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INSIGHT

MONTHLY COMMENTARY

Global Fixed Income Monthly: Dark Room Policymaking

MARCELA MEIRELLES | 15 MARCH 2019

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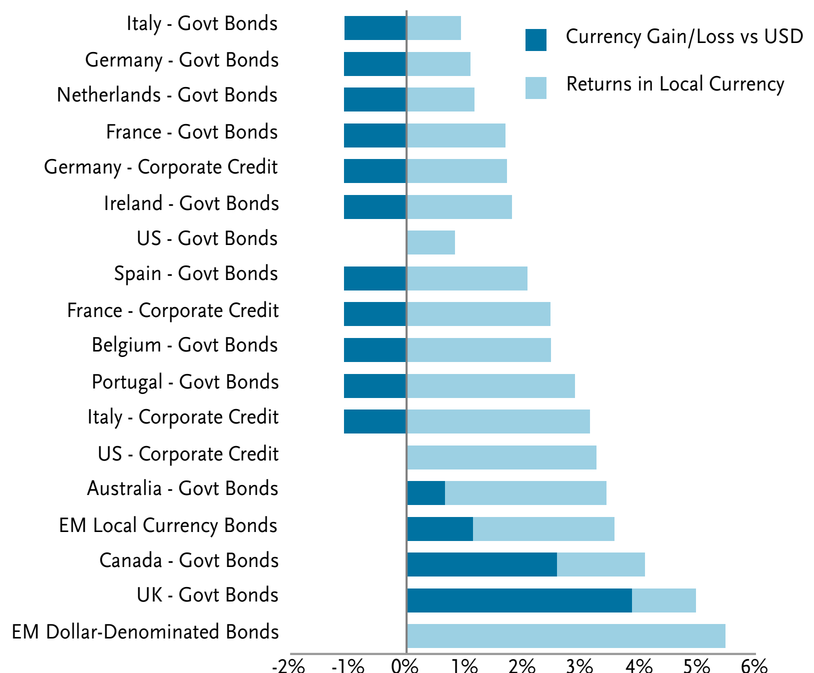
Dr. Meirelles is a Senior Analyst within the Fixed Income group responsible for international nominal and inflation linked bonds; she has been with TCW for over a decade having previously served as the firm's primary Latin America Credit Analyst. She brings the firm strong experience as a former Economist with the Federal Reserve Bank of Kansas City, where she conducted research on inflation targeting and was responsible for the construction of U.S. macroeconomic scenarios. Born and raised in Brazil, Dr. Meirelles was an Economic Policy Advisor for the Brazilian Senate and the Health Ministry of Brazil. Prior to that, she was a Researcher with the Institute of Applied Economic Research (IPEA) in Brasilia. Dr. Meirelles earned her PhD in Economics from UCLA, where her dissertation focused on the optimal design of inflation and fiscal targeting regimes. She holds a Master in Economics from the University of São Paulo and a BA in Economics from the University of Campinas, Brazil. She is a CFA charterholder.

Central bank policy communication has lately been peppered with frequent references to moving in a poorly lit environment. Speaking at the Economic Club of New York in late November 2018, Federal Reserve Chairman Jerome Powell compared the exercise of assessing the adequate pace of monetary tightening to walking into that same conference room and all of a sudden the lights went out. More recently, during the Q&A session that followed the March 2019 policy meeting, ECB President Mario Draghi also used the diminished visibility metaphor to describe the current exercise of gradually adjusting monetary policy tools: "in a dark room, you move with tiny steps."

The market read these comments as a step up in a dovish language that signals no rush toward rate hikes. So far this year, this meant a green light to search for yield, with outperformance of emerging market bonds and corporate credit. Italian corporates are among the best performing assets year-to-date, despite a stagnant economy.

Year to Date Returns*



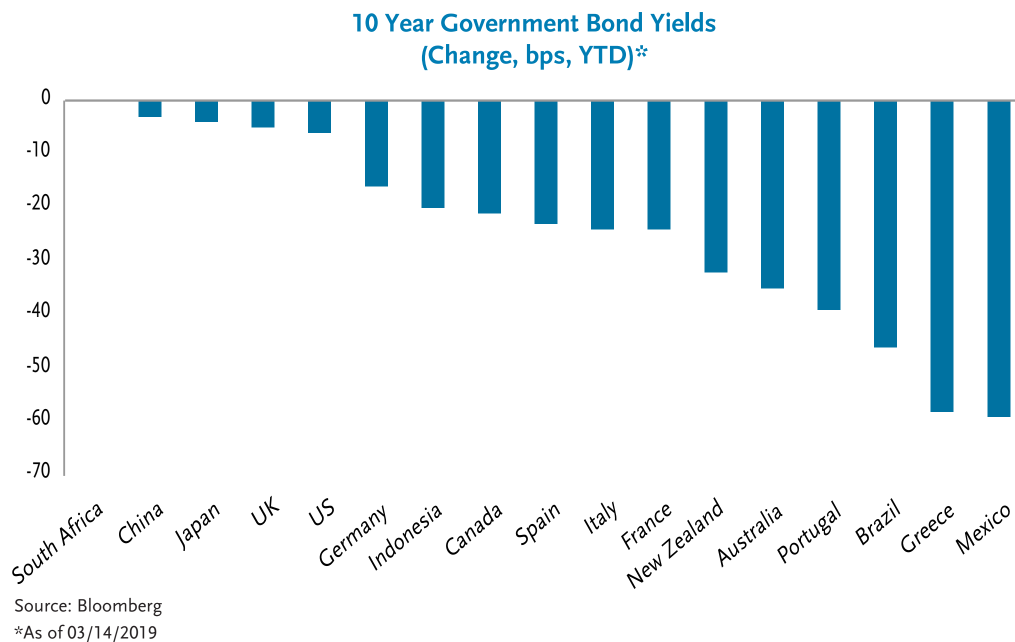
*As of 03/13/2019

Source: Benchmark returns based on JP Morgan EM indices and Bloomberg Barclays Global Aggregate Index

How can we reconcile central banks' caution regarding the activity and inflation outlooks – as captured in their broad based downward revisions of economic forecasts – and outperformance of assets with high global growth beta?

One possible explanation is that central banks' revised economic forecasts have been a "marking to market" exercise that adds little to what investors already knew, which is a global economy facing headwinds related to trade protectionism and excessive leverage but still counting on plenty of monetary policy stimulus. This is particularly true for the case of the modest adjustment by the Reserve Bank of Australia (RBA) to its forecast of real GDP growth in 2019, from 3.25% to 3%, and of core inflation, from 2.25% to 2%. Given the sharp deceleration in household consumption observed over the last few months, which in turn is at least in part explained by a 10% decline in home prices from their peak, a revision of economic projections was already largely expected.

But there is still plenty of evidence that central banks can move markets, so at least some new information is being conveyed. In fact, after years of exceptionally low monetary policy, most of the heavy lifting is being done through communication, in particular by changing the official view on the balance of risks for the economy. The strategy finds support in empirical research: in a paper published last year by ECB staff, researchers discuss how central bank announcements impact the market through two main channels: monetary policy decisions and the information content of the central bank's assessment of the economic outlook[1]. Once again, the RBA provides a good example. A day after the RBA's February monetary policy meeting, Governor Philip Lowe made a speech[2] in which he removed the policy tightening bias of monetary policy, citing more balanced risks to the economic outlook. This fueled a bond rally from already very low expectations of rate hikes, making Australia one of the best performing local treasury markets year-to-date, second only to select emerging markets and periphery Eurozone:



Source: Bloomberg
*As of 03/14/2019

The ECB had already shifted its assessment of the balance of risks, tilting it to the downside. Interestingly, in its last policy meeting, ECB President Draghi kept the emphasis on this language, even after a very significant downward revision of the central scenario for inflation and real GDP growth. The reason, he noted, is that there is only so much monetary policy can do.

1 Marek Jarocinski and Peter Karadi, "Deconstructing monetary policy surprises: the role of information shocks", (ECB working paper series, 2018.)

2 Governor Lowe noted: "Looking forward, there are scenarios where the next move in the cash rate is up and other scenarios where it is down. Over the past year, the next-move-is-up scenarios were more likely than the next-move-is-down scenarios. Today, the probabilities appear to be more evenly balanced.", "The Year Ahead: Address to the National Press Club of Australia", Sidney, February 2019.

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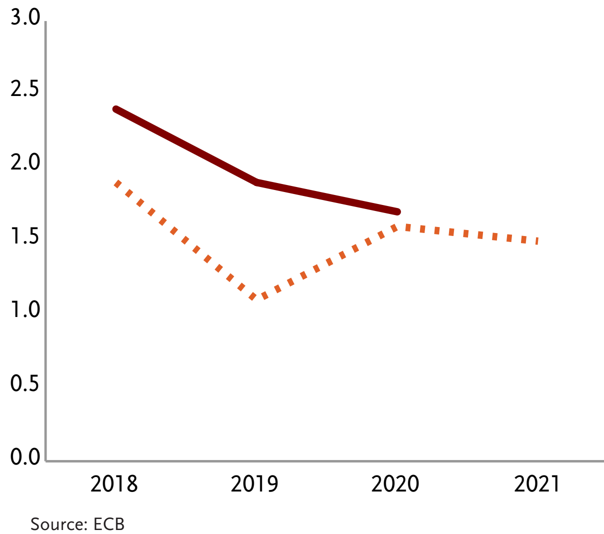
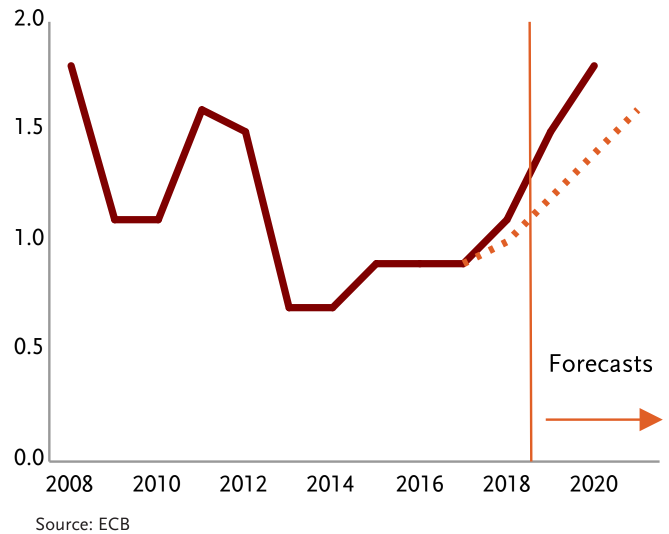
Shock and awe?
ECB Eurozone Real GDP Growth Forecasts



Source: ECB

Still too optimistic?
ECB Eurozone Core Inflation Forecasts



Source: ECB

March 2018 Forecast   March 2019 Revised Forecast

Putting all these elements together, one can try to rationalize a few aspects of market reaction and performance. Patient central banks that, in their own words, are moving in a poorly lit, uncertain global environment are not in a rush to hike rates. This provides the so called Goldilocks environment for high-beta growth assets. But they are also telling the markets that the outlook is definitely less bright and could be even worse than that already expected. This explains the rally in global treasury markets, almost as if these securities worked as a hedge (or at least as a deflation hedge). The balance of risks will tilt one way or another, and one of these strategies will work better than the other. Unsure about which way the pendulum will swing, investors shy away from picking a favorite. ■

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