
Weekly Market Flash

A Central Bank Declaration of Independence?

September 9, 2016

Central banks in developed and (most) key emerging markets operate independently from their national governments. This independence is what endows monetary policymakers with the ability to act in times of economic strain while elected officials, hemmed in by unyielding partisan constraints, bicker haplessly on the sidelines. Increasingly, though, a taskmaster of an entirely different stripe has dominated the deliberations of monetary mandarins. Global asset markets were the unseen, but very much felt, presence in the room when the Fed convened this year to debate policy actions in January (China-sparked stock market correction), March (post-correction nerves) and June (Brexit). Asset sensitivity has been no less on the table for deliberations in Frankfurt, London and Tokyo.

The perceived reluctance of the Fed and other central banks to “provoke” risk asset markets into tantrums has drawn criticism from observers who see the bankers’ dependence on asset price movements as unhealthy and likely to end badly. Perhaps the most telling evidence of this phenomenon is in the chronic gap between the short to intermediate term interest rate projections of central bankers themselves and the market’s own take, from spot rates at the short end of the curve to Fed funds futures projections around upcoming FOMC outcomes. This week offered some evidence that the bankers may be trying to strike back. We’ll know more in the coming weeks about how much of this is posturing and how much is actual policy.

Super Mario Stands Pat

In the same week when the electronic form of Super Mario took the leap onto Apple’s new iPhone 7, real-life ECB chairman Mario Draghi chose, not only not to move, but not to say anything about not moving. The former was not a surprise; not many observers expected the ECB to announce an expansion of its current €80 billion per month bond purchasing program. But there was a general sense that Mr. “Whatever It Takes” might give a verbal nod in one or both of two ways: to extend the term of the current program from March to September of next year, and/or to indicate a widening of the eligible asset pool for ECB purchases. That second issue may be in any event unavoidable, given supply constraints on the amount of available debt under current eligibility rules.

Nothing in any way explicit, though, came from Draghi. Slumbering Eurozone bonds were suddenly jolted out of their summer reverie; the 10-year Bund yield is actually positive for the first time in many weeks. Flummoxed investors now wonder if the ECB’s silence portends something more profound; namely, an incipient declaration by central bankers that fiscal policymakers need to join the team, and meanwhile short-term asset prices be damned.

On Deck: Janet and Masahiro

Are bond yields overreacting to the ECB’s absence of verbal cues? It certainly would not be the first time. A less dramatic reading of Thursday’s meeting would simply be that Draghi’s stimulative inclinations haven’t changed at all, but that he still has work to do in bringing a likely reluctant Bundesbank on board with any expansion to the current framework, either for an extension or for a widening of the eligible asset pool. We imagine it likely that yields may fluctuate back and forth over the next ten days or so, driven more by tea leaves-reading than anything else. Both the Fed and the Bank of Japan meet in the first half of the week after next. We have made it clear in recent commentary that we see a vanishingly small chance that the Fed would actually raise rates in September, given the general absence of a need to do so and the charged political environment into which such a move would be made.

A string of recent musings by Fed officials, though, and most recently that of the normally dovish Eric Rosengren of the Boston Fed, has kept the Fed’s September meeting very much in the center of market chatter. Coming as it did on the heels of Draghi’s silence yesterday, asset markets are repricing expectations. In particular, Rosengren offered shades of Alan Greenspan *circa* 1996 with a reference to the dangers of “ebullient” asset markets in a

climate of perpetually low rates. We should note, though, that while Rosengren got most of the headlines his was not the only view in circulation today; fellow FOMC voting member Dan Tarullo offered a more cautious observation, based on the same available empirical data informing our own recent opinions, that there is still enough slack in overall growth and price targets to not necessitate immediate action.

If the Fed does move on 9/21 – and we still do not think it will – we would see that as genuine evidence that a concerted declaration of independence is at hand. Our view would be bolstered further still if the currently very hard to read Masahiro Kuroda and his colleagues at the Bank of Japan signal at their meeting an intent to back off further forays into negative interest rate territory.

Fight or Flight?

More interesting still, though, would be the central bankers' reaction to what could be a very nasty aftermath in those asset markets spurned by the bankers' attempt at liberation from their clutches. How steely would the resolve of Janet, Mario and Masahiro be in the face of a violent spasm in equity and other asset markets? After all, it's not like elected politicians and their fiscal policy executors are waiting in the wings, ready to swoop in with their own pragmatic solutions to our economic problems. Nor is there much evidence of the kind of robust organic economic growth that could get asset prices back on track after an initial swoon. Are central bankers really ready to cut the cord and see how markets survive in a world of diminished stimulus? All verbal (and non-verbal) Kabuki aside, we don't imagine they will be inclined to tempt fate.

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