



Change is in the air as the Fed, BOC and ECB pivot on policy

Weekly Market Compass: Can central banks' policy shift offset the economic slowdown?

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There is an old Chinese proverb that states, "When the winds of change blow, some people build walls and others build windmills." In other words, some people embrace change while others fear it. I've come to the conclusion that the speed of the change has much to do with how a change is received. Just look at the past week, when we saw abrupt changes in the direction of the wind for central banks, followed by largely negative reactions.

Central banks had a change of heart

Last week was a pivotal one for central banks, continuing a trend begun a few weeks before by the Federal Reserve. First came the decision from the Bank of Canada (BOC) to keep rates as is, which was expected. However, the big news was that the BOC dropped its commitment to continue raising rates. This is a less dramatic "about face" than the one we witnessed with the Federal Reserve, but it signals a change of heart; BOC Governor Stephen Poloz only recently said that he believes further rate hikes are necessary to get to a neutral range.¹

Now, it is clear that the BOC has concerns. For one, it has become increasingly worried about Canada's financial system vulnerabilities. As I've noted before, the BOC has been specifically focused on "historically high levels of household debt and elevated housing market imbalances." But it's also concerned about the global economy; in its statement, the BOC noted that "the slowdown in the global economy has been more pronounced and widespread than the Bank had forecast."

Then came an even bigger change of heart from the European Central Bank (ECB) at last week's meeting. According to forward guidance, rate hikes will not occur until the end of the year at the earliest. This was a departure from its earlier stance, as previous ECB statements had encouraged the view that the ECB might raise rates later this year. This may also have implications for balance sheet normalization, as it is widely expected that balance sheet normalization will not begin until after rates begin rising.

The ECB also announced there would be a new series of seven quarterly targeted longer-term refinancing operations (TLTROs) starting in September. These are relatively cheap loans to banks in the hopes that banks increase lending activities in order to stimulate the economy. Whether these new bank loans will be utilized (and whether they'll be materially impactful) will depend on whether banks believe they have more profitable ways to use these funds than last time.

The outcome of this most recent ECB meeting came as a surprise, as the ECB had just ended quantitative easing in December and appeared to be on the path to normalization. Of course, both the forward guidance on rates and the new TLTROs are seen as reactions to the regions' worsening economic backdrop. And that's no surprise given that the ECB lowered its growth and inflation forecasts. The extent of the revisions was relatively large, with gross domestic product (GDP) growth revised from 1.7% to 1.1% for 2019, and core inflation revised from 1.6% to 1.2%.²

ECB President Mario Draghi explained that this change of stance occurred because the ECB is “trying to get ahead of the curve.” This set off some alarm bells as many market participants were not aware of any curve, so to speak. Draghi also described the economic environment as one of “continued weakness” and “pervasive uncertainty,” blaming external factors such as protectionism, geopolitical uncertainty and fragility in some emerging economies. What’s more, Draghi seemed to leave the door open to a reignition of quantitative easing, asserting that the ECB was “very open” and “determined” to act if necessary without giving any specifics.

I believe the market reaction to the ECB decision and press conference was negative because of the abrupt nature of this change of stance, not dissimilar to what we saw with the Fed several weeks ago – or with the Bank of Canada. These central banks didn’t ease markets into their respective policy stance changes; rather, these pivots came suddenly. Adding to worries is that this policy change came on the heels of a growth forecast downgrade by the Organization for Economic Cooperation and Development (OECD), which moved its forecast for 2019 global growth from 3.5% (in November 2018) to 3.3%. The OECD explained, “High policy uncertainty, ongoing trade tensions, and a further erosion of business and consumer confidence are all contributing to the slowdown.”³ For the ECB in particular, Draghi has largely maintained the confidence of markets, but with his tenure expiring at the end of October, he is a “lame duck” – which could lead to the assumption that any stimulus that is enacted could easily be taken away by his successor.

Have central banks done enough to offset the economic slowdown?

Now we see the Fed, the Bank of Canada and the ECB pivoting, while these central banks as well as the central banks of India and China are all loosening their policies in one way or another. The central question is whether they have done enough to offset the current economic slowdown – and the answer depends on how severe that slowdown is.

I remain of the opinion that the slowdown will be relatively modest, given all the stimulus in the system (particularly from China). My view is that as long as central banks attempt to be data-dependent, they will be able to manage most economic downturns, although in the case of the ECB, I believe it may have to resort to a resumption of quantitative easing in order to do this. Having said that, I must admit that the task may be more difficult this time around given that central banks were barely able to begin the normalization process before having to become more accommodative again. Thus, we must ask whether central banks have enough dry powder to combat a significant crisis.

What’s more, we must continue to monitor the next frontier of populism, which could focus on attacking central banks, given that they are arguably removed from the democratic process, filled with elites and may have contributed to greater wealth inequality in the past decade. That could prove dangerous, as central banks are what saved us from the Global Financial Crisis. For now, it seems jitters will abate as markets digest these abrupt central bank pivots. I expect that markets should improve even more if we see that these policy changes have a positive impact on the economy.

What to watch this week

Looking ahead, this is a critical week for the UK. On March 12, the House of Commons will vote on a revised version of Prime Minister Theresa May’s Brexit plan. It is expected to fail, which would then mean another vote on March 13 to decide whether members of parliament support a “no deal” Brexit. That vote is widely expected to fail as well, meaning that the UK will then need to begin working on obtaining an extension of Article 50 so that it can work on a Brexit deal that is more palatable to the majority of Britons.

In this case, the wind appears to have stalled as the UK tosses and turns but makes no real progress – at least until an abrupt wind of change begins blowing if Britain exits the EU on March 29. We will want to stay tuned.

Source

¹Bloomberg, "Poloz says Bank of Canada rate hike path 'highly uncertain,'" Feb. 21, 2019

²Trading Economics, Euro area GDP annual growth rate, as of Mar. 11, 2019

³OECD, "OECD sees global growth slowing, as Europe weakens and risks persist," Mar. 6, 2019

Important information

Quantitative easing (QE) is a monetary policy used by central banks to stimulate the economy when standard monetary policy has become ineffective.

Gross domestic product is a broad indicator of a region's economic activity, measuring the monetary value of all the finished goods and services produced in that region over a specified period of time.

In a "no-deal" Brexit, the UK would leave the EU in March 2019 with no formal agreement outlining the terms of their relationship.

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