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Global CIO Outlook
Complacency in Uncharted Waters

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When the four living Chairs of the Federal Reserve gathered in New York recently for a **roundtable discussion**, it was a mostly dry affair. There were several lighter moments, however, including one that was unintentionally illuminating. Moderator Fareed Zakaria, marveling at how the Federal Reserve balance sheet had exploded from approximately $900 billion to over $4 trillion on Ben Bernanke's watch, asked him how the Fed was planning to unwind its massive portfolio. Bernanke deadpanned, "Well, fortunately, I don't have to do it." As the audience erupted in laughter, he turned to Janet Yellen, who was sitting beside him. "He left that to me," she quipped, and more laughter ensued.

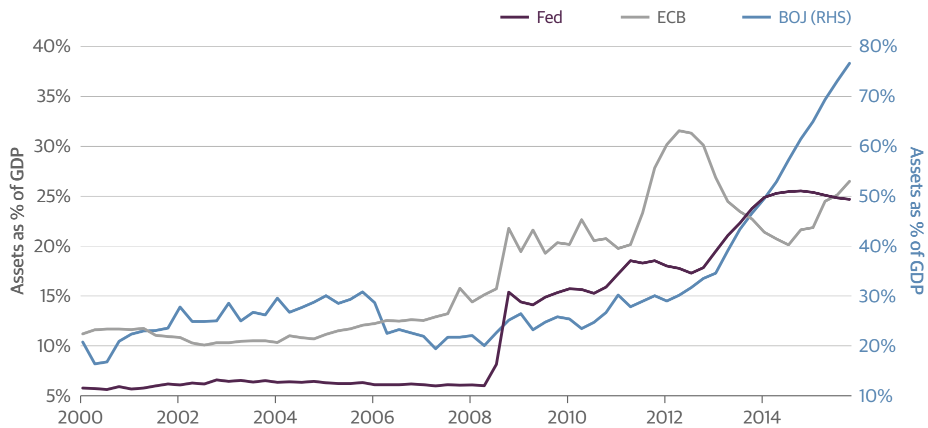
Frankly, if there is humor in this situation it is a dark kind. Central bankers of advanced economies, prompted by the financial crisis to deploy unprecedentedly aggressive monetary policy with no historical data or roadmap to guide them, are still engaged in these policies. The Fed's balance sheet in pre-crisis 2007 was just 6 percent of nominal gross domestic product (GDP); today it is 25 percent. The European Central Bank's (ECB) balance sheet has gone from 13 percent to 26 percent of euro zone GDP in that same time period. The Bank of Japan is on another monetary planet entirely, having grown its footings from 22 percent to 77 percent of GDP over that same timeframe.

While Bernanke went on to give a more or less substantive answer—let the assets run off over time, and keep paying investment "profits" to the U.S. Treasury in the meantime—the blitheness of his response reveals much about central bank hubris regarding monetary policy as the duration and scale of operations deepens.
The irony is that none other than Janet Yellen, then head of the San Francisco Fed, gave a sobering assessment of quantitative easing (QE) in a **2009 speech**. She said, "[T]here is still a lot we don't know about the magnitude and duration of the effects of these policies....Truly, we are sailing in uncharted waters, marking our maps with every bit of information along the way."

Major central banks have aggressively expanded their balance sheets over the last several years, heading deeper into unknown territory in an effort to stimulate their slow growth economies. In the years ahead this unprecedented surge in monetary stimulus will become a challenge for policymakers as they seek to return to more normal conditions and avoid unintended side effects their policies have caused.

Central Bank Balance Sheets Present Looming Challenge

Central Bank Assets, % GDP



Source: Haver Analytics, Guggenheim Investments. Data as of 4Q2015.

That wasn't a very comforting thought about QE amid the chaos of 2009, and today's macroeconomic and market environment lead me to believe that nothing has changed except central bank complacency about asset purchases. When QE was new, central bankers were alive with concerns, but judging from their recent roundtable banter they have become positively inured to the situation. I would caution them to pay attention to signs that the financial markets will be a challenge going forward.

For example, more monetary liquidity pumped into other countries or regions—Japan, Europe and China come to mind—eventually spills into the United States. I think this accounts for what we are seeing right now in the fixed-income markets—risk assets are rising in value as Treasury yields are falling. Typically, Treasurys tend to rally when risk assets are under pressure, and vice versa. But now risk-free and risk assets are moving together, which indicates to me that this is part of the rising tide of liquidity coming in from central banks around the world.

Another market area that is clearly not behaving according to the central banks' script is foreign exchange. Japan's current laundry list of woes is topped by the strengthening yen, which is a major headwind for its moribund economy. The Bank of Japan is due to convene later this month, and may decide that the best course of action is to intervene directly to drive down the value of its currency. Such direct intervention basically will entail selling yen and buying U.S. dollars, and typically those dollars go to buy U.S. Treasurys. Europe is probably not far behind: It has tepid growth, a strengthening currency, and more potential downside to their policy rates. This means there is a high likelihood of a fairly good bid on Treasurys in the coming weeks that could be sufficient to push the 10-year U.S. Treasury note lower.

My message to central bankers is the following: Although the waters at the present time might seem calm, they are still uncharted and there are risks beneath the surface. QE and negative interest rates, once thought to be extraordinary measures, have become the new monetary policy orthodoxy in the largest developed economies. The data on the long-run effects are limited, but real-time experience with these policies offers a few lessons. First, we have learned from Japan that ever larger doses of unconventional monetary policy may be required in the absence of growth-enhancing structural reforms. Moreover, it is incredibly difficult to reverse these policies from an economy that has come to depend on them. Second, in Europe we are learning that such policies offer limited benefits unless paired with a coordinated fiscal plan. Finally, we have learned here at home that trying to "normalize" policy, even in a gradual manner, can strain financial markets.

In late 2012, following the launch of QE3 and with the Fed's balance sheet totaling approximately $3 trillion, former Dallas Fed President Richard Fisher **acknowledged** that the further the Fed sails into these uncharted waters the greater the likelihood that "even the slightest deviation from this course could induce some debilitating mal de mer in the markets." He went on to confess that not one central bank "anywhere on the planet has the experience of successfully navigating a return home from the place in which we now find ourselves. No central bank—not, at least, the Federal Reserve—has ever been on this cruise before."

My own sobering assessment is that the exclusive focus on monetary policy to stabilize markets and economies is inherently destabilizing in the long run. No one knows what lies ahead in these uncharted waters, but there is likely a leviathan lurking just beneath the surface of the placid waters that monetary policy is attempting to maintain.