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Fund Manager Commentary

Normalisation

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The United States is normalising rates. Current US interest rates are now close to estimates of core inflation, indicating that the extraordinary loose monetary policy of the last ten years is at an end.

In 2008, as the banking crisis took hold, the speed at which money moved around the system almost ground to a halt, threatening a 1930s style depression. To counter the lack of 'velocity' of money flowing around the economy, governments decided to increase the 'mass' of money within the economy via Quantitative Easing. This is now being reversed in the US. Bonds purchased to introduce extra money into the economy are now coming up for redemption. Proceeds received merely go to pay off the 'overdraft' facility created back in 2008 / 2009. The US government is repaying the money it borrowed from itself.

In reversing quantitative easing the US is draining excess money from the economy. The key is to reduce the 'mass' in co-ordination with the increase in 'velocity'. Whilst the numbers themselves are huge, it should not be too difficult, as long as somebody, somewhere, is calculating the numbers properly. And I cannot imagine that they are not. Afterall, calculating the figures is a whole lot less tricky than setting up quantitative easing in the first place, regardless of actually selling the concept to markets, which was done, convincingly so.

What impact will this have? Firstly, US monetary policy is now broadly neutral. This is appropriate as the economy continues to power ahead. Fiscal policy is still, courtesy of the tax cuts late last year, loose. But that is of little consequence. As the US economy continues to power ahead, tax receipts can rise just a little faster than spending, therefore few will notice the sacrifice of tighter fiscal prudence.

What should be noted is the size of the US economy relative to the rest of the world. The US accounts for a quarter of the worlds GDP. Yet only around 10% of the economy is traded for export. Thus, the US is huge, and mostly trades with itself. To the US, the rest of the world matters little. Germany, by contrast, whilst the fourth largest economy in the world, represents less than 5% of global GDP. Furthermore, Germany trades over a third of it's' economy for export. The rest of the world matters a lot to Germany.

What does this mean for markets? People who live off savings will see a more normal deposit account rate set, rather than the artificially low rate we have seen for ten years. Those who are retiring over the next few years will see better pensions as annuity rates rise. Indeed, the Libor rate scandal which saw interest rates set rates at an artificially low rate, unlawfully, may have cost many thousands of retirees the pension they were expecting as the annuity rates linked to Libor were also artificially low. Quantitative Easing has had a similar impact to make this worse, for much longer. Although of course, entirely 'legal'.

Ultimately what is the effect on markets. Well, firstly that all others will have to normalise their interest rates in fairly short order to stay in line with the United States. The alternative of being the only one left doing QE would be to expose it as a confidence trick, and nothing more. Being naked on a nudist beach is fine, until you wake up to find that everyone else has put their clothes back on.

This means that the next to exit QE and normalise rates will be the EU and Japan. Japan has already reduced QE to a trickle already, and has thus ended it in all but name. As we are potentially at, or near, the short-term top of the US interest rate cycle then the upward pressure on the US dollar should be at, or near, the end. As the next block in the economic cycle to normalise is the EU then we should see progressively more support for the Euro as QE is seen to be ending, and interest rates seen to be rising across the EU.