

The benefits and problems with QE

Published on: 24 June, 2022 | Author: Investment Team

Much like the recent heatwave, Inflation has once again dominated the headlines as the latest inflation print in the UK breaks through recent records. Consequently, many pundits debate causes and offer solutions to central bank policy makers within developed economies.

We feel it is important to remind readers of the origins of the inflationary surge and provide some perspective for UK investors.

There is no doubt that Brexit, the post pandemic return to higher demand, and the Russo-Ukrainian War are all contributing factors; however, we believe that the causes run deeper and date back to the GFC and the programme of Quantitative Easing (or QE).

QE affects an economy in a similar way to cuts in the interest rate. It lowers rates on savings and loans whilst stimulating both consumer and commercial spending.

Here's how QE works:

1. Central banks buy government bonds or corporate bonds from other financial companies and pension funds.
2. When they do this, the prices of these bonds tend to increase which means that the bond yield, or 'interest rate' that holders of these bonds get, goes down.
3. The lower interest rate on government and corporate bonds then feeds through to lower interest rates on loans for households and businesses, which boosts spending in the economy.
4. QE also affects the prices and valuations of other assets like shares and property.

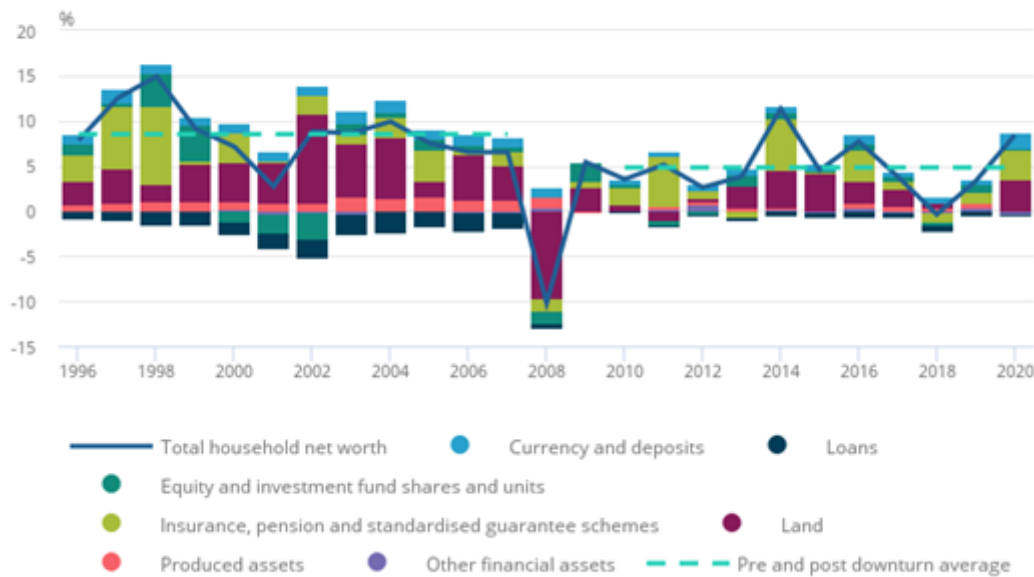
In simple practical terms, the Bank of England buys £1 million of UK government bonds from a pension fund. In place of those bonds, the pension fund now has £1 million in cash. Rather than hold on to that cash, it will invest it in other financial assets, such as shares, that give it a higher return. In turn, that tends to push up the value of shares, making households and businesses holding those shares wealthier, which in turn makes them likely to spend more, boosting economic activity.

This process has been a staple of developed market monetary policy since 2008. When you next consider the measures that were put in place to avoid a long and protracted recession induced by the Covid Pandemic this exacerbated a further transfer of wealth from the government's balance sheet to household and corporate balance sheets.

Inflation is driven by an excess of demand versus supply in a conventional economic cycle; however, we believe QE has complicated the picture when we compare this inflationary period with that of the 1970s and late 1940s. In both of these previous cycles, household wealth was not as widely spread through home ownership and other assets such as pensions and investments. As the explanation above highlights, QE was designed to increase asset prices and, in the UK, has added significant wealth to those individuals and families that owned property and other investments.

Figure 3: Land and pension schemes were the largest contributors to growth in households' net worth in 2020

Contributions to growth in UK households' net worth, current prices, 1996 to 2020



Source: Office for National Statistics – National balance sheet

This increase in the balance sheet of UK households has dramatically altered the spending power of many over the past 15 years and must be considered as part of the supply/demand equation that we highlighted earlier. The war in Ukraine has brought this issue to a head this year as it has affected the supply side of the equation, whilst the demand element has remained robust for many in the economy due to QE and government support schemes through Covid.

We highlight this as it is not only an individual's wages that needs to be considered when the press talks about a cost of living crisis, or the trades unions request higher pay settlements, it is their overall balance sheet which has been supplemented by the government for over a decade. The coming years will likely result in some of this wealth being redistributed and used to meet the higher costs of goods and services. Unless people are willing to accept a lower standard of living.

We are now in the eye of a cost-of-living storm which is fuelled mainly by very high and rising energy costs and by rising food costs. When press commentators talk of a cost-of-living crisis and the trades unions demand higher wage settlements, they focus only on household income and ignore the wealth on many households' balance sheets which has itself been inflated over the past decade by central bank policy and, more recently, by government policy. Our expectation is that the next cycle for investors is likely to see some of that accelerated growth in asset values given back as investment returns adjust to a higher cost of capital and as households strive to maintain their standards of living.

Important Information: Any views, insights, or commentary are for general information only, do not constitute personal investment advice or research, and are intended for UK residents. They may not be appropriate in all jurisdictions. While sourced from information we believe to be reliable, we make no guarantee as to accuracy or completeness. Past performance is not a guide to future results, and the value of investments can go down as well as up.

Regulatory Disclaimer: Tacit Investment Management is the trading name of TIML Limited (No. 9228395), part of Tacit Holdings Limited (No. 10611211). Both companies are incorporated in England and Wales, with the registered office at 14 Hanover Square, London W1S 1HN. TIML Limited is authorised and regulated by the Financial Conduct Authority (FCA ref. 670184) and approves and issues this communication under Section 21 of the Financial Services and Markets Act 2000. Please note, tax and estate planning services are not regulated by the FCA.