



Is This the End Of Quantitative Tightening?

How an end to quantitative tightening could impact bond markets.

May 2019

KEY INSIGHTS

- The end of quantitative tightening could represent a significant regime shift for financial markets.
- Tariffs exacerbate growth fears and could add to the dovish impulse of major central banks.
- There is potential for duration to act as a good diversifier again for investors versus equity risk.

Will major central banks call time on quantitative tightening? At a time when global growth is already under close scrutiny, the threat of trade tariffs has returned. If this threat lingers, it could prompt central banks to become even more cautious this year. During our latest policy meetings, the investment team discussed these developments and their implications.

2019 has seen a number of central banks, including the Federal Reserve, hit the pause button on interest rate hikes. Others, such as in Malaysia and New Zealand, have gone as far as to unveil new stimulus measures, including cutting key lending rates. "There were signs of quantitative tightening coming to an end even before trade talks soured," said Arif Husain, portfolio manager and head of International Fixed Income. "But tariff discussions create uncertainty and will add to the dovish impulse coming out of major central banks."

Against a fragile growth backdrop, tariffs have the potential to depress momentum further, given their tendency to act as a financial tightening mechanism. To counter these potential negative effects, most developed market central banks would have to lean on the side of caution. "Current tariff tensions reinforce the view that central banks of developed market countries may have to become more accommodative," said Mr. Husain.

An end to quantitative tightening would represent a significant regime shift in financial markets. In fixed income, this could significantly enhance the potential for core government bonds to deliver positive returns and to once again serve as safe-haven assets. "The Fed's pause has reset new lows for Treasury yields so there's more room for rates to rally during times of market stress," Mr. Husain said.

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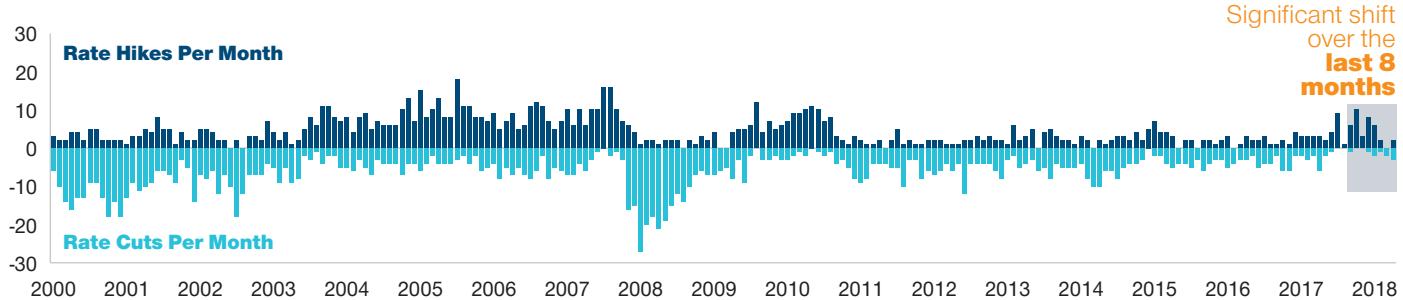


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Each month, our portfolio managers, analysts, and traders conduct an in-depth review of the full fixed income opportunity set. This article highlights a key theme discussed.

(Fig. 1) Central Banks No Longer in Tightening Mode

As of May 14, 2019



Source: BIS Central Bank Policy Rates.
Analysis by T. Rowe Price.

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Head of International Fixed Income

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Head of International Fixed Income

At a portfolio construction level, this means that owning duration may again be a good way for investors to diversify their asset allocation. "We are back in an environment where duration can help investors diversify away from equity risk," said Mr. Husain. "This is important for portfolio construction as it means that we don't have to rely so much on being defensive in credit markets to achieve diversification against equities within our fixed income strategies."

The team noted that an attractive option in the current environment may be to add duration risk in countries that were candidates for rate hikes at the beginning of the year. Sweden and South Korea stand out in this regard as central banks in both countries have now rapidly changed course. Also worth considering are central banks that were on hold but are now expected to cut. Australia is a good example here, although it is debatable whether an interest rate cut would be supportive for the local economy in the absence of an economic rebound from its key trading partner, China.

Not all central banks will abandon tightening plans, however, and selective country allocation will continue to be a key aspect of duration management.

"Countries like Norway and the UK are more likely to increase rates in the future due to local inflation pressures," said Mr. Husain.

The perception that quantitative tightening may be ending could also have a profound effect on currency markets, although it is worth noting that the U.S. dollar has been well supported so far this year despite the Fed pausing its tightening cycle. "Contrary to expectations, the Fed's pause has not led to a significant rally in foreign currencies against the U.S. dollar."

Growth, even though it has slowed, continues to favor the U.S. over most of its developed market peers. This has proved supportive so far for the U.S. dollar. "The irony is that the pause in the Fed tightening cycle has made U.S. fixed income more attractive," remarked Mr. Husain, adding that at the margin the cost of hedging U.S. assets back into foreign currencies has become less punitive as markets have priced out interest rate hikes.

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