



By Terry E. Nager, CFP®, CLU®, ChFC®

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## Are the Markets Being Controlled by the World's Central Banks?

The brief answer is “YES.” However, as with most complex situations, there are other aspects to consider. To begin: a central bank is a national bank that implements government’s monetary policy and issues currency. Some are independent, as in this country. Others act as an arm of the government like China. There is no question that the economic power of the Federal Reserve Board of the United States (FED), the European Central Bank (ECB), the Bank of Japan (BOJ) and the People’s Bank of China (PBOC) is almost unlimited. This fact gives rise to the question: Can the central banks make the markets rise on a permanent basis without large volatility? The answer is: they would if they could, but realistically even their collective power has limitations.

Let’s begin by doing a review of recent, mostly successful interventions (that is what they call it when the central banks get involved). First we will look at the FED and its actions after the market crash in 2008. In November of 2008, about 3 months after the Lehman Brothers collapse, the FED under Chairman Ben Bernanke initiated the Quantitative Easing plan. **QE 1**, as it was called, began in Nov. 2008 and lasted for 17 months. It involved the FED buying \$100 billion per month of mortgage backed securities there-

by injecting \$100 billion per month totaling \$1.7 trillion. The stock market in terms of the S&P 500 had a strong increase during **QE 1** (see graph).

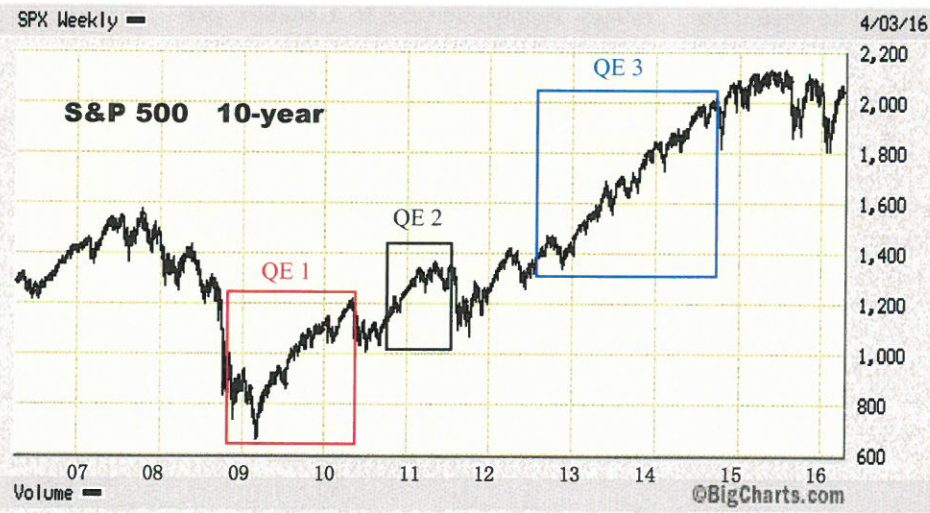
**QE 1** ended on March 31, 2010 and the market’s progress halted. The FED realized that more was needed and kicked off **QE 2** on Nov. 3, 2010. This stimulus package was much smaller than the first one, it was \$600 billion and only lasted until June 30, 2011. The FED purchased only US Treasuries (no mortgages) and the market had a

moderate increase during **QE 2** (see graph).

After **QE 2** ended, the FED waited over a year before beginning **QE 3** which was composed of buying \$40 billion of mortgage securities per month in addition to \$45 billion of US Treasuries and this program was said to go on indefinitely, in other words, with no ending date. However, the FED chief, Bernanke decided that injecting \$85 billion per month had to come to an end and the economy as well as the markets could stand on their own. October 29, 2014 brought **QE 3** to a close with a strong market increase for a slightly more than two year

period (see graph). The FED used three QE programs to inject about \$3.5 trillion into the US economic system and markets, and yes it can be labeled a success but at what cost? In terms of the economy; the price was very high for a lukewarm recovery from a deep recession. In terms of the stock market; the returns were favorable. Looking forward, there are two important points to consider and evaluate in the ongoing judgement of the merits of the QE programs: first all of that newly created money must go somewhere – such as, into the stock market – second, the economic activity must pick up in order for the corporate earnings to support the increasing stock prices.

The European Central Bank (ECB) has a brief history with QE but they are becoming an aggressive player in this game. The ECB, under Mario Draghi, began their QE program in March of 2015 at 60 billion euros per month and in March of 2016 expanded that to 80 billion euros per month – that equals about \$87 billion per month. Draghi and the other European central bankers are very concerned with the sluggish economy in Europe and have fears of deflation. Therefore, they have taken other aggressive actions to stimulate economic activity like more bond refinancing programs and interest rates that are not just low, they are actually negative.





Although it is probably too early to pass judgement, the ECB QE program has not been successful in terms of the major European stock markets. However, Draghi seems resolute and will continue with QE and other programs to turn the European economy around (*Graphs 1 and 2*).

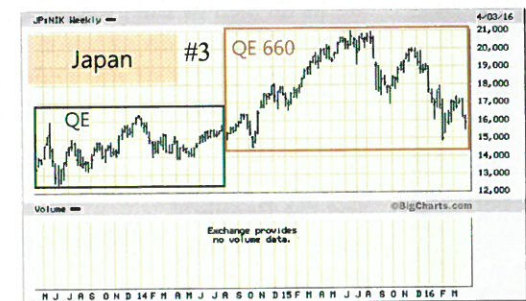
Japan first introduced QE in 2001. Between 2001 and 2004 the Bank of Japan (BOJ) created 35 trillion Yen (a few hundred billion dollars). In 2006 QE was reversed and then restarted in October of 2010. Beginning April 2013 a more aggressive intervention was begun expecting to end in 2014. The primary purpose of QE in Japan is not the stock market, it is to generate inflation because the Japanese have experienced deflation which has slowed their economy. In 2014, instead of ending QE, the BOJ upped the QE to \$660 billion annually. Presently, the leadership in Japan is frustrated because the Yen has been appreciating in value which not only holds down inflation but also makes their goods harder to export because they are more expensive. There is an increasing likelihood that the BOJ will do even more to stimulate the economy and try to generate more inflation (*Graph 3*).

China's People's Bank of China (PBOC) does not use QE as the other central banks do, instead they use a combination of lowering interest rates, asset purchases by the government and currency devaluations. China's economy has been experiencing a slowdown and the leadership will do whatever it takes to get growth back on track. China has likely spent over one trillion dollars of its re-

serves fighting the downturn which has halted the decline but has not repaired the damage (*Graph 4*).

The conclusion that can be drawn from reviewing all of the interventions of the central banks is that the impact of their actions has had a wide variance in results. The FED has had the most success but one has to consider that the FED has the most economic power and utilized it at time of the most extreme need. The ECB and the PBOC are just beginning the implementation of large scale monetary intervention so the jury is still out in regard to how much success that they will have. The BOJ has had the longest experience with QE and while they have had success in the past, recently they are not having the desired outcome. This means that they are probably going to increase the size of their efforts to see if that will work.

The answer to the question about the markets being controlled by the world's central banks is still yes, but the effectiveness of large-scale money creation diminishes with usage. Each additional unit of money supply increase is a smaller percentage of the entire amount than the previous increase, therefore, more and more is needed to try to get the effect of the last increase. Ultimately, if too much money is created, the money begins to lose value (inflation) and if massive amounts are created then people lose confidence in the currency and the whole system falls. So, there are limits and the old-fashioned method of growth and earnings is still the best and safest way to solve economic problems.



## Outlook

**Looking Back:** The first quarter of 2016 has been a difficult one. There were two factors that caused performance to suffer. First, when the market corrected for the second time within a six month period and then broke through the previous low, we became defensive and it looked like the market would fall further. However, in accord with the subject of this newsletter, input from the central banks altered the landscape: the FED indicated that they were going to slow down on their expected rate increases and Draghi of the ECB upped the QE from 60 billion Euros per month to 80 billion. Clearly, the bankers had changed the playing field and fundamentals were forced to take a secondary role.

The second and bigger impact item was the fact that some of the key mutual funds in our portfolios underperformed because of their emphasis on technology and healthcare. The three Primecap mutual funds are examples. Virtually every one of our client portfolios has one or more of these three funds. Each has an excellent long-term track record. Morningstar has awarded the Primecap

management team its Domestic-Stock Fund Manager of the Year (all three Primecap funds have the same management team). However, the last six months have not been favorable but we do feel that these funds and our other funds that invest in either or both of these out-of-favor sectors will return to their normal performance levels in the coming months and years.

**Looking Forward:** The balance of 2016 is likely to produce some volatility because of the uncertainty in the political world in both parties. The economy is still slowly moving forward and there are enough uncertainties to limit the interest rate increases by the FED and the other central banks are going to continue to add stimulus. Therefore, the market should make moderate progress until the political direction becomes clear which could move the market in one direction or the other. Also, any unforeseen geopolitical event could always change the interim direction of the market.