CENTRAL BANKS: TIPTOEING TOWARDS TIGHTER POLICY

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Nikolaj Schmidt
Chief International Economist

As the global growth backdrop has improved in the second half of this year, major central banks are tiptoeing towards policy normalization. The Federal Reserve this week raised its policy rate for the first time since December 2015 and for only the second time this decade. Perhaps more important than the rate hike itself, was the signal of a faster pace of tightening to come; Fed policymakers’ median projection for rate rises was increased to three quarter-point rises in 2017 from two previously. Despite Fed Chair Janet Yellen's attempts to put a dovish spin on the meeting, interest rates rose meaningfully, equities sold off and the U.S. dollar strengthened. The moves come amid capital outflow pressure from China and an already significant tightening of financial conditions. With our proprietary leading indicators signaling that U.S. growth is set to moderate, the more hawkish rate hike projections for next year risk a replay of the disruptive adjustment we saw at the start of 2016.

Meanwhile in Europe, the European Central Bank (ECB) said this month that its asset purchase programme would be extended until at least the end of 2017, but that from next April the pace of buying would be reduced to EUR 60 billion per month from EUR 80 billion. While the central bank announced plans to start scaling back its bond buying, ECB President Mario Draghi exceeded expectations with his reassurance that stimulus support would continue for as long as needed. Essentially, the central bank has delivered a reasonably dovish message to the market: the pace of buying is being reduced, but they are committed to purchasing for longer. Altogether, this has been well managed and the ECB has meaningfully reduced the uncertainty about changes to its monetary policy stance in 2017.

We expect the Bank of Japan (BoJ) to remain on hold for a while yet. In September, the BoJ made a rather significant change to its policy framework as it tweaked its focus from a quantity target (“we will purchase JPY 80 trillion of government bonds per year”) to a price target (“we aim to purchase JPY 80 trillion of government bonds per year, but we will not buy if the yield on the 10-year government bonds is materially below 0 basis points”). By shifting from a quantity target to a price target, the Bank of Japan aimed to address two problems: first, the flatness of the yield curve, and in particular subdued long-term yields; and second, the market’s view that the BoJ would run out of government bonds to purchase in the not-too-distant future. In aggregate, the BoJ introduced a reasonably clever mechanism to address these concerns and, after some revolt, the market has largely accepted its new framework.

Right now, the market is grappling with a number of cross-currents. It is caught between discussion about fiscal expansion in the U.S., fiscal tightening in the rest of the world and a global monetary policy stance that is slowly tightening. In the U.S., the prospect of a fiscal expansion in an economy where the output gap is closing raises the spectre of inflation (in 2018/19). We should remember that the electoral promises of President-elect Donald Trump are far from approved by Congress. In reality, the fiscal expansion could take a long time to materialize and be much smaller than what Mr. Trump has promised. All said and done, markets have embraced the prospect of stronger growth and yield curves have steepened as a result. Equity markets, meanwhile, have surged as investors have embraced the promise of a reduction of taxation on dividends, capital gains and corporate earnings. The expectation that U.S. growth will outperform the rest of the world has pushed the dollar higher against both emerging and developed market currencies. December’s U.S. Federal Open Market Committee meeting seems to have reinforced those trends.
WHAT DOES THIS MEAN FOR MARKETS?

In Europe, we believe that the political uncertainty related to the rise of populism and a challenging electoral calendar for 2017 (elections in France, Germany and the Netherlands) will keep credit spreads of periphery countries under pressure to widen. In addition, Mr. Trump’s electoral victory creates an environment that makes it more likely that the European Union will make it easier for UK Prime Minister Theresa May to strike an acceptable agreement on Brexit. This may strengthen sterling against the euro.

Over a slightly longer horizon, for global interest rates to sell off durably, the proposed fiscal stimulus in the U.S. needs to be powerful enough to close the global output gap. However, a large portion of the Republican fiscal package will have a low multiplier as it is composed of tax cuts for the wealthiest individuals. In addition, there will be a time lag between the impact of the fiscal easing (not before the third quarter of 2017) and the impact of the tightening of global financial conditions currently percolating through the global economy.

Overall, we think the steepening of the yield curve could offer investors a good opportunity to increase their allocation to fixed income.
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