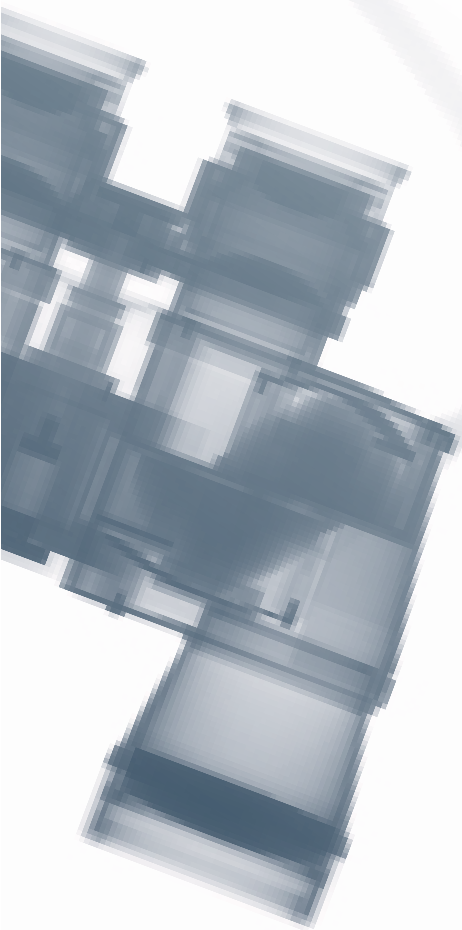
Heartwood Investment Management

15 June 2018

Investment Insight

Weekly Insight



A hawk in dove's clothing

This week saw a swathe of key central bank meetings from the European Central Bank (ECB), Federal Reserve (Fed) and Bank of Japan (BoJ).

On Thursday, the ECB announced the amount of money it intends on printing each month – quantitative easing - would be reduced to zero by the end of 2018. Thereafter it plans on keeping the balance sheet the same. This was widely expected by financial markets. What wasn't expected was ECB President Mario Draghi's comment on interest rates, which he would be held at zero until the summer of 2019 (just before Draghi's term as president ends in October). Monetary policy in Europe is extremely stimulative and is likely to remain so for the foreseeable future. The context is that the ECB is extremely wary of making a policy error having in the past hiked rates twice shortly before major economic events – in 2008 just before the financial crisis and in 2011 just before the European crisis.

In our opinion, Draghi's statement was a masterstroke, communicating a hawkish ambition while simultaneously sounding dovish. The market reaction was lower bond yields, a weaker euro and a rally in equities – in other words a great outcome given the message. While these market moves may not persist indefinitely, the ECB has laid out the future path for monetary policy over the coming year, giving the markets one less thing to worry about. This should be positive for risk appetite.

The ECB wasn't the only central bank to announce a policy change. Earlier this week, the Fed increased rates by 25 basis points, the second hike this year. The indication from the Fed's 'Dot Plot' - a projection of where Fed policy members expect interest rates to be each year - was for no additional rate hikes over this hiking cycle, but the timing of them was moved forward, with now more near-term hikes expected. So far this cycle the Fed has hiked rates seven times – once in 2015, once in 2016, three times in 2017 and twice in 2018 (so far). The Dot Plot suggests there are six more rate rises to go, so on that basis they are just over half way.

Our analysis suggests that Fed policy is close to neutral, i.e. soon to enter into restrictive territory. At the same time, the Fed is reducing the size of the balance sheet through quantitative tightening. A move into restrictive territory is not the end of the world, but is something to be mindful of. It becomes a problem when policy moves into very restrictive territory. The analogy we are fond of using involves a frog in water. If you put a frog in boiling water, it will jump out. If you put a frog in cold water and then gently heat it up, it will stay there and will ultimately perish. The tipping point is when policy becomes overly restrictive, i.e. the water starts to boil! When that happens with Fed policy is debatable, but we don't think it will be this year, our view is more likely the second half of 2019.

In Japan, there was little news from the BoJ meeting. However, in this case 'no news is good news' as the BoJ is comfortable maintaining yield curve control with ongoing stimulus.

All eyes will now be on the Bank of England next week with the Monetary Policy Committee meeting taking place on 21 June. No action on rates is expected, with Brexit uncertainty continuing to play a big role in influencing the Monetary Policy Committee's judgement. Next week we also have the annual ECB Forum in Sintra, Portugal. It will be attended by Mario Draghi, Haruhiko Kuroda, Governor, Bank of Japan and Jerome H. Powell, Chairman, Board of Governors of the Fed, amongst others, so it's quite possible that some further policy tweaks are hinted at.

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Clear Thinking

Contact

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