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## This week the Fed will remind us that it's the world's central bank

Weekly Market Compass: When central banks intervene, investors may need to rethink accepted risk/reward profiles

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**Jul 29, 2019 | Kristina Hooper, Chief Global Market Strategist**

Back when I was in high school, I worked as a lifeguard. I thought it would be a great job, with an opportunity to get a tan and do some summer reading. However, it was a lot of responsibility for a 15-year-old, and I found myself running around with a first aid kit, bandaging cut toes and knees, and even having to perform a water rescue in my first few weeks on the job. I soon realized that I could save myself a lot of trouble, especially since I hated the sight of blood, if I strictly enforced the rules - like no running in the pool area - in order to pre-empt accidents and other mishaps.

Now that I look back, I was no different than the Fed. It is clearly leaning towards proactiveness these days as it seeks to pre-empt a greater crisis down the road, underscoring the theme that an ounce of prevention is worth a pound of cure. And the Fed may not be alone, although it may be taking the lead in this regard.

Last week the European Central Bank (ECB) met. It offered up dovish rhetoric and made it clear it would explore policy options. However, it decided to maintain the status quo at its monetary policy meeting - and this of course fell short of market hopes. The market initially responded by taking bond yields lower, but then gave back most of its gains.<sup>1</sup> In my view, neither the ECB nor Eurozone (EZ) governments are ready to act pre-emptively with monetary or fiscal easing.

What are the reasons for this reticence? I believe it's because domestic demand - especially consumption and services - is holding up well in many EZ economies, supported by relatively tight labor markets and ultra-low interest rates, even as manufacturing and investment suffer from trade and geopolitical frictions. Of course, the US economy is in even better shape than the eurozone, especially where consumption is concerned, as evidenced in the first estimate of second quarter gross domestic product (GDP) in which consumption was above 4%.<sup>2</sup> This begs the question: why is the US almost certain to cut rates this week?

I believe the answer lies in the fact that the Fed has evolved into the world's central bank more than simply that of the US alone. That was certainly clear in the Global Financial Crisis and it's becoming clear again as we live through what I like to call the Global Trade Crisis. And as the world's central banker, it must be a cautious lifeguard, focused on preventing a crisis before it occurs. And so I expect the Fed to cut rates by 25 basis points this week despite a strong - albeit decelerating - US economy (especially since the Personal Consumption Expenditures Index (PCE) remains below target, and I expect wage growth to continue to be relatively modest in the July jobs report).

After all, the International Monetary Fund (IMF) issued a clarion call for stimulus last week, when it released its July World Economic Outlook. The IMF revised global growth for 2019 down to 3.2% from 3.3% in April, which continues a series of downward revisions to growth. Of note is that the IMF substantially downgraded its estimate of world trade growth to just 2.5% this year, which is a downgrade of nearly a point since April's forecast. To provide a frame of reference, as recently as 2017, global trade was growing far more robustly, at a 5.5% rate.<sup>3</sup> As the IMF explained, "Global growth is sluggish and precarious, but it does not have to be this way because some of this is self-inflicted. Dynamism in the global economy is being weighed down by prolonged policy uncertainty as trade tensions remain heightened..." The IMF urged, "Monetary policy should remain accommodative especially where inflation is softening below target. But it needs to be accompanied by sound trade policies that would lift the outlook and reduce downside risks."

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Just like a lifeguard that can't stop thunderstorms but can force swimmers to leave the pool, the Fed can't control trade, but it can certainly control monetary policy accommodation. This sounds familiar and harkens back to the Global Financial Crisis when the Fed couldn't provide the fiscal stimulus the economy needed, but it could control monetary policy accommodation. And so it did. This sets us up for a scenario where the US takes the lead among major central banks in moving towards greater accommodation. But I believe the ECB and other central banks are likely to follow suit.

And so we need to consider implications of the Fed's decision this week in particular, and greater monetary policy accommodation in general. It seems appropriate to refer to the playbook created by the Global Financial Crisis for some guidance. During the GFC, central bank actions altered risk and reward profiles and created a yield scarcity in markets that lasted for years, and, which I believe is likely to intensify, given that central banks are turning more accommodative. While it depends on the investor, it will most likely mean a reach for higher yields that could push many investors out on the risk spectrum - to emerging market sovereign debt and corporate debt including high yield, given relatively higher return potential. We could see investors add exposure to US municipal bonds for the yields. And, of course, for some investors - especially individuals - a reach for yield could take them to dividend-paying stocks.

There is a valid concern that investors are being pushed into riskier asset classes. However, so long as central banks remain accommodative, they artificially render these "riskier" asset classes (such as stocks) less risky by placing what amounts to puts under them (the Bernanke put, the Yellen put and what will now be the Powell put, if all goes according to plan). This results in what I consider to be "artificial re-pricings." In other words, they accurately reflect the current risk/reward scenario, which includes factoring in lower rates and quantitative easing (QE). The same can be said for so-called "safe haven" asset classes that can be artificially rendered riskier because of central bank accommodation, especially QE.

When I was in business school in the 1990s, my finance professor referred to Treasuries as "risk-free return." However, because of QE in response to the Global Financial Crisis, I would argue that Treasuries became more like "return-free risk." That's what extremely accommodative monetary policy does - it alters risk and reward profiles. And so, just as we saw after the Global Financial Crisis, investors are being pushed into riskier corners of the investing world; however, because of central banks' actions, they are arguably less risky - at least for the time being.

Mark Twain wisely explained that, "History doesn't repeat itself, but it does rhyme." I expect we will be seeing central banks doing some rhyming very soon.

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## Source

<sup>1</sup>Bloomberg

<sup>2</sup>US Commerce Dept

<sup>3</sup>IMF

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## Important information

**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.

A **basis point** is one hundredth of a percentage point.

**Personal consumption expenditures (PCE)**, or the PCE Index, measures price changes in consumer goods and services. Expenditures included in the index are actual U.S. household expenditures.

A **put option** gives an investor the right to sell a security at a specified price within a certain time frame.

A **central bank "put"** is when a central bank responds to an economic crisis through highly accommodative monetary policy, which tends to calm markets and support stocks.

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

**Safe havens** are investments that are expected to hold or increase their value in volatile markets.

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