In the six years since Lehman Brothers collapsed, global financial markets have held to one certainty: central banks were their friends, willing to support asset prices and deploy the unlimited firepower of a monopoly printer of money.

The force of central bank actions – or often, just the hint that they might act – drove impressive rallies across markets. After reaching a post-crisis bottom in March, 2009, US share prices have surged above previous peaks, with the S&P500 rising 170 per cent. The FTSE
All-World Share Index is up 130 per cent over the same period. Bond yields, which move inversely with prices, tumbled to historic lows; across much of continental Europe investors in effect pay to lend short-term to governments.

Even amid the turmoil of the eurozone crisis and periods of global political instability, investors saw the central banks as an anchor of stability. But the expected end of the US Federal Reserve’s quantitative easing programme this month – which expanded the central bank’s balance sheet to $4.45tn – will mark the moment when that anchor is lifted.

While deterioration in the US economy could yet force the Fed to turn QE back on again, its next step is more likely to be a rise in its interest rate target, which has sat near zero for almost six years. The last time the Fed raised rates was in 2006.

The end of QE is already upsetting markets. With the global economic outlook turning distinctly gloomier – the International Monetary Fund last week warned of a new era of mediocre growth – investors are bracing for rougher times. The All-World Share Index has tumbled 9 per cent since early September. Yields on 10-year US Treasuries, which move inversely with prices, yesterday saw a sudden lurch below 2 per cent – the lowest for more than a year.

Given the uncertainty about what happens next to global economies and financial systems – the unknown unknowns as well as the known unknowns – further disruption is inevitable. “The current monetary regime is so second nature to all of us that if you change that regime you should not be surprised if the initial reaction is rather extreme,” warns George Magnus, former chief economist at UBS.

“How financial markets react will help determine the success or otherwise of an unprecedented policy offensive by central banks. Along with the Fed’s programme, the European Central Bank flooded the eurozone financial system with liquidity and their UK and Japanese counterparts launched aggressive QE policies.

The objective was to avert economic catastrophe and ensure the proper functioning of markets. A relatively smooth transition to a more normal policy framework could help global economic growth by boosting investor confidence and allowing markets to channel finance to the real economy. A bumpy ride, however, could unwind the shaky progress made so far – as well as fuel fears that QE has masked serious weaknesses in the financial system, left markets overdependent on central bank support and simply created the conditions for the next crisis.

Turning points in the interest rate cycle are rarely easy to manage. “Historically, US monetary policy tightening has always caused some fallout for the global economy – regularly and consistently,” Axel Weber, UBS chairman and former Bundesbank president, warned in Washington last week. “My advice to investors is: fasten seat belts.”

In 1994, an unexpectedly sharp tightening of US monetary policy caused havoc in bond markets. The Fed has since honed its ways of communicating with markets – and is proceeding with extreme caution this time, clearly telegraphing that the first rise in US rates is probably at least six months away. But the Fed’s challenge in navigating the world into a post-QE era is particularly complicated.

For a start, the global economy is at an awkward juncture. While the US economy is recovering, Europe may be falling back into recession, and fragilities are apparent in emerging markets. To some extent, looser monetary policies in Japan and the eurozone could act as a counterbalance to the Fed’s shift towards an eventual rate rise. However, there could still be abrupt moves in currency markets.

“There is certainly a risk of serious complications in this multi-track world of central banking,” warns Mohamed El-Erian, chief economic adviser to Allianz, the German insurer. “Judging from history, sharp and rapid currency adjustments often end up breaking something.”

Because interest rates have been so low for so long, even a small absolute increase could have a much greater impact than in the past. QE also may have changed the way markets function. The sheer size of central bank operations means they often are the market, acting as the most important lenders, or buyers of assets. By deliberately flooding the financial system, they have also disrupted the traditional way of controlling interest rates – by
rationing access to liquidity.

As it moves toward lifting rates, the Fed will have to reassert control over market borrowing costs. “Central banks have interfered with the basic plumbing,” says Manmohan Singh, market infrastructure expert at the IMF. The Fed’s usual target – the “Fed funds rate,” or the market cost of borrowing reserves – is no longer a good indicator of financial conditions, Mr Singh says. “It sounds technical but it matters – the effects will reverberate around global markets,” he says.

The Fed has had plenty of time to prepare and it is testing new ways of controlling borrowing costs. But communicating with markets will become more fraught as the first rate rises approach. Both the Fed and Bank of England have made tighter monetary policies conditional on improving economic data, which is another way of admitting many unknowns. “It will take a lot of skill on the part of the Fed and presumably also the Bank of England to communicate to markets what is on their minds – if indeed they know what is on their minds,” says Mr Magnus.

Even a relatively small inflection can cause trouble. A comment in 2013 by Ben Bernanke, then Fed chairman, hinting at plans to “taper” QE purchases led to a sudden reversal of capital inflows into emerging markets. After years of low bond yields because of QE, investors had poured into riskier economies seeking higher returns, but Mr Bernanke’s remarks changed their minds.

The disruption highlighted how interconnected capital markets had become, with retail – or non professional – investors quickly switching portfolios at the first scent of trouble.

The so-called “taper tantrum” proved relatively shortlived, and the Fed’s QE programme has been phased out with few real upsets. Many analysts argue that the footloose capital has fled, investors have learned from the experience and that emerging market equity and bond prices should better reflect the “fundamentals” of local economies.

“It is growth differentials that ultimately drive capital from one place to another,” says Gerardo Rodriguez, portfolio manager at BlackRock and a former Mexican finance official.

A deliberate objective of QE was to encourage risk taking as a way of boosting economic growth. “Quantitative easing has driven up strikingly the price of risk assets, but the Fed would not see that as a distortion, it is exactly what it wanted,” says Harm Bandholz, chief US economist at UniCredit.

In June, however, the Bank for International Settlements in Basel – which acts as a bank for central banks – warned that “euphoric” markets had become detached from economic reality. “The issue is less QE per se and more the extent to which central banks, acting without the support of other policy makers, have opted for liquidity-induced growth at the risk of future financial instability,” adds Mr El-Erian.

Less clear is the extent to which QE has changed investors’ behaviour. A striking feature this year, until recent weeks, has been the lack of financial market volatility at times of heightened geopolitical tensions – whether over Russia’s incursions into Ukraine, chaos in Iraq or pro-democracy demonstrations in Hong Kong. One explanation is that markets had been mesmerised into believing central banks will always ride to their rescue.

Investors have become used to a world of unlimited liquidity, warns Mr Magnus. “Change that and you change the whole psychology of investing.” Adds Mr Skeoch: “The structural impact [of QE] on economies and markets is not understood well at all. The band of uncertainty is wide.”

Still, there is widespread agreement that market volatility is likely to rise as higher US interest rates edge closer. In the past, crises often followed periods in which interest rates were low relative to economic growth rates – in the US just before the dotcom crash at the turn of the century, for instance, or in Germany in the early 1990s before the continent’s exchange rate crisis.

“It is natural to feel worried given that history shows that when interest rates go ‘too low’ bad things happen,” says Benjamin Mandel, US economist at Citigroup in New York.

The uncertainty over how markets will cope with the unwinding of crisis-fighting monetary policies is all the greater because they coincide with upheaval in regulations affecting the global financial system. The aim was to strengthen the system’s resilience – but rule changes may have unintended consequences.
To make banks safer, for instance, bond dealers now hold relatively little “inventory” – stockpiles of bonds held to meet orders quickly, especially corporate bonds. As a result, markets “now have the same problem as Lehman”, argues Alberto Gallo, strategist at RBS. If confidence in the market disappears, a “liquidity crunch” could hit. “Bond dealers cannot offer liquidity and they are carrying less risk,” says Mr Gallo.

When tensions increase, desperate sellers may be able to do so only by slashing prices – turning a small event into something much bigger. “Low interest rates have fuelled issuance [of bonds], which is hiding all sorts of stuff in markets and this is what we are worried about,” says Richard Prager, head of trading and liquidity strategies at BlackRock, the asset manager. “What happens when rates rise and investors need to sell bonds? Without the shock absorbers you have the potential for a disorderly repricing.”

That sense of nervousness has been apparent in the markets. The Vix index of US stock market volatility – known as the Wall Street “fear gauge” – has hit levels not seen since the eurozone crisis. Markets now listen more warily to comments from Fed and other central bank officials, hoping that there will be delays in tightening monetary policy. Any hints at further loosening elsewhere are seen as positive by at least some investors – even if they follow poor economic news. A suggestion by a Fed official this week that another round of QE was still possible in the US stabilised stock markets briefly.

A new certainty may be dawning on markets: volatility is back and their relationship with central banks is changing, with unpredictable consequences.

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