How the evolving role of Central Banks affects Investing

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Central Banks play an important role in the investment environment. They issue money, they set the cost of money and they control both the amount and the velocity of money in circulation. Every investment instrument is denominated in monetary units, so it is directly affected by central banks' monetary policy actions. Central banks, however, are underway a shift in the role they play in the global financial ecosystem.

Since the great financial crisis in 2008-09 the world economy has entered a long-term deleveraging face as total money supply is following a descending direction as a multiple of monetary base. This is an outcome of large-scale bond purchases and repo actions conducted by central banks around the globe.

Because of the deleveraging phase that the world economy is in, deflationary pressures arise, and central banks are forced to expand their balance sheet as they have no room left to lower interest rates further. In addition, any short-term crisis or any black swan event poses significant deflationary pressures in the short run which is essential to be counteracted. Thus, central banks are ready and willing to expand their balance sheets in unprecedented amount and pace.

What is more, monetary policy actions like forward guidance, quantitative easing, targeted financing, outright monetary transactions, are now deemed as conventional monetary policies, so they can be implemented instantly. Additionally, current state of the art technology, allows central banks to access important information and analyze data in no time. So, they can act literally in "negative time".

As investors, we want to exploit any risk adjusted profit opportunity. By knowing the general phase of our economy and that central banks are ready to provide unlimited liquidity if any short-term risk arises, we can take advantage of any short-term dip in risk assets. There is a great deal of effort from central banks to reduce risk anytime risk rises. The profit proposition that we want to exploit is that, monetary policy has a time lag between announcement and actual results felt in the economy.

Investment participants tend to be guided by fear and panic coupled with their actual need of liquidity which lead them up to selling their assets causing prices to fall. This fall usually is greater than needed because of the central banks' stimulus. We must understand that after the shock is over, the economy will start regaining momentum, this time with much greater monetary base. This will lead to higher nominal values.

Of course, this is an investment strategy that involves an important amount of unbiased information, technical knowledge, precise timing and strict risk management. It's not an easy-to-implement shortcut to become a millionaire. But, if implemented precisely, gives us an incomparable advantage in our fight against financial markets.