



Shifting from reflation to the higher yield trade

Central bank liquidity has been a key support for economic activity in recent years. However, policymakers in the US, Europe, UK and Canada have recently signalled their intent to start to (or continue to) withdraw emergency stimulus and normalise monetary conditions. After several years of being part of the solution in helping to avert a global depression following the 2008 Financial Crisis, central bank policymakers are beginning to acknowledge that they now run the risk of being part of the problem, possibly contributing to excesses that have the potential to destabilise future growth. Worries about persistently low interest rates and their impact on the misallocation of capital, which many believe have contributed to growing income inequalities and the dissatisfaction of electorates with political elites, seem to be prompting this shift in narrative.

Whether these rhetorical efforts represent the early stages of a coordinated global tightening programme remains open to debate. In any event, the pace of any tightening being considered is likely to be very gradual and should still leave financial conditions very accommodative. What is evolving, though, at least in the US and Europe, is that policymakers appear willing to overlook recent inflation disappointments, which they see as transitory, and instead are focused on the solidity of global growth. In their view, deflation risks have been defeated and the discussion now shifts to the adjustment of the current policy framework, which has been established for an emergency situation. Meanwhile, policymakers from the Bank of England have emphasised that the tolerance level for above-target inflation (the target being 2%) is at the limit, although we expect this hawkishness might prove short-lived given downside risks to UK growth prospects.

While central banks are likely to proceed carefully to avoid any disorderly market disruption, we have to acknowledge that policy risk is rising. Balance sheet reduction in the US, tapering in Europe and further targeted tightening measures in China could all impact market liquidity and sentiment, despite overall financial conditions still remaining accommodative. These potential outcomes also come at a time when the growth momentum appears to be softening in the US and UK, albeit at the margin. By implication, in the future, the onus would fall to governments to support growth as central banks step back from financial markets.

It remains early days and for now, at least, economic fundamentals continue to support risk asset markets. Nonetheless, more policy uncertainty is likely to add to market volatility and higher bond yields to reflect a less dovish posture taken by many central banks. The marked rise in the 10-year German bund yield at the start of July is a clear symptom of this shifting narrative. We may now be entering a period which is not so much characterised around the 'reflation' trade, but rather the 'higher yield' trade.

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