

VIEWPOINT

The Central Banking Moment of Truth

BRIAN SMITH | MARCH 11, 2016

*“You must unlearn what you have learned.
Try not. Do. Or do not. There is no try.”
-Yoda*

We have reached the point where central banks not only have to deliver expectations, but they also have to promise the moon. Failure to do so results in a punishing response by financial markets. Evidence of this can be seen in recent market reactions in Europe and Japan, where central bank actions had the opposite of their desired effects. One interpretation is that this was the result of poor communication. The alternative is that central banking stimulus is approaching its limits. The truth is likely somewhere in between.

Mario Draghi’s Nightmare:

On March 10th, Mario Draghi announced that the European Central Bank (ECB) would further lower its deposit rate to -0.40%, expand asset purchases to \$80 billion per month from \$60 billion, and employ a 4-year lending facility to further pass on the benefits of the negative deposit rate. This combination far surpassed expectations, leading most to anticipate a “beneficial” market reaction in the form of a weaker Euro and higher European equities.

Then Mario Draghi stated in the press conference that he “doesn’t anticipate more rate cuts based on current view.” This is the central banking equivalent of giving your significant other a more expensive necklace than they wanted for Valentine’s Day but saying that going forward they will never get anything ever again – the necklace is a sunk cost, yet they leave more disappointed than before!

Accordingly, the intraday market reaction was ugly – European equities reversed down almost 5% from their pre-statement levels and the Euro strengthened meaningfully. While this move was partially reversed by the end of the week, markets no longer are demonstrating calm reactions to the central banking medicine being provided.



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Japan – Land of the Rising Yen?

In late January, Japan experienced a nearly identical market reaction when the Bank of Japan (BOJ) surprised markets by moving to negative deposit rates. Despite only going slightly negative within a tiered system, Governor Kuroda surely expected markets to welcome this abnormal monetary policy action by weakening the Yen and lifting Japanese equities in traditional “risk-on” fashion. Markets did the opposite. The Yen rallied 6% versus the dollar and the Nikkei dropped meaningfully lower.

There are two interpretations of these surprising recent market reactions in Europe and Japan.

First Interpretation – No Half Measures:

Markets do not appreciate half measures. Central banking actions have the most market impact when they come without limits. If a central bank puts a self-imposed or implicit limit on its program, then the market sees through this and price straight to the end-game.

The U.S. Federal Reserve’s QE1 and QE2 programs both were capped in magnitude and duration, and proved insufficient. It was only when the Fed employed “unlimited QE” that they were ultimately able to exit from the program, as the market did the heavy lifting for them. Even Mr. Draghi, himself, had previously demonstrated the power of unlimited promises with his statement in 2012 that the ECB will do “whatever it takes” to preserve the Euro.

Past central banking modus operandi has therefore to present overwhelming strength and coerce the market into going where the central bank desires. At the end of the day, going against central banks was like betting against the house in that they have a theoretically unlimited balance sheet.

The recent Europe and Japan market reactions may therefore have simply been communication errors. If Draghi had reiterated that the ECB was prepared to act as needed, maybe the market would have responded as expected. If Kuroda had coerced a more unanimous BOJ vote (instead of a close 5-4) combined with strong language of deeper negative rates to come, maybe the Yen would be 10% weaker.

Then again, maybe not.

Second Interpretation – The Gig is up:

If the manager of the house accidentally exposes that the house does not have an unlimited bankroll behind it, then the game has changed. The house is no longer unbeatable, and free market must determine accurate asset pricing. When central banking actions produce not only diminished results, but the opposite results of what was intended, the next move becomes increasingly unclear.

Global central banks appear to be increasingly reaching the end of their ability to influence markets.

Furthermore, if overwhelming monetary policy is not achieving its desired results, how can central banks ignore the pernicious side effects of increasing wealth inequality, overleveraged corporations, and obscured free market clearing levels? For fiat-based currencies founded on trust, this is a problem.

Central banks are, of course, mandated to pursue their economic growth and price stability objectives. Yet, increasing public criticism and market rejection of their actions going forward should cause their actions to be more half measured in nature, and thereby less effective.

Maybe the monetary policy safety net gig is up.

How Does This Affect the Fed & the U.S.?

The United States is clearly in a much better economic situation than most of the rest of the world. The jobs market is robust, the housing market has largely recovered and core inflation measures are finally trending higher. The Fed is therefore currently deciding how aggressively to hike and not focus on negative rates or additional QE.

Overseas rejection of central banking policy action is an extremely meaningful development however. To the degree that negative rates and expanded balance sheets are being called into question globally, it makes it increasingly unlikely they will be pursued by the world’s reserve currency in the event of a future economic downturn. While the Fed will surely posture that it has unlimited ammo to combat any future recession, in actuality, its willingness and ability to do so may be greatly reduced.

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Applications to Portfolio Management:

If central banks start to back away from overwhelming monetary policies, then global financial markets must be viewed from a completely different perspective.

Specifically, investors should expect heightened volatility and be cognizant of wider deflationary tails. Fundamentals should also take on increasing significance. If fundamentals were to deteriorate into a recession, “breakable” asset classes will have nothing to support them and will see significant price corrections. Asset classes that are “bendable” will fair slightly better, but “safe-haven” asset classes may be the only assets spared in a rejection of central banking omnipotence.

From a broader portfolio perspective, there is still a place for actively-managed bond funds in any investors’ portfolio despite low yields. While yields may appear paltry compared

to pre-2008 levels, this does not mean that they cannot go substantially lower in the event of weakening economic fundamentals amidst reduced capacity for central bank support – as evidenced in Europe and Japan.

A Whole New World:

With close to \$7 trillion of government debt trading at negative yields globally, this is clearly not the investing climate of the past. Do central banks simply need to communicate better or do they need a complete rethink of their monetary policy tools? This is the key question for global central banks. Against this backdrop, next week’s Bank of Japan and U.S. Federal Reserve meetings will be very intriguing. The moment of truth is rapidly approaching.

*“Truth is like the sun.
You can shut it out for a time,
But it ain’t goin’ away.”*

-Elvis Presley



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