

Inflection: Central Banks at Crossroads

Inflection:

From the rhetoric it is apparent that the Fed wants to raise rates, the question is not if, but when. The ECB's recent inaction and signals point to a pause and a possible rethink about QE. The BoJ is currently assessing the efficacy of current QE and has already surprised the market by its hawkish inaction in the face of weak data.

PMI data have been consistently strong globally with the exception of Japan and recently in the US. Japan is slowing but less severely and the US data is a single data point in a robust trend.

Recent musing by the financial elite have been leaning towards fiscal policy.

1. Are the world's central banks near or at the point of inflection in super low rates?

The Fed is clearly at the inflection point. The question for the Fed is not if, but how quickly rates will be raised. The options are between slow and super slow. The UST market is unlikely to be complacent.

The BoJ is likely to be at an inflection but is it between holding and handing the responsibility to fiscal policy, or is it to accelerate monetary easing towards further unconventional measures such as debt forgiveness? Economic data while indicating continued deterioration are slowing in their descent presenting the risk that the BoJ may maintain status quo or even cut back stimulus. Or, if fiscal policy is expanded, the BoJ may deem it unnecessary to increase its efforts. Interest rates can be cu

t further or QE expanded but current efforts have not been effective and more of the same is unlikely to be helpful. The only shock and awe policy left is to cancel some of its holdings of JGBs effectively monetizing legacy debt. Politically and culturally, this is unlikely.

The ECB is reviewing the effectiveness of its QE program. On recent cyclical data, the ECB may conclude it has done enough. The Eurozone does not have fiscal union and fiscal policy will be decided at the national level although Brussels will have influence through the Maastricht conditions. Politically, Europe has less scope for fiscal policy, and even less for a concerted effort.

2. Has monetary policy reached its limits?

The question is moot in the US for now, although a prudent Fed would at least academically consider its options should the economy slip back into recession.

The BOJ is likely at its limits. It already owns a third of the national debt and is struggling to find assets to buy. It's NIRP has resulted in a rise in deposits. Economic data remains weak although the pace of decline has slowed. More data are required to be certain but the current evidence is that monetary policy has had limited impact.

The ECB is likely close to limits. Negative interest rates have led to limited cash hoarding, including by corporates. The asset allocation of the QE has been politically constrained resulting in the capital flowing to where it is needed less, Germany and France, instead of the periphery. The ECB is unlikely to be able to increase the scale of QE although it could make further progress by moving asset allocation away from the capital key.

3. Will fiscal policy be deployed and to what extent?

In the US this is academic. Politically also, it will depend

on the future composition of Congress, the Senate and who occupies the White House.

In Japan, fiscal policy engaged now will only be another salvo in a series which has seen the national debt swell to 2.5X of GDP. However, given the BoJ's recent demeanour and Abe's control of Upper and Lower Houses, fiscal policy cannot be ruled out.

Politics will make fiscal policy difficult to approve in Europe. Germany can afford it but doesn't need it. France might but probably can't and peripheral Europe almost certainly cannot afford it but might need it most. The political uncertainty in Europe makes this a difficult call.

4. Asset prices are very sensitive to the base curves. Equities are cheap relative to bonds but otherwise expensive. IG spreads are reasonable to cheap and HY spreads are reasonable. The problem reduces to developing a view around base curves.

USD.

Short end is very sensitive to Fed funds. Long end is more sensitive to inflation. Long end will find less upward pressure from risk of fiscal policy.

JPY.

Japan is already engaged in fiscal policy albeit not in a determined way. This would normally exert upward pressure on yields. Much will depend on the BoJ's review of QE due 21 September. The results could be a) mission accomplished, b) QE didn't work, more needs to be done, and c) QE didn't work, a new approach is needed. I'd a) then JGB yields will likely rise as will JPY, if b) JGB yields will likely fall as will JPY. The last scenario is the most interesting but unpredictable. A debt cancellation is the most likely strategy left and is one which allows Japan to raise more debt and

spend more. On its own, c) should drive yields lower with JPY, however, c) is also an enabler of an acceleration in fiscal policy which would drive JGB yields higher.

EUR.

The system wide PMIs indicate a cyclical recovery in the Eurozone which should signal a success of policy to the ECB. The recovery, however, is not evenly distributed. The recovery in Spain is threatened by politics, the recovery in Italy by politics and specific issues in its banking system. France is in a very slow recovery with high political risk. Germany could do without any monetary or fiscal support. A tailored monetary solution is difficult given the single currency and the adherence to the capital key in QE allocation. A targeted solution would be to get off the capital key or engage national level fiscal policy.

The above would likely be neutral to positive for the EUR. Yields would react at national levels. If the ECB gets off the capital key, peripheral bonds will outperform. If national level fiscal policy is implemented, peripheral and core bonds will likely sell off. If both policies are implemented bunds suffer most.

Bank capital.

Bank capital spreads are mostly impacted by regulation and credit quality. They are, however, not immune to volatility in the base curves.

Rising rates will improve bank profitability. However, banks have significant exposure to sovereign bonds and could face losses if bonds sell off. The first order consequence is an improvement in the profit outlook for banks. Banks are generally more profitable in a higher yield and steeper yield curve environment. This is well highlighted by the relatively high short term correlation between government bond curves, yields and bank stocks

Rising rates may provide some volatility and a buying opportunity.

Loans.

Loans carry very little duration, particularly as LIBOR rises above the LIBOR floor, typically 1%. Higher rates may put pressure generally on corporate balance sheets through higher debt service and refinancing costs. The inflection point may introduce volatility to the loan market which could be a good buying opportunity.

IG.

IG spreads have compressed considerably in the short term and while in the longer term they may be cheap, in the short term the momentum from a duration sell off will likely carry IG with it. Buying opportunity if duration hedged.

HY.

Same technicals as IG. HY could be more resilient as duration element is smaller and credit fundamentals remain robust.