FROM QUANTITATIVE EASING TO QUANTITATIVE TIGHTENING

Ask the PORTFOLIO MANAGER

Why has equity market behavior changed in 2018?

Transcript of a video recorded on May 30, 2018.

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I think there are two basic reasons. Both are the recognition of trend reversal.

Back in 2016, in the summer of 2016, we believed that the bond market was experiencing the March of 2000 for bonds. What I mean by that is that the March of 2000 was the great peak in technology shares, 15 years ago. The mistake that investors made at the time was they grossly misjudged the growth outlook.

Bond investors in the summer of 2016 had grossly mispriced the long-term growth outlook for the major economies. Since then, there's been a gradual but sure recognition that the deflation risks have been ebbing.

In the first quarter of this year, the confidence of investors that the deflation risks were not on the horizon was the key change. Again, it goes back to this point that we have probably seen the peak of the bull market in bonds for the rest of our professional careers.

That bull market began in 1980, and it concluded in 2016. The other key shift of sentiment relates to Fed policy. Although the Fed has articulated its desire to normalize, many investors didn't believe them.

When we combine the first point that I made vis-à-vis growth expectations, investors have finally embraced the idea that the U.S. Fed is going to normalize interest rate policy.

The good news is that it will happen very slowly. The inflection from quantitative easing to quantitative tightening will probably be a process that lasts right through 2020 or 2021. Our reference point for this is the quantitative tightening that took place after the Second World War, from 1946 to 1951. That was also a very extended affair.

In this particular case, I think it will be an extended inflection because Europe and Japan are just well behind the United States by at least four or five years.

The inflection obviously portends higher interest rates, but it will be slow, and that's why we say that the rest of this bull cycle will be a race between robust corporate fundamentals on the one hand, and higher interest rates on the other. Those two points, the end of the growth mistake and the return to normality of U.S. monetary policy, are what changed equity behavior in 2018.

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Video recorded 5/30/18.

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