US balance sheet normalization unlikely to undermine global liquidity

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The US Federal Reserve has already started raising interest rates from financial crisis-era lows. Now, it is preparing to embark on what could be the more perilous part – unloading the US$4.5 trillion of bonds it holds on its balance sheet. Paul Chan, Head of Multi-Asset & Hong Kong Pensions at Invesco, explains how pension investors should position themselves in light of the shrinking Fed balance sheet, and why he prefers US equities to European equities.

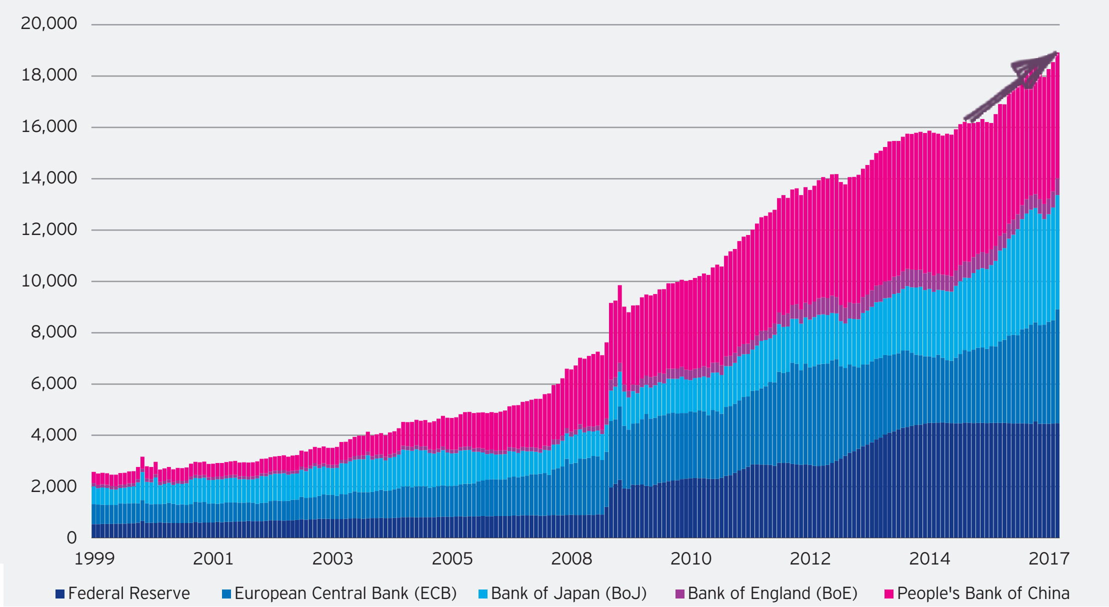
Q: Why are investors concerned about the unwinding of the US balance sheet?

The overall recovery in the US is on track, with the unemployment rate coming in at 4.3% in May 2017, the lowest since May 2001. In response to this, the Federal Reserve (Fed) concluded that the economy no longer needs help and therefore has scheduled three increases in interest rates in 2017. In addition, the Fed is actively considering a profound change in US monetary policy – shrinking its portfolio of Treasuries and mortgage-backed securities. Many investors are concerned that the shrinkage of the balance sheet may impair global liquidity. But I don't think so.

The Fed's balance sheet in total now runs US$4.5 trillion, of which US$3.7 trillion came from buying Treasuries and mortgage-backed securities in response to the financial crisis in 2007. This quantitative easing was aimed at injecting money into the economy and encouraging global bank lending to revitalize the anemic economic growth. The Fed stopped buying large quantities of assets in October 2014. Since then, it has kept the size of its balance sheet constant, buying just enough to replace maturity securities.

I believe that the shrinkage is unlikely to have significant impact on global markets. This is because global liquidity is still well supported by other G5 central banks – a total of more than US$ 18 trillion, of which the US represents about 23% (Figure 1). The US balance sheet shrinkage itself will not undermine global liquidity, as other central banks are unlikely to retreat from their aggressive accommodative policies together.

Figure 1: Global liquidity is well supported by assets of other central banks (US$ billion)

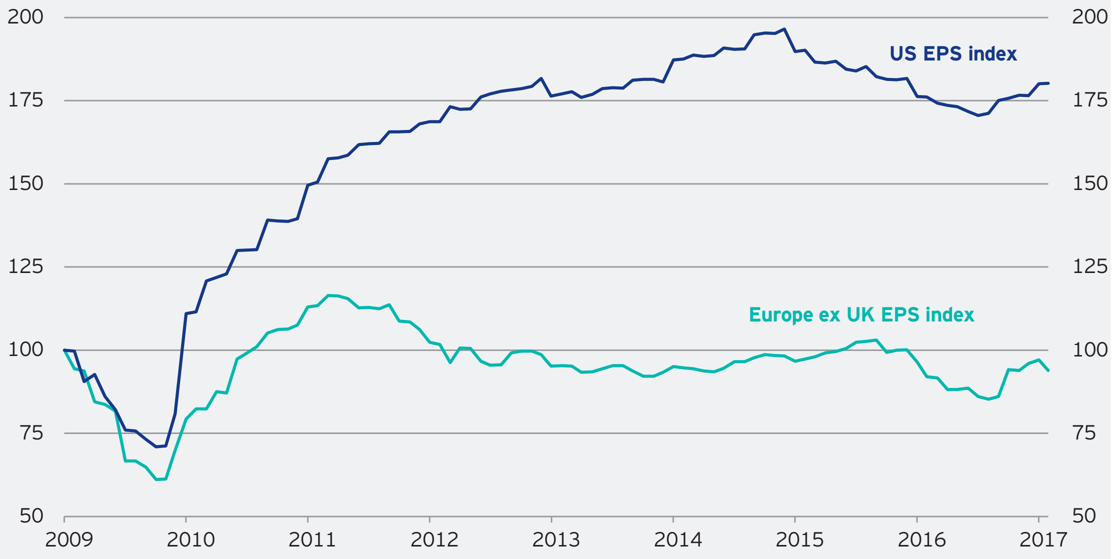


Source: Macquarie Research, Bloomberg, as at 22 May 2017

Q: Under current conditions, what should pension investors be looking for?

Despite the fact the Fed is proposing to shrink its balance sheet, overall interest rates remain low, and investors struggle to find any returns from government bonds. Equities remain the choice for pension investors seeking growth. We continue to favor US equities due to their large exposure to the world's leading technology companies – companies that we believe are shaping the world. These companies, representing about 20% of the US equity market, will not only benefit from the US domestic recovery, but also global demand for their innovative products and services. Their earnings growth, much more sustainable than Europe (Figure 2), remains the key driver for the equity market.

Figure 2: US equity earnings have outperformed European equities (EPS index March 2009=100)



Source: State Street Global Markets, Thomson Datastream, data as at 22 May 2017

Q: What do you make of European equities, which have much stronger returns this year?

Europe has been doing well this year, up 15.8% (MSCI Europe-EUR) over the past 12 months, driven mainly by cyclicals such as financials, industrials, energy, and materials. Unlike the US, Europe is dominated by "cyclical stocks", which are closely geared to economic conditions, and commodity prices. The strong earnings growth of European cyclicals is largely the result of stronger commodity prices in 2016, which may not be sustainable heading into the second half of the year as commodities have retreated recently. The outlook for Europe remains unclear given the series of political elections – which may lead to market swings that pension investors don't want to see. The French election gives some indication on the German election scheduled for later in the year but it will still need to be closely monitored. Structural headwinds surrounding Brexit, as well as high levels of excess leverage and negative geopolitical developments, are also likely to constrain growth in the region.

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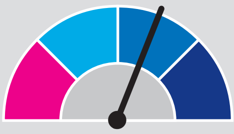
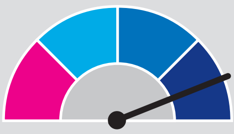
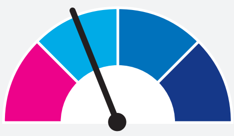
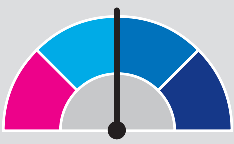
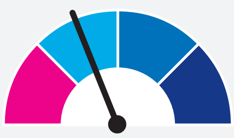
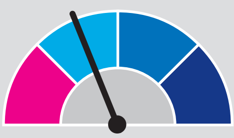
Strategic asset allocation

Asset Class	Positive	Negative
Equity **Moderately favorable** 	■ Dovish developed markets central banks ■ Steady economic expansion in the US ■ Rebound in energy and materials prices	■ Low growth, low return with moderate experienced volatility ■ Valuations at long term historical averages ■ Downward earnings growth
Bond **Less favorable** 	■ Accommodative central banks policies ■ Low inflation risk	■ Valuation at multi-decade high ■ Record lows in rates and yields ■ Cyclical recovery expectation will raise bond yield
US Equity **Favorable** 	■ Private sector balance sheets continue to strengthen ■ Corporate profits benefit from globalization ■ Economic growth momentum strengthened	■ Valuation above long term average ■ Below trend growth and inflation
Europe Equity **Less favorable** 	■ Current account continued to improve ■ ECB started QE purchases of government bonds ■ Cyclical recovery in earnings	■ Brexit uncertainty ■ Rising non-performing loans (NPLs) for the Italian banking sector ■ Jobless rates stayed elevated
Japan **Neutral** 	■ Bank of Japan mulls more easing ■ Healthy corporate balance sheets ■ Valuation at below long-term averages	■ Downgrade in earnings amid strong Yen ■ Stubborn deflation ■ Tight labor market dampens productivity growth
Asia Pacific ex J, H, C* **Less favorable** 	■ Fundamentals appear to stabilize after two years of deterioration	■ Gradual slowdown in growth ■ Exports growth remain anemic ■ Central bank have limited reason to ease monetary policy ■ Valuation rose above long term averages
China & Hong Kong **Less favorable** 	■ Valuations below long-term average ■ Economic growth in Mainland China has stabilized	■ Banks are expected to see rising non-performing loans ■ High levels of corporate debts ■ Weak domestic demand in Hong Kong

Source: Invesco, as at 12 June 2017. The strategic allocation is on a relative basis (From the perspective of Hong Kong pension investing). Opinions and forecasts are based on current market conditions and subject to change without notice. * J = Japan, H = Hong Kong, C = China (Mainland China)

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