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How QE distorts prices

One of the main differences between free market and communist economies is the role of prices. In free market economies, prices play a central role as they aggregate valuable information over demand and supply in a single figure that guides economic agents – producers and consumers – to make their choices. In communist economies, on the other hand, prices do not incorporate any information, since what is produced and consumed is defined in a plan decided by a central authority.

A prime example of free market economies are financial markets, a virtual place where millions of sellers and buyers continuously exchange standardised products. In these markets, and more than in any other markets, prices play a key role. This is the very reason why trade takes place.

A *Quantitative Easing* (QE) programme, as decided by a central bank, is a plan that consists of buying large quantities of assets[1] whatever the price is. As a consequence, prices lose their precious information content that normally enables investors to switch meaningfully between different asset classes. One example for this is the current development of government bond yields. It makes no sense that long-dated German government bonds have a negative yield, nor does the fact that Italian yields are lower than their US counterparts. Even more shocking is that the Bank of England wasn't able to buy enough gilts during the first days of its new QE, even though the price offered to pay was high and above market prices. Furthermore, it is common knowledge that gilts are overvalued.

QE programmes are designed differently across central banks, including to various degrees sovereign bonds, corporate bonds, asset-backed securities and equities. They all have in common to purchase mainly sovereign bonds. The yields of these government bonds play a central role in asset allocation as they are seen as *risk free* rates and thus set the basis for the pricing of all assets. Consequently, the distortion in this specific market segment, reinforced by negative interest rate policies of central banks, has a cascading effect on other assets, thus leading to mispricing of all financial assets. According to the Financial Times[2], the market value of negative-yielding bonds amounts to USD 13.4tn, a mind-boggling figure that shows the extent of the price distortion in this key market segment. In addition to central bank purchases of other above-mentioned assets which directly distort prices of risky assets, liquidity and risk premiums are further altered by investors' *thirst for yields*, forcing them to take more risk for a given return.

No matter how strongly distorted each individual market price is, asset prices remain *consistently* priced vis-à-vis each other. For example, the yields of US treasuries and German bunds – two assets that share very similar risk characteristics in the investors' eyes – become similar once the currency hedging costs are taken into account; and this despite different economic conditions and different central bank behaviours. Equity markets have all gone up significantly, even to new highs in the US, as the *thirst for yields* has obliged investors to buy equities despite an overall general pessimism and meagre growth prospects. The same is true for corporate bonds. Finally, the VIX Index[3], nicknamed *the fear index*, is close to its lowest level, as if the world economy would be looking forward to a blue sky outlook.

While mispricing can be observed in all asset prices, financial markets behave consistently, in sync, according to their own logic. We are asking ourselves how long this situation will last and how far it can go. The situation will last as long as central banks' credibility remains intact, or in other words, as long as they are willing and able to act convincingly in the eyes of market participants. And it can go as far as the most powerful and thus most credible central bank will be able to set prices at ridiculous levels. If this proves to be

[1] For instance, the monthly purchases of the European Central Bank amount to EUR 80bn and the yearly purchases of the Bank of Japan amount to JPY 80tn.

[2] http://www.ft.com/cms/s/0/973b6060-60ce-11e6-ae3f-77baadeb1c93.html#axzz4HZXmWYWF

[3] "VIX is a trademarked ticker symbol for the CBOE Volatility Index, a popular measure of the implied volatility of S&P 500 index options; the VIX is calculated by the Chicago Board Options Exchange (CBOE). […]the VIX represents one measure of the market's expectation of stock market volatility over the next 30-day period." Source: https://en.wikipedia.org/wiki/VIX.

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true, risk-free yields are set to converge to the lowest level and risky asset prices to increase virtually independently from economic fundamentals. Like in communist economies, the outcome is ultimately equality, not fairness.

Three potential symptoms could indicate that this situation is in its terminal phase. First, the credibility of central banks and governments is directly challenged, resulting in rising and diverging government bond yields as risk is repriced. Second, the currency market absorbs a part of the mispricing by rebalancing economies and markets via sizeable exchange rate adjustments. Third, the loss of credibility is directly reflected in the domestic loss of purchasing power, in other words inflation. This type of inflation, however, is not due to the usual *too much money chasing too few goods*, but to a lack of confidence in the government. This can potentially lead to hyperinflation, as extreme events such as Germany in the 1920s, Hungary in 1946, Zimbabwe in the late 2000s and Venezuela today remind us.

While we do not see any of these symptoms flourishing, a way to protect against this eventuality would be to invest in gold, an asset which is not under the direct control of institutions and an alternative to cash whose costs have increased dramatically with the introduction of negative rates.

In this context, the case of Japan is interesting in many respects and is a source of hope in the view of our analysis. For more than two decades, Japan has experienced a *zero economy*. This is an economy where growth, inflation and yields have been low. According to the IMF, government debt to GDP has been multiplied by 5 since 1980 to about 250% nowadays and is unsustainable. In addition, Japan has experienced various government and central bank policies with essentially no effect: yields have not repriced and growth and inflation have not come back. The Japanese yen has moved in the opposite direction to the Bank of Japan's intention, indicating that investors are challenging the credibility of the Nippon central bank, but without triggering a full-fledged credibility crisis. *Japanisation* of financial markets and Western economies could thus be a benign outlook.

The wide use of unusual monetary policies in the Western world, in particular QE, has distorted massively all asset prices. While assets are mispriced, it remains true that they are consistently priced vis-à-vis each other. As long as central banks remain credible, this situation could last longer. Currently, no terminal phase symptoms are observed, which means that the convergence in prices should continue. Gold is a good hedge against an abrupt end of this system, unless we all become Japanese.

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[4] Literally "if that's the way it is" (https://en.wiktionary.org/wiki/%E3%81%95%E3%82%88%E3%81%86%E3%81%AA%E3%82%89#Japanese)