
Weekly Market Summary

29th of April 2016

Markets Starting to Lose Faith in Central Bankers ... End Game Fast Approaching !! Fadi Nasser (SVP – Head of Treasury Sales)

The last 10 days have witnessed central bankers' meetings in Europe, US and Japan. And whilst all 3 meetings are now behind us – having resulted in little change to current monetary policy stances - we take a moment to summarize statements / market reaction associated with those gatherings:

- **European Central Bank (ECB) Meeting – 21st April 2016:** The ECB's April meeting was a non-event - creating little excitement – and follows the central bank's announcement of big changes in March (as a reminder, the March 10th ECB meeting witnessed the announcement of an aggressive package of quantitative easing measures - an increase in the value of monthly asset purchases by one-third to € 80 billion, a plan to include non-investment grade corporate bonds under the new buying program and new four-year loans for European banks, with those carrying interest rates as low as the deposit rate (-0.40%!) – that incited a big equity and bond market rally). Details of the upcoming purchases of corporate bonds, which are scheduled to begin in June, were the most significant news this time. Indeed the universe of assets eligible for buying appears to be considerably larger than it seemed last month, and that in turn should allow the quantitative easing ("QE") program run a bit longer, if needed. ECB President Mario Draghi's positions on negative interest rates ("the experience with negative interest rates has so far been positive, but that might not be the case of they were pushed further below zero"), the need for support from fiscal policy and structural reforms ("with rare exceptions, our monetary policy has been the only policy in the last four years to support growth"), and "helicopter money" (refers to an aggressive increase in the money supply through a coordinated act between monetary and fiscal authorities, as part of a list of unconventional tools that central banks/governments could use to ward off inflation/improve growth prospects) were unchanged. Last, Draghi repeated his oft-cited line that the ECB stands ready to act with all available instruments within its mandate, in the event of an unwanted tightening of financial conditions. The euro closed little changed on that day at \$ 1.1290 after climbing as high as \$ 1.1400. German bund yields jumped 8 bps (from 0.16% to 0.24%, a 50% increase!) – the most in four months – as speculation mounted that planned purchases of corporate debt will erode central bank demand for sovereign securities.
- **US Federal Open market Committee (FOMC) Meeting – 27th April 2016:** Federal Reserve policy makers left the US Fed funds rate target unchanged at 0.25% -- 0.50% (Esther George, president of the Kansas City Fed, dissented for the second meeting in a row, repeating her preference for a 25 bps increase), but signaled they are open to raising interest rates in June, acknowledging the improvement in global financial markets and downplaying recent weakness in the U.S. economy. The FOMC omitted previous language that "*global economic and financial developments continue to pose risks,*" instead saying officials will "*closely monitor*" such developments, according to a statement released on Wednesday evening following a two-day meeting in Washington.

“Labor market conditions have improved further even as growth in economic activity appears to have slowed,” the FOMC added. *“Growth in household spending has moderated, although households’ real income has risen at a solid rate and consumer sentiment remains high.”* The Committee reiterated that it will probably raise rates at a “gradual” pace. Extending a hold since raising interest rates by a quarter in December from close to zero, the Committee said that inflation has continued to run below the Fed’s 2% and market-based measures of inflation compensation remain low. Officials omitted an assessment of whether the risks to the outlook were balanced or not for the third straight meeting. Despite continued strength in the labor market, the Federal Reserve balked at another move at the first 3 meetings in 2016, amid worries that weak global growth and turbulence in financial markets might harm the U.S. economy. Markets have since calmed and inflation has showed signs of rising closer to the central bank’s 2% target, but growth in the U.S. has recently slowed (as depicted by yesterday’s US GDP release, which showed US growth slowing to a +0.5% annualized rate in the first quarter of 2016). The bottom line is that the FOMC claims to be in tightening mode, but remains extremely cautious about the risks from the global economy. And whilst the FOMC’s confidence on the domestic economic front remains equally and oppositely balanced by its lack of confidence in the global economy, a rate hike in June remains a highly uncertain outcome (next Fed meeting is scheduled for June 15th, a week prior to the UK referendum that will decide on whether it will stay or leave the European Union!). Stocks, bonds and commodity prices have rallied on the Fed decision, possibly as investors were reassured by the central bank decision to proceed gradually in raising interest rates if and when the US growth/inflation outlook improves further. The US Dollar weakened following the Fed announcement, reaching yesterday its lowest level since June 2015 on the back of weaker-than-forecast economic growth.

- **Bank of Japan (BOJ) Meeting – 28th April 2016:** The Bank of Japan’s decision – at yesterday’s meeting - to hold off on adding stimulus to an economy that is crawling along the bottom stunned markets, sending the yen surging and stocks slumping (a slight majority of economists surveyed by Bloomberg had expected the BOJ to act). It also left some analysts scratching their heads about the BOJ’s communications strategy and its ability to steer markets in the future. Reactions ranged from shock to frustration. One even described the central bank’s decision as mysterious. *“The BOJ seems to have descended into a haze of confusion,”* said Richard Jerram, the chief economist at Bank of Singapore. *“They mismanaged expectations running up to the meeting -- and that is clear from the market reaction.”* Nevertheless, Governor Haruhiko Kuroda told reporters at a press conference after the policy meeting that he wants to wait and see how the introduction of negative rates in January affects the economy and added that the BOJ does not have a communications problem. Not everyone agrees: A consistent strategy of surprising markets could begin to backfire if investors start to drift away from the central bank’s messaging, according to market analysts. And that is not the first time that Kuroda has wrong-footed investors; The governor ruled out negative interest rates only to introduce them in January and he is known to like surprising markets for maximum impact. He also has a track record of waiting to see the effect of policy changes as they flow through the economy before deciding on fresh action. This time around, the sense of urgency for the BOJ to act had been fueled by the yen’s gain of about 10% versus the dollar since the beginning of the year, along with tepid inflation and the economy’s struggle to get traction. Kuroda had said repeatedly that the BOJ would not hesitate to add stimulus, if necessary, and expressed concern about the impact on exporters of the currency’s rapid appreciation. Instead, Japan’s central bank on Thursday again pushed back the timing of when it expects to meet its key 2% inflation target, and gave few clues away about the next move in policy. A slew of economic

data released just before the policy meeting highlighted the challenges: A key gauge of consumer prices slumped while the outlook for industrial production was poor.

In fact, negative sentiment about Japan's economy isn't hard to find. The International Monetary Fund in April halved its 2016 growth forecast for Japan to 0.5% and confirmed that deflation remains a major threat as real wages fall for four consecutive years. The Japanese yen surged to an 18-month high against the USD this morning, for a third month of gains. It has strengthened 12% this year (the most since an 18% gain over the same period in 1995), and was last trading at 107.06 and 121.92 against the USD and EUR respectively. The Nikkei 225 equity index tumbled by an unusually wide margin of 3.6%, losing 625 points during yesterday's session (Japan's equity markets were closed today).

That brings us to our main observation for the week:

The unintended consequence of many central banks pushing negative interest rate policy has been the resumption of deflationary headwinds, stronger currencies, and slower growth - the exact opposite of what struggling economies need. But when monetary policy is the only game in town, negative rates are likely to produce even more negative rates, creating a perverse cycle with important implications for investors. And frankly a world where money is lent for several years to the governments of Japan, Germany and Switzerland at a negative interest rate is simply too hard to comprehend!

Yet, empirical data strongly suggest that the velocity of money (i.e. the rate at which money is exchanged from one transaction to another to buy goods and services per unit of time) has declined precipitously as policymakers have moved aggressively to reduce rates. That in turn increases deflationary pressure with each dollar (or yen or euro) generating less and less economic activity, so policymakers must pump more money into the system to generate growth. As consumers watch prices decline, they defer purchases - reducing consumption and slowing growth. Deflation also lifts real interest rates, which drives currency values higher. In today's world of global trade, a strong currency is a headwind to exports. Obviously, this is not the desired outcome of policymakers!

Additionally, strategists/analysts are increasingly starting to believe that central bankers are nearly out of options and that could have a severe and lasting damaging impact on financial markets. After all, central banks can hardly raise interest rates and there is a growing realization that negative interest rates simply make no sense. Unconventional approaches of buying corporate bonds (ECB) and stocks (Japan) so far have not produced significant results, and run risk of tainting these assets for private investors.

As such, the next attempt to boost the economy or prevent potential market crisis will likely need to be accomplished through fiscal measures. However, the latter also bring increased level of government debt and increased market and credit risk of owning government bonds. These risks are in addition to current low yields and less favorable correlation of bonds to risky assets. The unfavorable risk-reward of government bonds near the point of zero yields will likely prevent asset managers from increasing holdings of government bonds. If there are no private buyers, governments can still place their bonds with central banks, with this trend is of course already in place (for instance, the Fed's holdings of US Treasuries increased from roughly 18% in 2008 to 34% today). Increased government spending, financed by central banks could indeed create inflation, but will further elevate the problem of debt viability.

If investors lose confidence that the debt can ever be repaid, they will reduce their holdings, increasing the cost to governments or inviting more central bank buying. This would eventually result in the devaluation of all currencies against real assets such as gold, high inflation or even outright defaults (as was the case in Greece). If such a trend develops in one of the large economies, it could have far-reaching consequences.

How can an investor hedge against the risk of these potential developments? One can reduce allocation to bonds and increase allocation to real assets and equity sectors related to real assets. Investors can also move away from bonds that are not backed by reserve assets such as currency reserves or gold.

Don't panic – or at least, not yet!! The global economy is not in the best of states, yet it is still set to grow at a decent rate this year. However the real question over the next few years will continue to be when and how deep the upcoming downturn will be.

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