Buckle Up For a Choppy Ride

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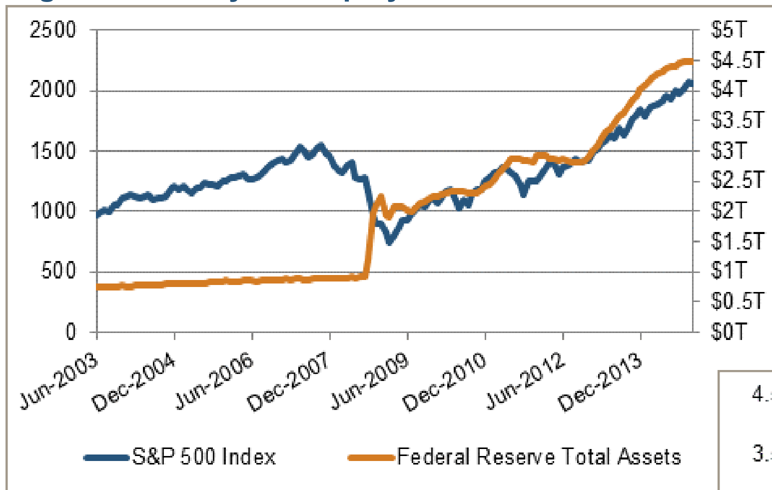
Key Points:

- While the Federal Reserve is moving towards the first U.S. rate hike, the Bank of Japan (BOJ) and the European Central Bank (ECB) are in need of progressive easing to fight deflation.
- Monetary policy divergences, in their current form, can be an obstacle to the success of the reflationary policies of the ECB and BOJ. With the dollar strengthening and oil, as well as other commodities, under pressure, the efforts of ECB and BOJ might turn out to be much less effective than hoped (even if likely needed), especially in absence of structural reforms in Europe and Japan.
- We believe global disinflation is likely to persist, keeping markets nervous about the possibility of episodes of deflation and reducing central bank effectiveness. Periods of heightened volatility are the likely outcome for such uncertainty.

Divergent World

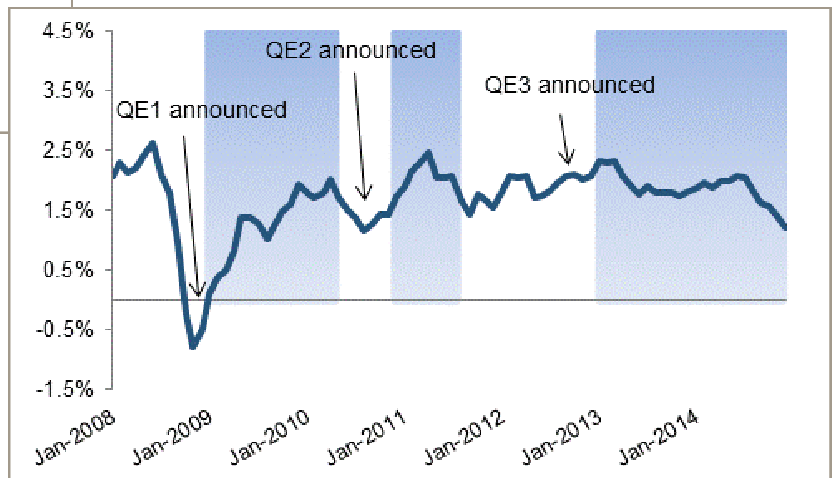
Whether or not it's rational, central banks are one of the main forces driving markets and their expectations; and they are doing so with both words and actions. Arguably quantitative easing (QE) in the United States has been successful in creating a positive wealth effect by contributing to the strong performance of the equity market, and containing inflation expectations (preventing them from falling into deflationary territory).

Fig 1: Fed Policy and Equity Performance



Source: Bloomberg and Federal Reserve
Data as of 12/31/2014

Fig 2: QE, QE Announcements and 5-Year Inflation Breakevens*



Source: Bloomberg and Federal Reserve

*Shaded areas are periods of quantitative easing – periods in which the Fed was actively engaged in large scale asset purchase programs. The blue line represents inflation expectations as measured by 5 year breakevens – breakeven inflation is the difference between the nominal yield on a fixed-rate investment and the real yield (fixed spread) on an inflation-linked investment of similar maturity and credit quality. Data as of 12/31/2014

U.S. growth and inflation should recover to more sound levels, if labor markets continue to improve. Unprecedented balance sheet expansion, as a response to the 2008 crisis, is yielding to U.S. policy normalization which should start at some point in 2015, when zero interest rate policy (ZIRP) will likely become a thing of the past.

On the other hand, threats of deflation and recession are leading other major central banks, like the ECB and BOJ, in the opposite direction, towards additional easing through balance sheet expansion (purchases of assets via monetary expansion). These major central banks find themselves at very different points in the economic cycle and need to implement opposite policies, creating what is referred to as monetary policy divergence.

Divergence might be with us for a while…

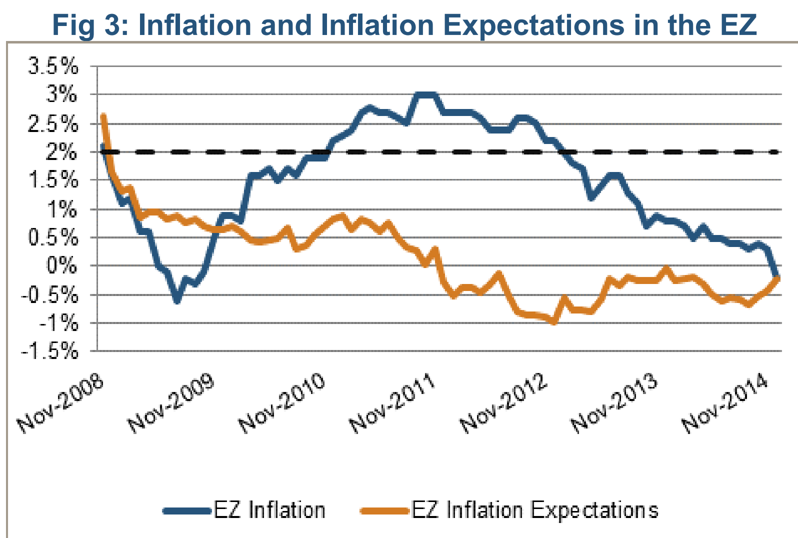
Monetary policy divergence is a theme that will most likely remain front and center in 2015 and beyond, given the outlook for inflation and growth in the Eurozone (EZ) and Japan, and the inherently deflationary structure of those economies.

The ECB has been rather reactive as opposed to proactive in responding to low inflation and growth. Inflation, and especially inflation expectations, has been well below the ECB's comfort zone for a long time.

The Bank of Japan has turned more aggressive, beginning in April of 2013 when it launched its quantitative easing program, one of the three arrows under the auspices of "Abenomics." The other two arrows being fiscal consolidation and structural reforms. However, well over a year after the launch of Abenomics, Japanese inflation is struggling to inch above 1% (when the impact of the one-off effects of the consumption tax increase of last April are removed), while GDP is contracting.

Structurally both the EZ and Japan are inherently disinflationary economies. Both run a current account surplus (therefore are dependent on international demand), have poor demographics (with population growth in negative territory), and suffer from weak domestic demand. Disinflation and possibly deflation could be extremely difficult to eradicate in Japan and EZ given the structure of those economies. Even aggressive monetary policy easing will likely not be successful in the absence of fiscal structural reforms.

Fig 3: Inflation and Inflation Expectations in the EZ



Source: Bloomberg
Data as of 12/31/2014

Both the ECB and BOJ have been very vocal about their commitment to continue to ease policy progressively to reach the 2% inflation target. Aggressive monetary policy easing can be successful in reviving inflation expectations, as the experience with the Fed's QE shows in the chart on page one (Fig. 2). However, the improvement in inflation expectations may only be temporary if it is not followed by an improvement of economic performance that validates higher inflation expectations.

Central banks and monetary policy easing cannot directly influence the structure of an economy. But they can build a bridge that supports an economy that is falling into a deflation trap while the private sector recovers (if it is structurally set up to be able to do so). It can also buy time while fiscal authorities implement necessary reforms for sustainable growth. Given history and political cycles, skepticism is expected around the ability of governments to pass tough structural reforms during recessionary periods. With reforms possibly taking a long time to come, central banks will continue to be the only game in town for a while.

Absent an improvement in economic performance, the temporary positive effects of monetary easing can fade away. When that happens, and if the central bank continues to be the only game in town, the central bank tends to get progressively more aggressive. However the marginal benefit of additional easing might turn out to be diminishing over time.

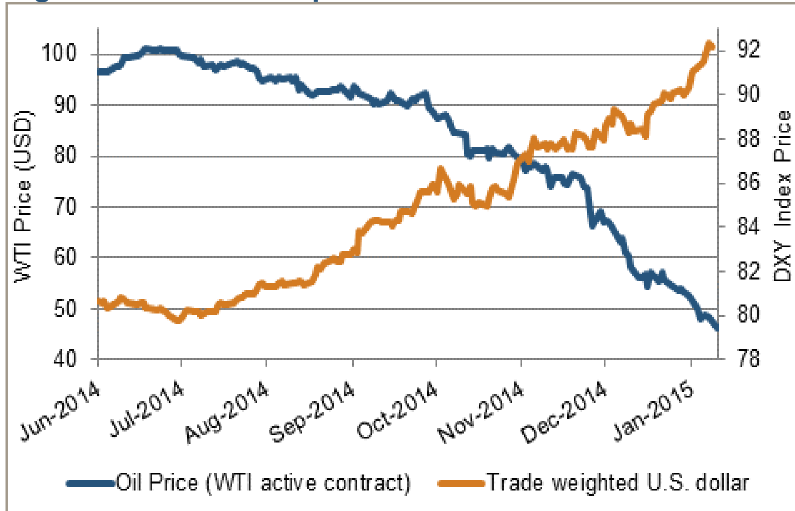
It is therefore very likely that in an environment where reforms are slow, those central banks that are fighting deflation will continue to do so for a while, and in a progressively more aggressive way.

The ‘divergence - dollar - oil’ link

The divergence in the macro performance across major economies, as a consequence of monetary policy, has been one of the drivers in the recent rise of the U.S. dollar, on a trade-weighted basis.

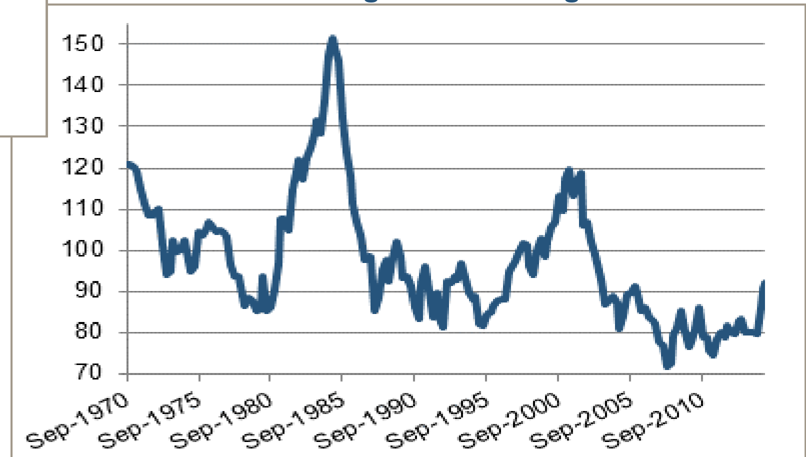
A strong dollar historically has put downward pressure on commodity prices. This time has been no different. In the case of oil in particular, a strong U.S. dollar, together with weak global growth and strong supply factors, have contributed to a sharp decline in commodity prices, which in turn has exacerbated disinflationary pressures across the global economy.

Fig 4: The Relationship Between the U.S. Dollar & Oil Prices



Source: Bloomberg. Note: the trade weighted dollar indicates the international value of the U.S. dollar by averaging the exchange rates between the USD and major world currencies. The currencies with major weight given countries trade volumes with the U.S. are the Euro (57.6%), the Japanese Yen (13.6%) and the British Pound (11.9%). WTI is West Texas Intermediate aka Texas light sweet crude oil – is it used as a benchmark in global oil pricing. Data as of 12/31/14

Fig 5: Trade Weighted U.S. Dollar



Source: Bloomberg
Data as of 12/31/2014

It is also worth highlighting that the U.S. dollar strength we have been experiencing in the last six months pales compared to historical peaks; and while the peak of the 1980s might be out of reach, the peaks of the early 2000s could still be in reach, even though it is 30% away.

With divergences persisting, the U.S. dollar could continue to strengthen, contributing to potentially new financial fragility for those emerging market economies (EM) in which U.S. dollar denominated debt has been accumulating at a fast pace in the last few years – a concern also recently expressed by the Bank of International Settlements (BIS) in their most recent Quarterly Review. The concern is that corporations in some EM have loaded up on U.S. dollar denominated loans, which are now swelling in local currency terms as the U.S. dollar continues to strengthen. Many of these EM might have to raise rates in an attempt to prevent excessive weakening of their currency which would likely result in currency mismatches becoming a real source of solvency concern. In turn, rate hikes in the EM will possibly continue to support low global inflation as well as ongoing downward pressure on, and volatility of, oil prices. And therein lies the rub: the easing efforts of the ECB and BOJ might be met by volatile but lower commodity prices, which could complicate the fight against deflation as lower energy prices trickle down to the rest of the economy and to core inflation indices.

Deflationary divergences and volatility ahead?

If the persistence of a strong dollar as a byproduct of policy divergence ends up hampering the reflationary power of central banks via the dollar-oil link, the risk is that markets become less responsive to monetary policy. From a marginal effectiveness perspective, the BOJ and ECB may need to become even more aggressive in their attempt to move towards their inflation target and remove volatility from markets.

Divergences may limit the success of easy money on boosting inflation expectations in Japan and Europe, absent concrete progress on reforms. As a result, markets might start growing more skeptical of the sustainability of an environment in which central banks and their liquidity injections continue to drive up market pricing. Therefore, episodes of volatility in market sentiment, like the recent one in between September and October, could become more frequent.

It is possible that the Fed will lean towards delaying rate hikes to take out some insurance on the solidity of the recovery before fully exiting ZIRP. Therefore, global monetary policy divergences could be mitigated in the short term by a dovish Fed and an ECB that is likely to continue to act very slowly towards further easing.

However, given the structure of these economies, divergences are likely to be with us for a while. In an environment as uncertain as today's, it is important to be well positioned for a variety of market outcomes. Investor's portfolios should be dynamic and diversified across a wide variety of asset classes which can provide opportunities for attractive risk-adjusted returns in up markets while serving as a buffer to help mitigate drawdowns during market turmoil. At Windhaven we strive to build strategies that are well positioned across a variety of economic scenarios and market cycles.

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