 and Nasdaq bourses to drift higher and US treasuries to survive the down-forces of the August quantitative tightening.

All said, classic bull rallies require the momentum of a bull herd. Despite the cronyism and polarisation of Donald Trump, nothing has interfered with the continued velocity of the risk-on Trumponics trade, which began in November 2016.

Not only is President Trump near assured of winning November 2020, it is increasingly likely he will soon seek to repeal the 22nd Amendment to the United States Constitution, which limits the presidency to two terms.

Through an accepted risk modulation lens, the probability of capital impairment is not only seen by pulling out of active risk assets (such as equities) and moving to cash but – as was the case in 2012, 2013, 2015, 2016 and up to today – missing the potentially five to nine more years of the Trumponics bull run.

Crony capitalism and Trump's deplorable political corruption may be gutting global democratic institutions as we know them, but in the callous world of markets, bull's eye performances are found in the numbers and not the ideals.

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