QE and ZIRP have introduced massive distortions?

Tim Farrelly | farrelly's | 05 July 2016

Quantitative Easing (QE) hasn't been inflationary, but it has caused massive investment distortions. Ditto the zero or negative interest rate policies (ZIRP and NIRP) of many central banks. Beware! The chickens are coming home to roost.

This is another claim that seems plausible. Huge sums have been invested in emerging market equity and debt, and high-yield debt in general. But, have the flows really been caused by QE, ZIRP and NIRP? (You have to love these new acronyms!)

How can we tell? One way is to look at prices. If these flows have indeed been distortions caused by the flood of cheap money coming out of the US, Europe and Japan, then it is reasonable to assume that prices will have gone up - considerably. And, if the distortions are massive, then prices should have increased - massively.

Now, what do we find? You guessed it, the opposite.

You would think that if low rates and QE had caused a massive flood of indiscriminate money to chase yields, we would see a massive fall in the spreads on corporate debt over the past five years. In fact, the average spreads on BBB-rated debt have risen from around 1.8% pre-GFC to around 2.1% (as at early June) and have averaged around that since 2011. High Yield spreads have risen from 5.1% to 6.1%. It's hardly evidence of a flood of indiscriminate investing.

What about the flood of money chasing corporate debt in Emerging Markets, where government bond rates are higher so the total coupon (government bond rate plus the spread) is higher? Surely that would result in a narrowing of spreads vis-a-vis similar quality corporate debt in Developed Markets? Again, the opposite has occurred. EM debt used to attract the same spread as DM debt of a similar credit quality. Now, the spreads are higher for EM, not lower.

Emerging market equities? Surely a flood of money would have resulted in soaring Price Earnings ratios? Again, there's zero evidence of distortion. PEs are around 14 now and have been closer to 10 for much of the past five years.

So, what has caused the flood of capital to EM and High Yield securities? Perhaps, a better explanation is that growing EM economies have had a strong demand for capital in order to fund their growth and have had to pay up to get that capital. This is just business as usual. There may well have been over-investment or misallocation of capital along the way and, if as a result, a lot of this investment doesn't work out, blame over-enthusiastic managers - not QE, ZIRP or NIRP.

QE, ZIRP and NIRP are causing massive investment distortions?

It's nuts and you can clearly see it's nuts.

Tim Farrelly is principal of specialist asset allocation research house, farelly's Investment Strategy, available exclusively through PortfolioConstruction Forum. Tim is a member of PortfolioConstruction Forum's core faculty of leading investment professionals.
