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Is this the end of an era for central banks?

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A change in mindset

Persistent, widespread inflation and quickly rising inflation expectations have led to a change in mindset among many Western central banks.

Markets digest the shift

I believe assets globally have reacted negatively because the pivot away from ultra-low monetary policy has been so swift and so large.

Where do we see opportunity?

One place where we see opportunities in the near term is in markets where their central banks are not on the monetary policy tightening bandwagon.

Last week was a pivotal one in the world of central banking. I don't think it's hyperbolic to ask whether, when we look back on last week, we will view it as the true end of ultra-easy monetary policy. Some would even see it as the end of a long phase in which risk-reward profiles of asset classes were altered by zero interest rates.

What are the signs of this sea change? Well, major central banks such as the US Federal Reserve and the Bank of England took steps to tighten monetary policy, in both big ways and little ways, with Fed Chair Jay Powell making it clear last week that lowering inflation is the Fed's biggest concern. But more important to me in terms of signifying the end of the era of ultra-loose monetary policy was the Swiss National Bank's decision last week to raise rates.

Why did Switzerland raise rates?

Yes, the Swiss National Bank (SNB) hiked rates by 50 basis points last week. This was extremely momentous — it was the SNB's first rate hike in 15 years. It's worth noting that Switzerland doesn't have the high inflation plaguing other Western developed countries, although the SNB just raised its inflation estimate from 2.1% to 2.8%.[1] So why hike so much, so suddenly? Motivating the SNB was the risk of second-round effects given high inflation in many other countries.

Thus, to me, the SNB's decision symbolizes Western developed-market central banks' move toward monetary policy normalization in the face of elevated inflation in many parts of the world. These central banks have largely changed their mindsets for the first time in decades — they've had to because of higher, more persistent, and more widespread inflation and quickly rising inflation expectations.

The roots of ultra-low policy

This era of ultra-low, experimental monetary policy began in response to the Global Financial Crisis, but its roots formed years before and have been an important part of the mindset of modern central bankers and business leaders, clearly shaped by the benefits of globalization. I was struck by an article written in 1994 titled "Inflation Overkill: Moving the Fed Into a Global Age" by the former CEO of American Express, James Robinson. In it he wrote, "The Fed must reassess the supremacy given to both its inflation fight and the use of interest rates as its primary policy tool. The risks that central bankers must balance have shifted. Inflation is far less threatening than the prospect of recession or slow growth, and raising interest rates to dampen inflation offers a cure that is often far worse than the disease."[2]

Robinson took a dim view of the limitations of the Fed's primary policy tool, "The general weakness of the Fed's approach is illustrated by its attempts to combat inflation in the early 1980s, when interest rates had to reach a staggering 20% before their effects could be felt."[2] Robinson finished his essay by warning, "We are presented with a historic opportunity to reshape the world for the better. Will we have the courage to challenge outdated assumptions, procedures and tools?"[2]

Robinson's questions were ominous; however, it took more than a decade and a financial crisis for most major central banks to change their assumptions and tools. That ushered in the era of experimental monetary policy — involving not just ultra-low rates but large-scale asset purchases -- which is just ending now. As I mentioned in my blog a few weeks ago, my old "mortgage calculator" from 1996 – which only showed mortgage rates between 6% and 20% — is quickly hurtling out of obsolescence, as the US national average for a 30-year fixed mortgage rate is at 5.91%.[3]

Now not every major developed central bank has made this mindset change. The European Central Bank (ECB) is tightening monetary policy but is simultaneously trying to bring down risk premiums for peripheral country bonds. The Bank of Japan (BoJ) remains in the "ultra low" mindset because inflation is not a significant concern for BOJ Governor Haruhiko Kuroda and his colleagues; they are more focused on yield curve control. However, most major Western central banks are in the process of this transition.

The fear of policy normalization

In contrast to Robinson's worry back in 1994 that central banks had been relying too heavily on very high rates, today, many others have the opposite concern. They argue that central banks had gone too far in the other direction by taking rates too low (below zero for the ECB, BoJ, SNB) and by printing too much money. This view also reflected the fear that financial repression was around the corner, as a way of reducing the real, inflation-adjusted value of excessive debt built up during the pandemic and before.

The reality is that the ultra-high rates of the 1980s and ultra-low rates of the 2010s represent outliers. We have lived in an abnormal environment so long that markets have come to fear normalization. However, I believe policy normalization will ultimately be positive; it is just initially painful and carries with it economic consequences, the monetary equivalent of ripping off a band-aid. But I believe there are compelling benefits to monetary policy and financial market normalization, once inflation has been restrained.

What might this mean for investors?

We need to be concerned with how this new monetary policy environment impacts asset prices. There is a significant body of academic research on this topic that explores the historical impact monetary policy has on asset prices. We have seen firsthand the carnage in recent months among risk assets, from equities to cryptocurrencies, and also "less risky" assets. But is this just a short-term phenomenon or is this the "new normal"?

I believe assets globally have reacted negatively because the pivot has been so swift and so large. Markets are still digesting the dramatic shift that began only a few months ago. Once the Fed has finished its “frontloading” of rate hikes, I suspect the environment will become less hostile for asset prices, especially higher quality credit but also equities. If Western central banks can slow tightening later this year (they likely feel some pressure to keep up with the Fed) it would potentially help the asset price environment. A long-awaited moderating in inflation should also help.

Furthermore, if we look over the horizon and take the long view as strategic investors and asset allocators, we can also look forward to a realignment of relative valuations across asset classes. Bonds have been rapidly repricing from yielding next to nothing in the US and UK, and literally less than nothing in the eurozone, Switzerland and Japan. After this normalization has unfolded, I believe bonds should once again provide coupons that can help investors cushion the volatility in riskier assets. I expect bond-equity diversification to eventually come back into vogue and help provide portfolio balance once again.

Equities and other risk assets may also perform well in a higher rate environment. Keep in mind projections for interest rates in the next two years still put rates for Western developed countries at low levels relative to historical norms. When Robinson’s article was published in September 1994, the fed funds rate was 4.73%[4] and would experience a 75 basis point rate hike in November, following by more rate hikes in the following months. A return to more normal monetary policy doesn't mean the end of stock bull markets. But I believe there needs to be a serious adjustment first, which includes an earnings adjustment, factoring in an impending economic slowdown brought on by tightening.

In the meantime, it’s worth noting that the impact of the Russia-Ukraine war on energy and food prices varies from one economy to the next, just as the response to the pandemic varies. This results in very different macro and market drivers, making a case for diversification.

Where do we see opportunity in the near term?

We see opportunities in the near term in markets where their central banks are not on the monetary policy tightening bandwagon. In particular, risk assets in Japan and China (with the exception of the property space) look attractive, in my view, on a currency-hedged basis (because their easier policy stance suggests that their currencies could weaken further against the dollar or major Western currencies).

Japan’s export sectors should benefit from its very weak yen, in my view. There is some risk that the BoJ could follow the SNB in raising rates because it starts to worry about inflation and second-round effects through a weak yen and stronger wages. But the BoJ is far from the SNB, just as Japan is far from Switzerland geographically and economically. Core inflation is still weak in Japan, and the government has been seeking ways to boost real wages in the face of a tight labor market for years. So we would expect the BoJ to remain reluctant to tighten.

China stands to potentially benefit from increasing fiscal and monetary stimulus – especially compared to the US, where the opposite is underway — as well as the slow reopening of its economy post-COVID shutdowns. Other emerging markets countries also offer opportunities in this environment, given where they are in the tightening cycle.

Over the medium and longer term, we see opportunities arising from a well-diversified (and higher-yielding) global portfolio, with exposure to equity, fixed income, and alternative asset classes.

With contributions from Arnab Das

Notes

[1]Source: Swiss National Bank, June 16, 2022 [2]Source: James D. Robinson III, "Inflation Overkill," Journal of Foreign Affairs, September/October 1994 [3]Source: Bankrate, as of June 21, 2022 [4]Source: St. Louis Federal Reserve Economic Data

A basis point is one hundredth of a percentage point.

Tightening refers to a monetary policy used by central banks to normalize balance sheets — in other words, to remove abnormal levels of monetary accommodation from the economy.

The yield curve plots interest rates, at a set point in time, of bonds having equal credit quality but differing maturity dates to project future interest rate changes and economic activity.

The federal funds rate (or fed funds rate) is the rate at which banks lend balances to each other overnight.