Cazenove Capital

Moving on… five year anniversary of Mr Draghi's "whatever it takes"

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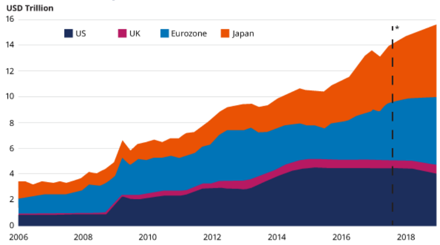
Against the backdrop of duller business cycles and at times mixed signals from economic data, financial markets have become increasingly sensitive to remarks and speeches from policymakers. An interesting development recently emerged in Sintra at the European Central Bank (ECB) Forum on Central Banking. Surprisingly, the event was marked by the emergence of a more hawkish tone in the rhetoric of the major central banks, a seemingly deliberate and coordinated act. Mr Draghi of the ECB and Mr Carney of the Bank of England both made hawkish remarks despite being renowned for their accommodative bias and inflation tolerance.

The beginning of an end of ultra-loose ('unconventional') monetary policy started with the Federal Reserve's (Fed) Quantitative Easing (QE) taper in 2014. More obviously, the process of interest rate normalisation began at the end of 2015, and to date, the Fed has raised four times. Thus, the Fed has taken the lead in policy normalisation, reflecting the economy's more mature position in the business cycle (certainly when compared to the eurozone, although not perhaps in relation to the UK) with other major central banks remaining in wait-and-see mode. In July, the Bank of Canada becomes the first Group of Seven (G7) central bank to join the Fed in raising rates in the current cycle, the first time it had changed rates since 2010. With synchronised global growth being a key macro theme this year, the question is whether synchronised policy normalisation will emerge as well. We think the bottom line is that the period of exceptional monetary stimulus is coming to an end and interest rates are going up, albeit gradually.

Value of assets in major central banks' balance sheets



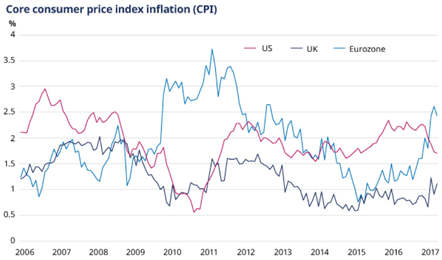
Source: Datastream.*Forecasts from Schroders.

US

The Federal Open Market Committee (FOMC) raised rates as expected and kept rate projections largely unchanged in June, attributing the downward drift in core consumer price inflation (CPI) to transitory factors. Fast forward a month, Fed Chair Janet Yellen's testimony to the Congress revealed greater uncertainty over the future course of core inflation as it continues to run below the committee's 2% longer-run objective. Mrs Yellen emphasised inflation as a key uncertainty and so too fiscal policy. She said that there is "uncertainty about when – and how much – inflation will respond to tightening resource utilization" and that this will remain a key focus for the Fed in the near term. This remark reflects the uncertainty caused by continuing weak wage growth despite robust employment gains and rising recruitment difficulties. The bottom line is that a gradual pace of policy normalisation is likely to remain the direction of travel but that lower inflation is receiving closer scrutiny, and any further weakness may lead the FOMC to hesitate in its projected normalisation process.

Following its June meeting, the Federal Reserve shed more light on potential balance sheet normalisation, and something that also received attention in Mrs Yellen's testimony. If economic data evolves as expected, "quantitative tightening" will likely be announced as early as in September. The reduction in QE will be done in a gradual way, achieved by not reinvesting a small portion of the monies received from maturing assets. Nonetheless, even though the Fed anticipates reducing the quantity of reserve balances to a level that is below current levels, reserves will remain considerably higher than before the financial crisis.

Core consumer price index inflation (CPI)



Source: Datastream

Eurozone

In an interesting development, Mr Draghi's speech at Sintra prompted markets to focus on the possibility of a turning point in monetary policy in the Eurozone. There was a decisive change in Mr Draghi's tone when compared to his renowned "whatever it takes" speech at the height of the Eurozone debt crisis. Five years on at Sintra, he said "as the economy continues to recover, a constant policy stance will become accommodative, and the central bank can accompany the recovery by adjusting the parameters of its policy instruments – not in order to tighten the policy stance, but to keep it broadly unchanged".

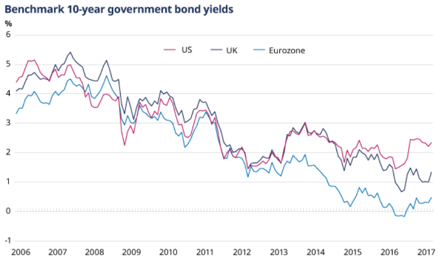
On the economy, Mr Draghi sounded upbeat: "all the signs now point to a strengthening and broadening recovery in the Euro area" and that "deflationary forces have been replaced by reflationary ones". Indeed, the cyclical recovery in the Eurozone has become more robust with first quarter GDP growth outpacing that in both the US and the UK. Importantly, growth is now more broad-based in terms of regions and sectors. Behind this, business activity indicators have risen to their best level in six years and consumer confidence has surged to the highest level in 16 years. At the same time, political headwinds have turned into tailwinds and conditions in the labour market have continued to improve.

Despite this better growth momentum, core inflation has remained subdued and at a rate that is around half of the ECB's 2% target. Despite the better position of the real economy, renewed weakness in oil prices and persistent structural issues may well cause the ECB to reconsider its apparent shift in thinking towards policy normalisation. The bottom line is that ultra-accommodative measures are no longer justified, but the ECB is likely to change its stance only gradually and cautiously.

UK

The debate on monetary policy normalisation in the UK is complicated by the trade off between weaker growth and overshooting inflation against the backdrop of Brexit uncertainty. Despite further evidence of a slowdown in real wage growth and heightened uncertainty after the general election, the Monetary Policy Committee (MPC) surprised markets with only a 5-3 vote on keeping policy unchanged in June. After the Bank of England (BOE) Chief Economist suggested that a policy change might be appropriate in the second half of the year, Mr Carney's remarks at Sintra fuelled further speculation that the BOE has started moving closer to a rate increase. Mr Carney said "some removal of monetary stimulus is likely to become necessary if the trade-off facing the MPC continues to lessen and the policy decision accordingly becomes more conventional".

Benchmark 10-year government bond yields



Source: Datastream

While we acknowledge the high chance that Bank rates will rise by the end of the year, we think the bar for policy normalisation remains high. Any decision to hike rates will be contingent on the extent to which weaker consumption growth is offset by other demand components and also on how the UK economy reacts to tighter financial conditions and Brexit negotiations.

So far, there is little evidence that net trade and investment will move the dial as much as hoped, and recent figures for industrial production and trade have looked disappointing. A potentially weak second quarter GDP report and a slight (albeit probably temporary) reduction in inflation may dissuade the more hawkish MPC members from continuing to vote for a rate rise.

Notwithstanding the intense debates that are clearly underway within the walls of the world's central banks and continuing reluctance to risk stifling growth, our take is that the debate on synchronisation in monetary policy normalisation is heating up. Despite forward guidance and communication from central banks, developments over recent weeks suggest that bond markets have not fully discounted the potential mood change, giving rise to the possibility that bond yields could rise sharply. We know from past experience that expectations can adjust quickly, and investors should be increasingly aware of the risks in fixed income.