

FX Insight

QE and FX Nuances

Recent Impact of QE on FX More Mixed

It is often thought that aggressive central bank QE tends to drive softness in FX. However, the impact on currencies from recent QE announcements by major central banks have been more mixed. In March this year, ECB's EUR750bn Pandemic Emergency Purchase Programme (PEPP) and BoE's new GBP200bn bond purchase programme—alongside signs of coordination with fiscal actions—arguably lifted dire market sentiments and helped EUR and GBP recover from their mid-Mar troughs. Broadly, QE programmes of individual central banks have to be evaluated in light of the interim macro environment, and in relative terms vs. actions of global peers.

Episode-by-Episode Review of Past Fed QE

An episode-by-episode review of Past Fed QE actions shows that the expansion of the Fed's balance sheet does seemingly contribute to a softer dollar. But this effect takes time, and the point-in-time macro context matters. The “pace” of QE matters as well. This time round, while the magnitude of balance sheet expansion in absolute terms is large (Fed balance sheet rose from 19% of GDP in end-2019 to 33% in May 2020), the pace is arguably slower than 2008 (Fed balance sheet more than doubled from 6% in Aug 2008 to 15% at end-2008).

In a risk-off environment, where there are risks of second wave infection, sino-US tensions, etc., there could still be demand for USD for funding/liquidity purposes and this could still serve to mitigate USD downside pressure, even as Fed balance sheet continues to expand.

EUR and GBP Less Sensitive to Central Bank QE Now

For the EUR and the GBP, we adopt a somewhat reduced-form econometric approach to extract their time-varying sensitivities to ECB and BoE balance sheet expansions. We found that as markets got used to the idea of QE, sensitivities of EUR and GBP to ECB and BoE's pace of balance sheet expansions may be on a structural decline over the last decade. The notable exception was in 2015-16, when the sensitivity of EURUSD to the pace of ECB buying rose. Markets likely viewed the ECB's asset expansion programme then as a dramatic change of policy.

In any case, the recent pace of expansion in ECB balance sheet (39% of GDP to 47%) and BoE balance sheet (22% of GDP to 30%) is arguably less aggressive than the Fed's (from 19% of GDP in end-2019 to 33% in May 2020). Downsides of EURUSD and GBPUSD from current QE programmes may be constrained.

On net, EUR and GBP can still be supported vs. the USD now, even as USD softness may not be a one-way bet now. It may take several quarters (for Covid risks to pass) for dollar down-moves to be more aligned with Fed balance sheet bias. In other words, when funding/liquidity concerns fade, the negative relationship between the USD and Fed balance sheet may come in more strongly.

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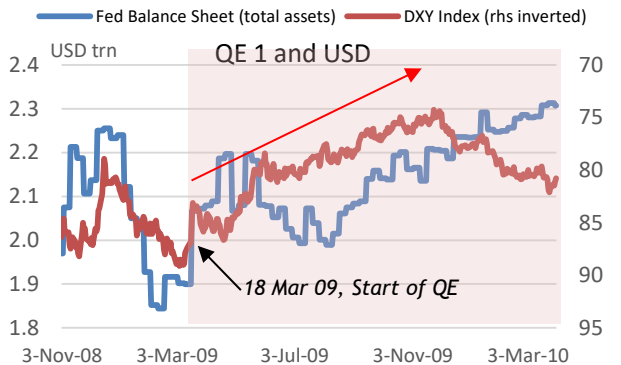
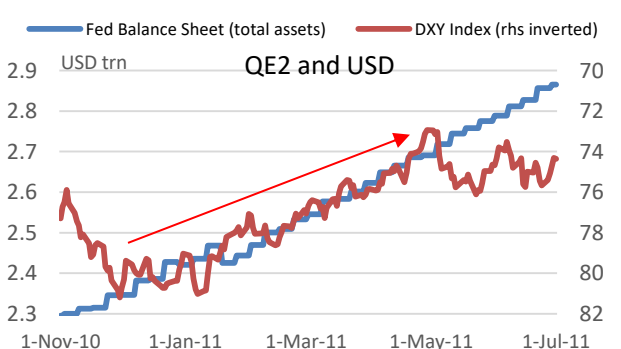
QE -> FX Softness?

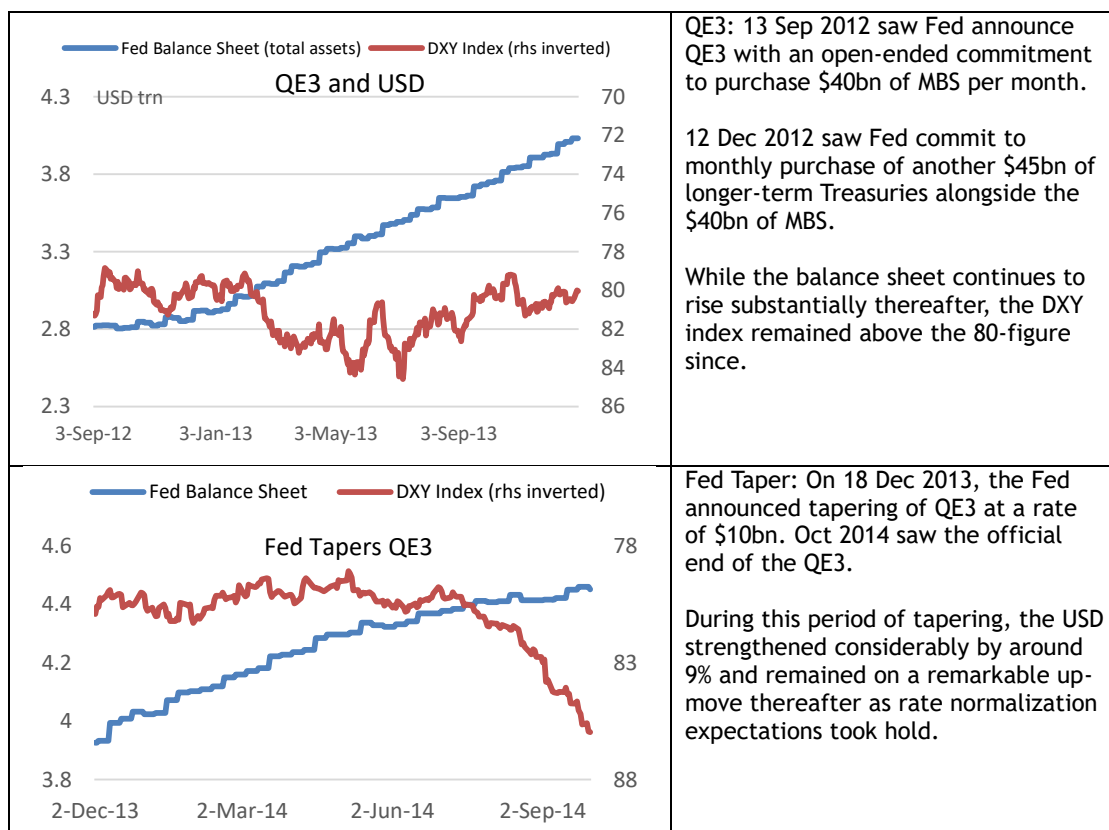
It is often thought that aggressive central bank QE tends to drive softness in FX. However, the impact on currencies from recent QE announcements by major central banks have been more mixed. In March this year, ECB's EUR750bn Pandemic Emergency Purchase Programme (PEPP) and BoE's new GBP200bn bond purchase programme, alongside signs of coordination with fiscal actions, arguably lifted dire market sentiments and helped EUR and GBP recover from their mid-Mar troughs. While GBPUSD pair softened on 18 June post the BoE's monetary policy announcement, it was more likely due to the absence of a clear stance on NIRP, rather than the widely-expected expansion of bond purchases (by GBP100bn).

Broadly, QE programmes of individual central banks have to be evaluated in light of the interim macro environment, and in relative terms vs. actions of global peers. Unlike 2008-2009 when Fed's actions formed the frontier for QE programmes, most central banks are now simultaneously engaging in monetary easing in attempts to mitigate the Covid-19 drag on their economies. Toolkits have also been expanded from the typical purchase of government bonds to corporate bond buying, yield curve control, and possible NIRP.

In this short piece, we look more closely at how broad dollar strength shifted historically alongside Fed QE programmes, as well as how sensitivities of EUR and GBP to central bank balance sheet expansions have evolved over time.

US: Fed's QE History and Corresponding Dollar Moves

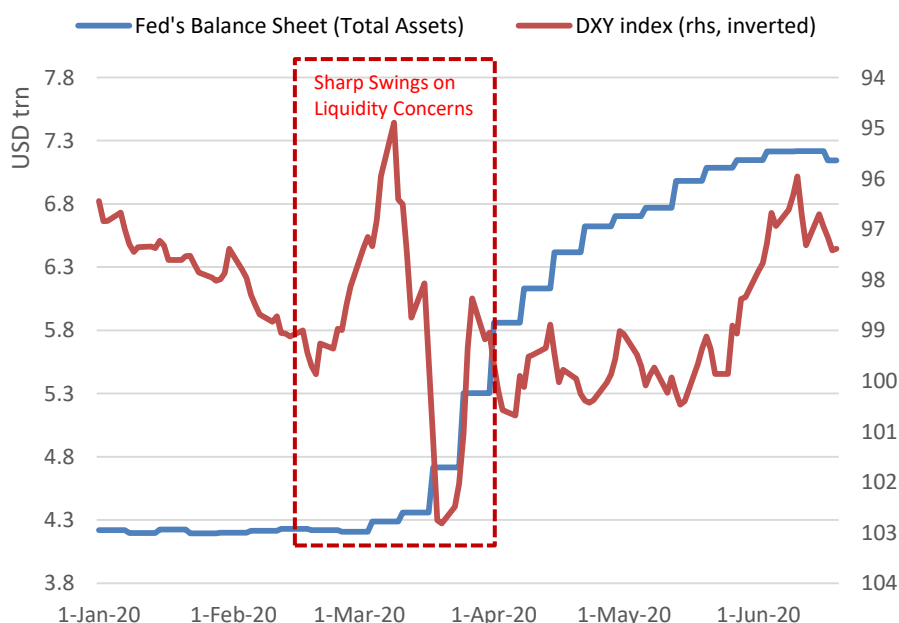
| Fed's History of QE | Fed's Balance Sheet and the DXY |
|---|--|
|  <p>— Fed Balance Sheet (total assets) — DXY Index (rhs inverted)</p> <p>USD trn</p> <p>QE 1 and USD</p> <p>18 Mar 09, Start of QE</p> <p>3-Nov-08 3-Mar-09 3-Jul-09 3-Nov-09 3-Mar-10</p> | <p>QE1: The Fed announced the first QE on 25 Nov 2008 with a purchase of up to \$600bn in agency MBS and agency debt. These purchases are supposed to be sterilized by Treasury sales.</p> <p>On 18 Mar 2009, the Fed announced an additional purchase of \$750bn in agency MBS, agency debt and \$300bn of Treasury Securities, this time unsterilized. The rise in its balance sheet was roughly in tandem with the USD weakness. DXY fell from near 90 to levels around 75 (-16% approx).</p> |
|  <p>— Fed Balance Sheet (total assets) — DXY Index (rhs inverted)</p> <p>USD trn</p> <p>QE2 and USD</p> <p>1-Nov-10 1-Jan-11 1-Mar-11 1-May-11 1-Jul-11</p> | <p>QE2: 3 Nov 2010, Fed announced the purchase of \$600bn of longer dated treasuries at a rate of \$75bn per month. QE2 ended in Jun 2011.</p> <p>For much of that period, the rise of the balance sheet from \$2.3trn to 2.9trn coincided with the USD's fall from its highs of 80 to lows of around 72 (-10%).</p> |



Source: Bloomberg, Maybank FX Research & Strategy

Subsequently on 23 Mar 2020, the Fed restarted large-scale QE with no limit. During the peak of crisis when risk assets were sold aggressively, the USD strengthened considerably on safe haven demands before reversing course, lower. Between Apr-Jun 2020, the balance sheet of the Fed jumped from \$4.3trn to \$7.2trn. The USD weakness was only more material in the past month as more economies started to ease lockdown. The expansion of the balance sheet and its impact of the USD is thus, less compelling in this episode.

Covid-19 QE



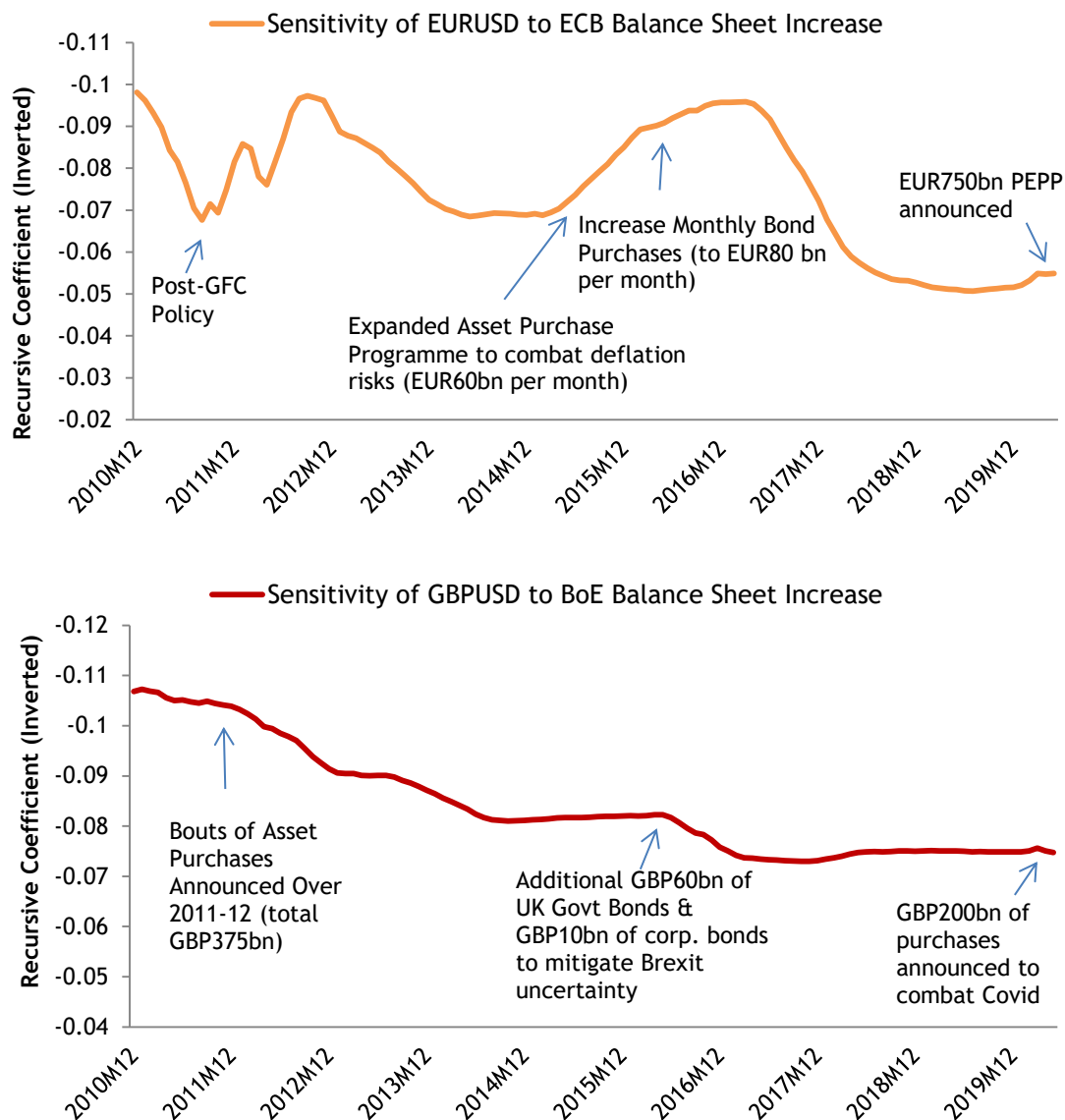
Source: Bloomberg, Maybank FX Research & Strategy

Broadly, the expansion of the Fed's balance sheet does seemingly contribute to a softer dollar. But this effect takes time, and as we noted above, the macro context matters. Another key point is that the "pace" of QE matters as well. When Fed tapered QE3, a still-expanding Fed balance sheet (reduced slope) was met with a rising dollar.

This time round, while the magnitude of balance sheet expansion in absolute terms is large (Fed balance sheet rose from 19% of GDP in end-2019 to 33% in May 2020), the pace is arguably a tad slower than 2008 (Fed balance sheet more than doubled from 6% in Aug 2008 to 15% at end-2008). On net, USD lower may not be a one way bet for now.

Sensitivities of EUR and GBP to Central Bank Balance Sheet Expansions Likely Lower Now Relative to Historical

For the EUR and the GBP, we adopt a somewhat reduced-form econometric approach to extract their time-varying sensitivities to central bank balance sheet expansions. Recursive coefficients are extracted from OLS regressions of EURUSD and GBPUSD pairs against respective (i) 10Y Yield Differentials vs. USTs, (ii) Industrial Production Growth, (iii) Central Bank Balance Sheet Size (normalized by GDP). FX and balance sheet variables are in natural logarithm terms.



Source: Bloomberg, Maybank FX Research & Strategy

Broadly, the econometric analysis reinforces the following:

- As expected, EURUSD and GBPUSD have negative relationships with the extent of their respective central bank asset purchases. This relationship is likely time-varying.
- As markets got used to the idea of QE, sensitivities of EUR and GBP to ECB and BoE's pace of balance sheet expansions may be on a structural decline over time.
- Increasing "shocks" are needed to have a more discernible impact on sensitivities.
 - The sensitivity of EURUSD to the pace of ECB buying rose over 2015-16 (i.e., recursive coefficient became more negative) as markets viewed the ECB's asset expansion programme then as a dramatic change of policy.
 - In comparison, for UK in 2016, BoE's asset purchase announcement likely did not result in GBP becoming more sensitive to BoE's balance sheet moves. Brexit developments was likely a greater driver of GBP trajectory then.
- On net, the impact of the latest rounds of Covid-led asset purchases by ECB and BoE on FX could be more modest than prior episodes.

Conclusion

Markets may be less sensitive to QE when policy support is viewed as critical for their economies, and when the same trend of balance sheet expansion is seen across major central banks.

For the dollar, we reiterate that it has 2 key aspects - an "international" role due to USD being the world's reserve and payment currency (for a lack of better alternative) and as a proxy of its domestic factors. So in a risk-off environment, where there are risks of second wave infection, sino-US tensions re-escalating, etc., there could still be demand for USD for funding/liquidity purposes and this could still serve to mitigate USD downside pressure, even as Fed balance sheet continues to expand. It may take several quarters (for Covid risks to pass) for dollar down-moves to become more aligned with Fed balance sheet bias.

For the EUR and the GBP, our analysis suggests that even pre-Covid, they were becoming less sensitive to central bank balance sheet expansions. In any case, the recent pace of expansion in ECB balance sheet (39% of GDP to 47%) and BoE balance sheet (22% of GDP to 30%) is less aggressive than the Fed's (from 19% of GDP in end-2019 to 33% in May 2020). Downsides of EURUSD and GBPUSD from current QE programmes may be constrained.

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