MV CAPITAL MANAGEMENT

Weekly Market Flash

What We Learned from Policy Week

September 23, 2016

The tumult and the shouting dies, the Captains and the Kings depart. Rudyard Kipling's 1897 "Recessional" comes to mind as we contemplate the remarkably quiet aftermath to September's much-hyped marquee policy events. Yes, there was a frisson of excitement in equity markets after the Fed lived up to its reputation as the definitive cautious, controversy-avoiding institution of our time. And the yen went hither and yon in the immediate aftermath of the latest blast of new policies from the Bank of Japan.

But as the brief tumult subsides, the S&P 500 is back in its July-August corridor while the VIX has crawled into yet another low-teens slumber. The yen, meanwhile, has blithely brushed aside any notion of bite in the BoJ's bark and is resuming its winning ways to the consternation of the nation's policymakers. September is not yet over. With just one week left, though, this oftentimes fearsome month appears poised to go quietly into the night. So is it smooth sailing from now to New Year's Eve? Is the overhang of policy risk off the table?

Dissent and Stern Words

We start with the Fed, where the policy debate was a simple will-they-or-won't-they (we thought the matter was settled some time ago for reasons articulated in previous weeks' commentaries, but still). Chair Yellen pronounced herself happy with the economy and the karmic "balance" of near-term economic risks, and put out a placeholder for December. A pair of hawks (Kansas City's George and Cleveland's Mester) were joined by habitual dove Rosengren of Boston in arguing for moving now.

That higher than usual dissent, along with a reasonable likelihood that headline economic numbers won't deliver much in the way of surprises in the coming months, does raise the likelihood of a December move. In the absence of some global shock manifesting itself between now and the December FOMC meeting, in fact, a 25 basis point move would be our default assumption for the outcome of that meeting.

Unlike last December, though, when a quarter-point move led the way into a sharp risk-off environment in January, we think the Fed could get away with a move without roiling markets. The difference between this year and last? Those silly, yet telling, dot-plots showing where FOMC members see rates one, two and more years down the road. Last year, the consensus view was a Fed funds rate of 3.4 percent by the end of 2018. Reality took a bite out of that, though, down to what is now a 1.9 percent end-2018 view. In fact, apart from two outliers (anyone out there from KC or Cleveland? anyone?), nobody sees rates going above 3 percent for as far ahead as the eye can see. A benign, historically low cost of capital world appears to be our collective future.

The Drunk Archer

If there is a fly in the balm, though, the identity of that fly may well be the other party heard from in Policy Week. The Bank of Japan gave no clear indication going into deliberations as to what it intended to do. On the other side, it left no clear consensus as to what its flurry of policy measures actually meant: was it stimulative, or neutral, or maybe even restrictive in its practical implications? At least one clear winner emerged: Japanese financial institutions. By not further lowering already-negative interest rates, and adding a twist to the current QQE program likely to favor a steepening of the yield curve, the BoJ is sending a little love to its beleaguered member banks. The Topix Bank index jumped about seven percent in the aftermath of the announcement.

The problem with anything the Bank of Japan says, though, is that it has a credibility problem. That problem was very much on display with the other main platform of the Wednesday policy announcement, namely the stated intention to overshoot the longstanding two percent inflation target. The Bank hopes that by explicitly targeting an inflation rate higher than two percent (how high? not clear) it will finally be able to deliver on that monetary policy "arrow" in the original Abenomics blueprint: pull the economy out of its chronic flirtation with deflation.

The problem is that inflation in Japan has been nowhere near two percent for a very, very long time. The idea that a new mindset of inflationary expectations could suddenly take hold to reverse this longstanding trend is extremely hard to take seriously. To use the "arrow" metaphor of Abenomics, it's as if a stone-cold drunk archer, wildly shooting at and missing a bulls-eye target, decides that the best way to hit the target is to move it even further away! It will take more than words to convince markets of any real change to Japan's price environment – as evidenced by the yen's prompt return to strength in the second half of this week.

Credibility Risk

Hence that "fly in the balm" comment we made a couple paragraphs above. The main risk we see in asset markets today is the credibility risk of the central banks that collectively have been holding things more or less together since the Great Recession. Lose that credibility and you lose a lot. Japan's economy has been stagnant for 26 years, and policymakers there are still throwing pasta at the wall to see what sticks. In the absence of either normal levels of organic economic growth or intelligent economic policymaking by national governments, a loss of confidence in the ability of central banks to deliver effective monetary policy is not something we can afford to indulge. This is not a risk we see as likely to actualize in the very near-term, but it is a key concern looking ahead to next year and beyond.

Masood Vojdani
President & CEO

Katrina Lamb, CFA
Head of Investment Strategy & Research

Investment Advisory Services offered through MV Capital Management, Inc., a Registered Investment Advisor. MV Financial Group, Inc. and MV Capital Management, Inc. are independently owned and operated.

Please remember that past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product (including the investments and/or investment strategies recommended or undertaken by MV Capital Management, Inc.), or any non-investment related content, made reference to directly or indirectly in this newsletter will be profitable, equal any corresponding indicated historical performance level(s), be suitable for your portfolio or individual situation, or prove successful. Due to various factors, including changing market conditions and/or applicable laws, the content may no longer be reflective of current opinions or positions. Moreover, you should not assume that any discussion or information contained in this newsletter serves as the receipt of, or as a substitute for, personalized investment advice from MV Capital Management, Inc. To the extent that a reader has any questions regarding the applicability of any specific issue discussed above to his/her individual situation, he/she is encouraged to consult with the professional advisor of his/her choosing. MV Capital Management, Inc. is neither a law firm nor a certified public accounting firm and no portion of the newsletter content should be construed as legal or accounting advice. A copy of the MV Capital Management, Inc.'s current written disclosure statement discussing our advisory services and fees is available for review upon request.