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# Central banks in the spotlight



The recent sell-off in equities demonstrated that investors are becoming ever more edgy about the prospect of rising interest rates and inflation. According to Bank of America's Global Fund Manager survey, two of the most prominent fears simmering in markets are; a crash in bonds caused by inflation, and a "policy mistake" by the Federal Reserve (Fed) or the European Central Bank (ECB). From here on out, markets will be increasingly sensitive to any data that indicates inflation is picking up – as we saw on February 2<sup>nd</sup> when rising wage figures in the US catalyzed a global retreat from equities. Investors will also be going through central bank communications

with a fine tooth comb for indications that they are becoming more hawkishly inclined... In the week ahead, communications are anticipated from both the Fed and the ECB.

## The Fed

The Fed is close to achieving its dual mandate of maximising employment and stabilizing prices (with an inflation rate steady around 2%). In January, core price inflation came in at 2.1% (annualized) whilst unemployment is at a 17-year low of 4.1%. The ever-beating drum of positive data is emboldening hawks within the Fed; mainly gradualists who believe monetary policy needs to be normalized in tandem with a normalisation in economic data. If the minutes of the January policy meeting, scheduled to be released on Wednesday, reveal more hawkish undertones, volatility could surge.

The Fed walks a tightrope between acting too aggressively, in a way that curbs growth and potentially ignites a bear market, and on the other hand, there is a risk that it falls behind the curve, allowing inflation and the economy to overheat.

On its path to monetary policy normalisation, the Fed has raised its target for the federal funds rate five times since December 2015 and markets see two rate hikes this year as a 'done deal' with a 50/50 chance of a third.

In the past, when the Fed hiked short-term rates to the point that yields on 2-year Treasuries exceeded those on 10-year notes, the yield curve 'inverted' and a recession almost always ensued. The Fed must be extremely delicate, not only in its actions, but in how it communicates the path for hikes.

Even if the Fed doesn't accelerate its hiking path and observes its current forward guidance, there is a danger that the new Fed Chairman, Jerome Powell, spooks the markets as he traverses a 'communication learning curve'. More significant than the release of the Fed minutes next week, will be Powell's first press conference following the FOMC meeting scheduled for 20-21<sup>st</sup> March.

## The ECB

The strong euro is posing as an obstacle in the ECB's plans to wean the Eurozone of off ultra-accommodative monetary policies. On Wednesday, the ECB will have a non-monetary policy meeting and investors will be attuned to any discussions concerning the euro. Euro strength is thought to be hampering the ECB's ability to get inflation up to its target of 'close to but less than 2%'. A firmer currency tends to dampen inflation by making exports more expensive and imports cheaper. The mere 1.3% inflation rate seen in January stems mainly from a light pick-up in consumer spending and energy costs. Normally, in the past, Mario Draghi, the ECB President has been able to talk down the euro, but it remains questionable as to whether he will still be able to do so amidst rising expectations for tighter monetary policies.

2018 is expected to be a year of higher volatility and acute sensitivity to inflation signals and central bank communications around interest rates. However, over the coming weeks, investors should bear in mind that markets are still bolstered by strong fundamentals. Data points to stronger revenues, margins and multiples to come and there is an opportunity in equity markets to benefit from the end of the cycle. Further, the recent display of fragility in the global sell-off, has served as a strong reminder to central banks that they are really walking on eggshells.

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