Surviving the US Federal Reserve's monetary policy roller-coaster

STIRLING LARKIN THE AUSTRALIAN MARCH 21, 2015 12:00AM

The Federal Reserve's expected rate rise under chairwoman Janet Yellen will have implications for the global investor. Source: AFP

CHANGE is often difficult to predict and the consequences can be hard to see as we are often slow to shift our beliefs.

We know US monetary policy tightening is coming but it is hard to know when and even more difficult to predict the impact.

Fortunately, history often provides us with the best lessons for what to expect. The Latin expression "ides of March" may best describe our predicament, because as well as infamously coinciding with the death of Julius Caesar, it was actually a term used to express a segue between lunar years, which were perceived as new periods of change.

The transition in the US from central bank stimulus to monetary policy tightening — which will be witnessed by the expected rate rise by Federal Reserve chairwoman Janet Yellen sometime this year — is set to become a historical event that will have direct implications for the global investor.

Understandably, much focus in recent times has been placed on the words and sentiment of central bankers, who have become the circus ringmasters using their balance sheet expansions to stoke the performances of their respective economies and markets.

But with the end of such expansions in sight, at least in the US, it becomes timely to learn from the lessons gleaned from history, which in the US, were the years following 1933.

Preceding the Great Depression and the partial US recovery in 1933, the "roaring 1920s" years saw a debt-driven boom that was inextricably pegged to gold bullion, referred to as the "Gold Standard" era.

Strict adherence to the Gold Standard once the Depression hit in 1929, prevented the Fed from expanding the money supply to stimulate the economy: it also prevented it from funding insolvent banks and government deficits.

For the US, the turning point came when, in April 1933, president Franklin D. Roosevelt passed "executive order 6102", which in effect criminalised the possession of monetary gold by any individual, partnership, association or corporation, thereby ending the practical implications of the US dollar's convertibility to gold bullion. Once off the Gold Standard, the Fed became free to engage in money creation, which today is politely referred to as balance-sheet expansion. Similar to this historical experience, following the GFC, the US today has witnessed "reflation" and debt deleveraging through a combination of rising nominal incomes, default and debt repayments, which can now safely be recognised as an economic recovery.

Most interestingly, however, as the table illustrates, during both corresponding periods of money supply expansion — that is the Fed regime of chairman Marriner Eccles from 1934 onwards and the modern regimes of Alan Greenspan, Ben Bernanke and now Yellen — also saw the highest levels of US stockmarket volatility.

As Michael Cembalest, chairman of Market and Investment Strategy for JPMorgan Asset Management recently observed, the Greenspan/Bernanke strategy of using ultra-low real policy rates to manage the business cycle has triggered a wild ride for investors.

This ride has been more volatile than the inflationary era of chairmen Arthur Burns and G. William Miller in the 1970s, more volatile than the tight money eras of William McChesney Martin (50s and 60s) and Paul Volcker (80s), and more volatile than the Marriner Eccles era when the Federal Reserve was dealing with the latter half of the Depression and years leading up to World War II.

Cembalest highlights that the combined 18 per cent equity market volatility of the Greenspan/Bernanke era is roughly equal to that which prevailed before the Fed existed at all (1913), when the US was beset with frequent deep recessions and depressions. He goes on to conclude that given these realities, we should be prepared for a realistic amount of volatility before the "Central Bankenstein" era is over.

Referring to not only US central bank intervention, Cembalest's comments have immediate implications for the Australian global investor as well. In the minutes of this month's meeting the Reserve Bank of Australia flagged the key takeaways from the half-yearly Financial Stability Review, ahead of its official publication on March 25.

During a time when Australian ASX 200 equity valuations could well be considered earnings-per-share and return-on-equity stretched, the RBA noted risks that the "search for yield" trend is currently distorting pricing in financial markets and is further exacerbated by a rapid growth in credit in some Asian economies.

This is the polite way of saying that China's domestic leverage has been overdone.

As I've noted previously, the RBA has little real influence over the direction of our Australian dollar and it continues to maintain its stance that our currency remains "above most estimates for its fundamental value".

With all this knowledge in hand — reasonable expectations of more volatility ahead, distorted Australian and overseas earnings-per-share and return-on-equity stockmarket valuations and stubborn currency pairings driven by macroeconomic forces out of our control — it now becomes ever more prudent to accept that change is afoot and that the investment environment could be very shortly turned on its head.

The anomalies of the past three years which saw hedge fund managers underperform, because of "financial repression" and benchmark favourites such as index ETF-trackers prosper solely for being at the right place at the right time, may be inverted once Yellen normalises interest rates.

The global investor should nevertheless take some comfort from the knowledge that the US business cycle is still midcourse and their real economy has legitimate room to grow.

When reflecting on the "wealth effect" of central bank stimulus, it may be wise to remember the words of Caesar, who said that fortune can bring about great changes in a situation through very slight forces.

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