Weekly Insight

Has central bank wizardry run its course?

Financial markets are increasingly focussed on the diminishing effects of the ongoing attempts by central banks to restore growth and inflation. The focus most recently has been on the Bank of Japan (BoJ), which was one of the first major central banks to enter into negative interest rates in January this year. Yet the impact of this policy to date has been limited, and some may argue in fact counter-productive, given the continuing negligible levels of growth and inflation in Japan.

However, it is not just in Japan where central bankers appear flummoxed. Despite nearly eight years of near-zero levels of interest rates, the US economy has not seen a meaningful acceleration in growth in the post-crisis years. Similarly, in Europe and the UK rates of growth are far below historic norms. Investors are now questioning whether ultra-accommodative central bank policies - emergency measures implemented after the Financial Crisis in 2008 - are now exacerbating the problem rather than offering a remedy, a scenario that previous Federal Reserve Chairman Ben Bernanke called the ‘’benefit, cost and risk’. To highlight some of the challenges:

- Abundant central bank liquidity seems to have had a marginal impact on the real economy. Critics will argue it has pumped up capital markets to unwarranted levels, thereby benefiting the rich who largely hold those assets and amplifying income inequality even further.

- Actual inflation and inflation expectations remain low and are falling in some economies such as Japan. Ultra-low interest rates appear to discourage investment, leading to a ‘hoarding’ effect among consumers and companies. Cheap money is all well and good, but there has to be demand for it.

- Aggressive quantitative easing (QE) – central bank asset purchase programmes – diminishes future returns across asset markets and leads to a likely long term misallocation of capital. ‘Zombie’ companies (those that might otherwise not survive were it not for ultra-low interest rates) were once talked about only in Japan but there are worries that this may be a more general phenomenon across developed economies, exacerbating oversupply and general lack of pricing power.

- QE depresses longer term interest rates, presenting challenges for pension funds and insurers to meet future liabilities. This is a particular problem across developed economies grappling with ageing populations.

- Negative interest rates have a damaging impact on commercial banks’ profitability, hindering their ability to raise short-term deposits. These funds would otherwise be used to seek profit by lending at a higher long-term rate. This constraint on bank lending effectively represents a tightening of financial conditions.

- Currency volatility is being encouraged, but not always in a way reflecting a central bank’s specific objectives. This has most clearly been seen in Japan where negative interest rates have not had their desired effect. The yen has strengthened 15% on a trade-weighted basis since January and this has hurt large-cap exporters, contributing to weaker economic activity. In the eurozone too, the currency has been relatively stable on a trade-weighted basis, and now European Central Bank policymakers are more focussed on generating credit growth rather than boosting external demand.

- Liquidity is likely becoming a bigger risk in bond markets. Bond prices have seen more price volatility over the past couple of years, albeit in isolated episodes. This has been particularly evident in Japan in the past few weeks, where longer-dated Japanese government bond (JGB) yields have seen sharp price swings relative to recent history. With the BoJ owning nearly 40% of the JGB market [Source: Japan Macro Advisors], there are worries that it is running out of bonds to buy due to the lack of sellers.

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Monetary policy alone will not restore growth and inflation

Growing dissent among central bank policymakers attests to the stresses placed upon them in their efforts to move inflation rates nearer to target. The BoJ's 'yield curve control' policy announced following the September meeting has been positioned as a more forceful approach to lifting inflation. However, this policy, which places a cap on 10-year JGB yields at or around zero to suppress yields at the short-end of the curve, did not met with unanimity. Some may view it as just another measure which prolongs and deepens the monetary policy experiment with unknowable consequences.

Moreover, the US Federal Reserve September policy meeting saw three dissenters who voted for an interest rate rise. The 'hawks' place more weight on the inflation outlook, believing that the transitory effects of lower energy prices and a stronger US dollar will diminish. However, others are more concerned about the strength of the overall economy, citing the levelling off of the US unemployment rate in recent months, due to a moderate increase in labour supply, as evidence that further employment gains are needed before the recovery is assured.

What is becoming clear from the various September central bank policy meetings is that central banks are struggling on their own to restore economic growth to a sustainable trend. Hopes were high ahead of the BoJ meeting that the resulting actions would potentially be a game changer. However, in our view, the decisions to place monetary controls on the yield curve and implement a more flexible approach to expand the amount of money in the economy are more evidence that policymakers are running out of productive ideas. Their ability to impact the real economy and to restore inflation is dwindling. Central bank commentary continues to strike a cautious tone. The BoJ has left the door open for additional easing. It is also significant that a data dependent Federal Reserve has revised lower its 'neutral' interest rate – the level of interest rates where the economy is at trend rate.

Ultimately, though, the burden has to fall to governments to administer policies and foster meaningful structural economic change. This will entail piling more debt on already highly indebted government balance sheets. Critics will say that history shows debt on debt rarely works and that governments have a very poor track record of allocating resources efficiently. However, even they would accept that direct government spending has a better chance of ending up in the real economy than current monetary tools. While the baton needs to be passed to governments, this seems only a long-term prospect.

How should investors position their portfolios?

In the meantime, investors are caught between an environment littered with macro uncertainties and one in which asset prices continue to benefit from the slosh of central-bank-induced liquidity. We believe the most prudent strategy is to stay close to neutral in equities, have a bias towards shorter-dated bonds, and to look to other asset classes for alternative sources of returns. At the same time, we are holding ample liquidity to take advantage of further periods of volatility as they inevitably occur.

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Important Information