

RBC WEALTH MANAGEMENT

Global Insight

Focus Article

Dialing back policy stimulus

With many economies on a firm growth footing, central banks think it's time to start to transition policy from extraordinary to ordinary.

Craig Bishop & Alastair Whitfield



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All values in U.S. dollars and priced as of October 31, 2017, market close, unless otherwise noted.



Wealth
Management

Dialing back policy stimulus



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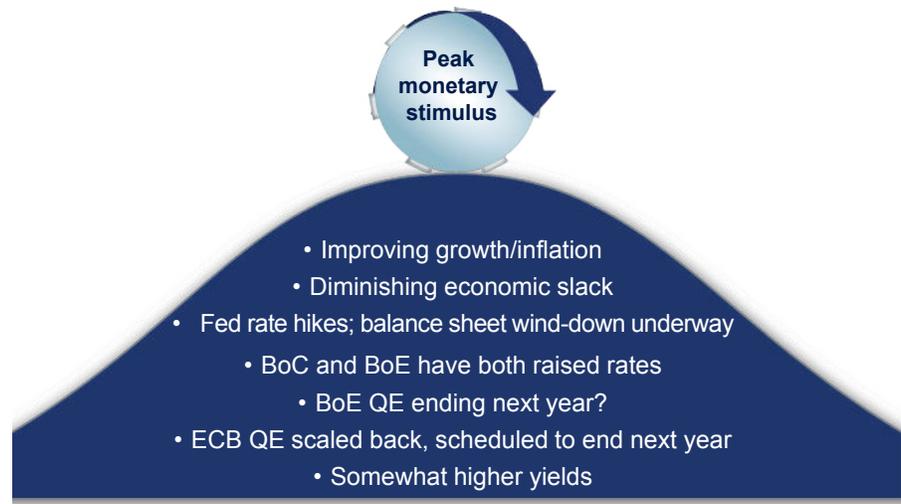
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Years of extraordinary monetary measures have allowed most major economies to regain a firm growth footing. Now a growing number of central banks feel the time has come to gradually return the policy setting to “normal.”

Global central banks used extraordinarily low benchmark rates and quantitative easing (QE) to deal with the impacts from the Great Recession and the European sovereign debt crisis. Now that economic conditions have stabilized central bankers feel it's time to begin normalizing monetary policy.

In this article, Craig Bishop and Alastair Whitfield provide their thoughts on the likely timing and trajectory of Federal Reserve (Fed) and European Central Bank (ECB) actions over the next couple of years.

Monetary stimulus is passing its peak



Source - RBC Wealth Management, RBC Global Asset Management

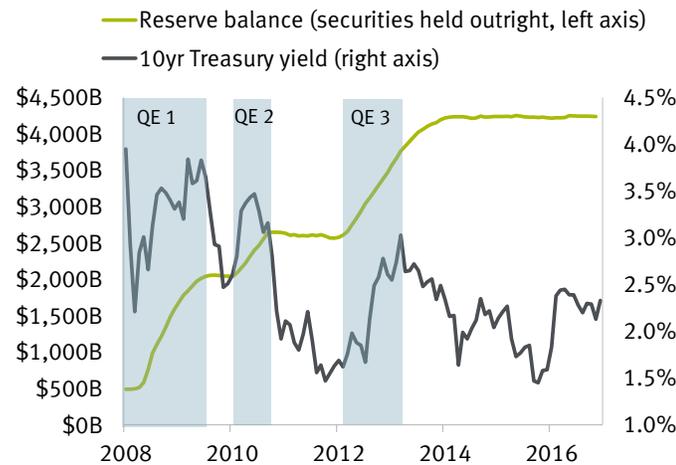
The great unwind

The Fed took short-term interest rates to zero in December 2008, where they remained for seven years. Recognizing that a zero interest rate policy wouldn't be enough by itself to stabilize the flailing U.S. economy, the Fed embarked upon a series of QE measures designed to lower longer bond rates as well as mortgage rates to more stimulative levels. That move increased the size of the central bank's balance sheet to \$4.5T (from about \$900B) over the course of six years (November 2008 to October 2014). In our view, the one-two punch of rate cuts and QE helped to pull the U.S. economy back from the brink and set the stage for its current solid underpinnings.

Dialing back policy stimulus

Once QE ended, the Fed acted to keep the size of the balance sheet near \$4.5T through the reinvestment of principal and interest payments until it judged the economy could stand on its own two feet. In the Fed's view, that time has arrived, and in October it began to unwind the balance sheet by not reinvesting all of the principal and interest payments it received that month. That amount left uninvested each month will taper higher over the next several quarters. Ultimately, reduced reinvestment and security maturities should result in an approximate \$2.0T–\$2.5T balance sheet. Due to the Fed's preparation, we don't expect this policy shift to be disruptive.

QE cycles and rate movements



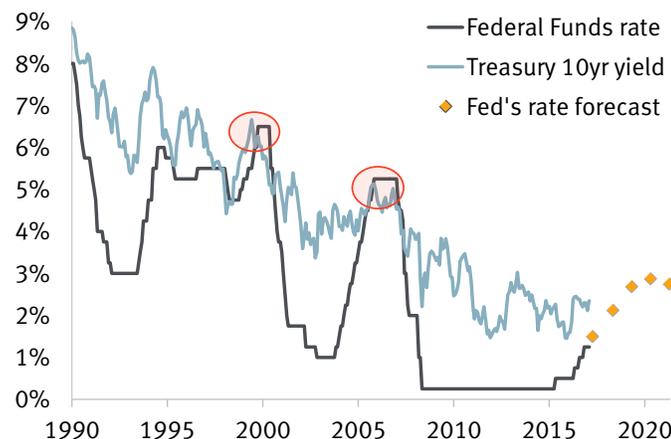
Past QE programs have corresponded to higher, not lower rates, as macro factors outweigh Fed demand changes.

Source - RBC Wealth Management, Bloomberg; data through 9/30/17

Rates – Fed on a mission

The Fed has been battling market expectations regarding its plans for raising interest rates since monetary policy normalization began in December 2015. It is not surprising the market remains skeptical of the Fed's forecasts given the four rate hikes forecast for 2016 turned into just one last December. But this year policymakers have stayed on track, with a likely rate hike next month fulfilling the Fed's three-hike projection from the beginning of the year. To us, the willingness

10yr yield typically restricted by peak Fed Funds rate



The Fed's long-run Fed Funds forecast of 2.75% could keep a ceiling on the 10yr yield.

Source - RBC Wealth Management, Bloomberg, Federal Reserve Forecasts; data through 10/5/17

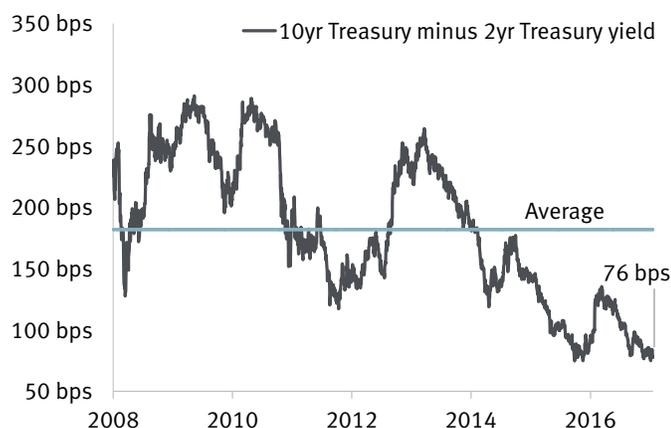
of the Fed to move ahead despite stubbornly low inflation—as measured by core Personal Consumption Expenditures (which exclude volatile food and energy prices) at 1.3%, well below the Fed’s 2% target—indicates a shift in attitude at the bank. The plan now, reading Fed Chair Janet Yellen and other officials, assumes inflation will reach the Fed’s target in the near term and they would rather act pre-emptively than wait for inflation to overheat. It is important to consider where Fed Funds settle when the Fed is done as this could determine the level on 10Y Treasury yields. In past hiking cycles, short- and long-term rates tended to converge at the terminal Fed Funds rate, and based upon the current “dot plot” (the projected path of short-term rates), it could be approximately 2.75% this time around.

Yield curves – Flatter for longer

The predictive power of yield curves has been on investors’ minds recently as the Fed’s rate hikes coupled with low inflation have combined to flatten the U.S. Treasury curve. The current 2Y/10Y Treasury difference is 76 basis points (bps), and the average since 2008 has been about 180 bps. Since December 2015, 2Y Treasury yields have increased 50 bps, while 10Y Treasury yields are higher by 4 bps.

Briefly, steep curves typically are seen as indicating an expanding economy; they also widen banks’ net interest margins and increase their appetite for lending. An inverted curve indicates the opposite, a slowing/recessionary economy as bank lending policies become more restrictive. Flatter curves have fanned recession fears, but, in our view, they more reflect current market dynamics of slow growth, inflation below the Fed’s 2% target, and steady, but gradual monetary policy normalization. To us this means the curve might even flatten further as short and long rates converge upon the terminal Fed Funds rate (see above) over the next two years. We do not yet see a recession on the horizon.

Further curve flattening likely as Fed tightens



Rising short-term rates from the Fed are likely to keep a lid on growth and inflation, pushing the yield curve flatter.

Source - RBC Wealth Management, Bloomberg; data period 10/14/08 – 10/31/17

Fiscal plans – Still waiting

Donald Trump’s election victory boosted hopes for a quick passage of his pro-growth agenda in the Republican-controlled congress. With Fed Chair Janet Yellen noting on several occasions the importance of fiscal policy and monetary policy to stimulate growth, expectations were high. Now, one year later, markets are still waiting and though currently buoyed by hopes for a grand tax reform plan, we believe the ultimate package will underwhelm growth projections, and tax reform

Flatter curves have fanned recession fears, but, in our view, they are more reflective of current market dynamics.

Powell will most likely continue with the slow and gradual pace of interest rate hikes, which has the market breathing a sigh of relief.

will become more modest individual and corporate tax cuts with a delivery date sometime in 2018.

Changing of the guard at the Fed

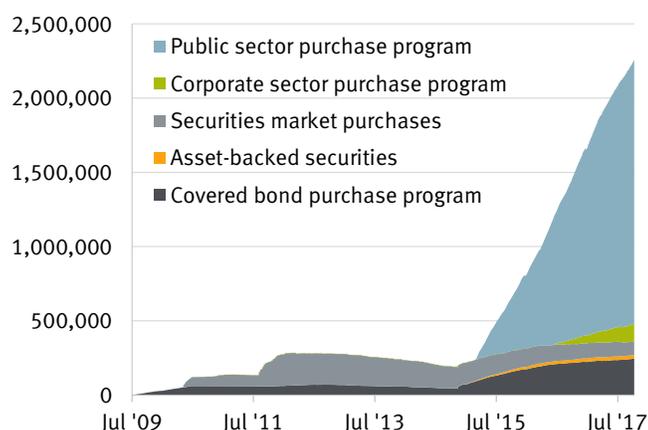
On the campaign trail, candidate Trump expressed his displeasure with Yellen even though his pro-growth agenda would likely benefit from current Fed policy. Despite the president saying Yellen has done an excellent job, Trump nominated current Fed Governor Jerome Powell to replace her as chair. Like Yellen, Powell will most likely continue with the slow and gradual pace of interest rate hikes, which has the market breathing a sigh of relief following speculation that Stanford University Professor John Taylor could be the next chair, as he was expected to be notably more hawkish with monetary policy. The bigger difference between Yellen and Powell lies in their stance on regulation of the financial services industry. Powell has stated that he is in favor of Dodd-Frank regulation and bank capital requirements enacted following the financial crisis, but notes that “we can do it more efficiently.” Powell also will likely look to reduce the regulatory burden on the small and mid-sized banks that felt the largest negative impact from financial crisis era reform.

Stealthy unwind in eurozone

The ECB’s gradual unwinding of its QE program is already underway. The central bank has increased the size of its balance sheet by more than €2T since 2009. Additionally, it has maintained a negative interest rate policy (NIRP) since the deposit rate was first reduced to -0.10% in June 2014 and subsequently cut to its current -0.40% level in early 2016.

ECB balance sheet expansion

Euro (in millions)



The ECB’s balance sheet has expanded by over €2T from its various purchase programs.

Source - RBC Wealth Management, Bloomberg; data through 10/16/17

The central bank started a slow unwind when it reduced its monthly asset purchases from €80B per month to €60B last December. In March of this year the language used by ECB President Mario Draghi removed reference to “using all instruments available within its mandate,” and then forward guidance was modified further in June by eliminating “or lower” when describing the future interest rate path.

Dialing back policy stimulus

ECB opts for “lower for longer” QE tapering.

Now the ECB has announced the next stage of its tapering plan with monthly purchases to be reduced from €60B at the end of this year to €30B starting in January 2018. This reduction is consistent with expectations prior to the recent meeting, and was not as aggressive as some economists’ estimates had suggested with the amount to be possibly reduced to €20B. However, despite this tapering process, the unwind is set to remain gradual with the central bank maintaining an accommodative stance toward monetary stimulus.

As mentioned, this was already well flagged and is line with what we have previously seen from the ECB in terms of providing forward guidance so as to minimize unwanted market disruption. Meanwhile, Draghi has remained dovish and indicated that net asset purchases are to continue until at least the end of September 2018, but even beyond if necessary. Additionally, the ECB indicated that it will reinvest redemptions from the purchase programs for an extended period of time and as long as necessary. This confirms the previous rhetoric which has forestalled any anticipatory rise in bond yields, and instead resulted in yields moving lower following the ECB’s meeting. A reduction in monetary stimulus would typically indicate higher interest rates further down the line, which would inevitably push bond yields higher. But this remains absent while the current policy is maintained. The implied probability of a hike in policy rates by the end of 2018 remains low at only 30%.

Germany and France 10yr minus 2yr yields



Expectations for a rate hike by the ECB remain low as seen by the relative lack of change in 10yr minus 2yr yield spreads since the start of the year.

Source - RBC Wealth Management, Bloomberg; data through 10/18/17

We believe the ECB’s cautious stance around potential interest rate hikes is warranted. While eurozone economic data has shown Purchasing Managers’ Index data remaining elevated and GDP maintaining solid momentum, debt-to-GDP ratios are only just beginning to turn lower in the large euro area economies, and trajectories in Spain and Italy still remain vulnerable to any shock in baseline assumptions. Also, investment growth remains sluggish across the region, raising the question whether there will be any change in interest rates before Draghi’s term as president ends in 2019.

Yield curveball

Normally, reduced bond purchases by the central bank would mean that bond prices would weaken and bond yields would rise. Given that the ECB is likely to keep short-term rates very low (probably negative) for some time, that would suggest a steeper yield curve. However, we expect any such steepening will be modest for two reasons.

Dialing back policy stimulus

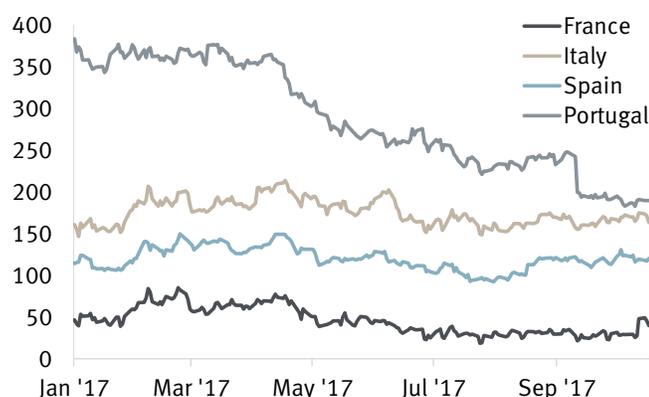
The bank's policy stance is likely to remain net accommodative until inflation ticks closer to its 2% target.

First, bond purchases by the bank have targeted longer-term maturities of peripheral country debt, which has kept the yields on those securities lower than they otherwise would be and restrained yields on core country debt in the process.

Second, bonds previously purchased by the ECB and scheduled for redemption in 2018 are estimated to be approximately €10B per month in 2018 by RBC Capital Markets, making the gross reduction in purchases significantly lower than the headline figure may suggest. Additionally, comments from the recent meeting suggest that these will remain a key feature for some time still.

Moreover, the ECB should be able to resist increasing its short-term policy rate for some considerable time. Despite solid GDP growth, a narrowing of the dispersion in economic performance between countries, and the steady decline in unemployment, there remains sizeable excess capacity keeping wages stable and core inflation low at just 1.1%. The bank's policy stance is to remain net accommodative until inflation ticks closer to its 2% target. Given that the ECB is likely to remain a significant participant in the market for the time being, we do not anticipate a sustained move higher in eurozone bond yields at this juncture.

Euro area 10yr yield spreads remain anchored



Despite talk of a QE unwind, euro area government spreads continue to remain relatively tight.

Source - RBC Wealth Management, Bloomberg; data through 10/18/17

Syncing up

We've focused on the Fed and the ECB in this article, but it can't be ignored that other central banks, such as the Bank of England and the Bank of Canada, are also moving to reduce monetary policy stimulus. So far, however, both are removing extra accommodation put in place to cushion the blow from recent economic and/or political events. Once completed, they will likely begin a holding pattern for future hikes, but we feel with improving global economic fundamentals it is only a matter of time before they too initiate the gradual, deliberate policy normalization process.

The Bank of Japan (BoJ) is likely to be the last to join the normalization party, all the more so given Prime Minister Shinzo Abe's convincing election win on October 22. However, Japan's economy is now growing consistently at 1% or better while the country's chronic deflation has given way to modest but sustained readings above zero. The prospects for more aggressive monetary easing have dimmed considerably and, in our opinion, further progress toward the BoJ's 2% inflation target will eventually begin to push market expectations toward anticipation of this last major central bank scaling back its extraordinary monetary accommodation.

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