Weekly Market Summary

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Better Dovish than Sorry … Central Bankers Rethink the Economic Outlook
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What a Difference a Quarter Makes!

Last December, US central bankers looked past market fury and White House criticism - unanimously voting to hike the overnight benchmark interest rate by 25 basis points in their final decision for 2018, even as market's expectations for a rate rise had recently dwindled on account of depressed equity/oil prices and weaker global data. In his ensuing press conference, Chairman Jerome Powell emphasized that whilst the Federal Reserve takes financial conditions into account when setting policy, they are only one of many factors it considers. In the end, the Fed's sole mandate is to ensure stable prices and low unemployment, and as long as the country's economic fundamentals are sound (and they certainly are, according to Mr. Powell), the financial markets can do whatever they want!

A week before (precisely December 13th, 2018), the European central Bank ("ECB") had ended its €2.6 trillion programme of bond purchases despite a deepening economic slowdown in the Eurozone in 4Q2018 (Italy in recession, Germany just avoiding one!) and a depressed core inflation rate (hovering around 1.0% Y/Y, half the ECB's 2.0% target). Back then, Mario Draghi confirmed that quantitative easing had been a resounding success and the "*only driver of this recovery*" at crucial moments. And whilst the ECB President warned of "*downside risks*" to the economy, he did stick to his line that the sudden slowdown over recent months was a hiccup caused by one-off factors and disruptions in the car industry - insisting that monetary policy remains "*very accommodative*" and citing buoyant investment.

And then 2019 Kicked-In!!

After putting traders on notice at their December 19th FOMC meeting that further increases in US interest rates throughout 2019 were firmly on the table, the US Federal Reserve executed one of its sharpest U-turns in recent memory. Leaving the benchmark Fed fund rate unchanged at 2.25%-2.50% in a unanimous 10-0 vote at the January 30th FOMC meeting, Jay Powell - the Fed chairman - unveiled new language that opened up the possibility that the next move could equally be down, instead of up. Forecasts from the Fed's December meeting for another two rate rises this year were now history! Changes to the Fed's previous guidance were needed, Mr Powell argued, because of "*cross-currents*" that had recently emerged: Among them were slower growth in China and Europe, trade tensions, the risk of a hard Brexit and the federal government shutdown. Financial conditions had also tightened, Powell added.

A similar dovish European monetary decision was quick to follow: Meeting in Frankfurt yesterday, the European central Bank ("ECB") downgraded its macroeconomic outlook considerably (2019 growth significantly reduced to +1.1% from a +1.7% annual projection at the December meeting, whilst 2019 inflation was dropped to 1.2% from a 1.6% forecast in December), and as a result its members unanimously took three major policy decisions: First, the ECB Governing Council extended forward guidance on rates by one quarter (no rate hikes expected "*through the end of 2019*"). Second, a new series of quarterly TLTROs ("Targeted Long-Term Refinancing Operation" that aim to provide banks with a cushion of liquidity for use in their lending activities to businesses and consumers across the Euro area) will be launched starting in September 2019 until March 2021, each with a maturity of two years at a rate indexed to the refinance rate (currently at 0%). Third, fixed-rate full allotment at the ECB's refinancing operations will be extended until March 2021.

"*The persistence of uncertainties related to geopolitical factors, the threat of protectionism and vulnerabilities in emerging markets appears to be leaving marks on economic sentiment*," Draghi told journalists in his ensuing press conference. "*The risks surrounding the euro area growth outlook are still tilted to the downside.*" As a result, the Euro currency dropped to a 21-month low against the USD (last trading at 1.1210, with a weekly closing below 1.1250 later today most likely resulting in an additional move lower towards 1.1000 for the EUR/USD currency pair over coming days/weeks). Bonds across the Eurozone jumped on the news, pushing yields sharply lower (Germany's 10-year yield dropping down to 0.05%, their lowest lowest since October 2016!)

The Rise of the Doves!!

The start of 2019 has surely been a period of dovish turns at central banks, as officials in Europe unleash more stimulus, while their peers in the U.S., Canada, U.K. and Australia indicate they are in no hurry to raise interest rates (a dear GIB colleague who recently questioned the real meaning of the word "dovish" was provided with the following clarification: A dovish central banker is one that supports monetary stimulus to revive or jumpstart the economy, whilst delaying rate hike(s) well after economic data has shown a marked improvement in growth and a surge in inflation).

A key reasoning behind the renewed dovishness of central banks lies in the souring economic picture - a concern emphasized by yet more downgrades to the outlook in past days: The ECB cut its growth forecast by the most since the advent of its quantitative-easing program, whilst, in a gloomy report, the OECD slashed its own predictions for global growth, and warned that worse may be ahead. And news from around the global economy continues to disappoint: Factory reports from China, South Korea and Taiwan have added to a souring in sentiment across Asia, and U.K. data confirms signs of Brexit strain. Still, it was not all bad news: Italy's economic contraction at the end of last year was less than first estimated, the Euro area's services sector rallied and productivity gains in the U.S. last quarter exceeded forecasts.

Yet central bankers' latest about-face remains confusing to say the least! Many of the recently tabled hazards were already perfectly apparent in the last few months of 2018, when central bankers' language was still pointing to healthy growth, albeit with some downside risks. One explanation could be that more dovish officials have gained sway over the decision-making process in past months. Another is that central bankers could have been influenced by market pressure; In this respect, a recent study by the Bank for International Settlements has cited market volatility and central banks' changing rhetoric as another instance of the "*extraordinarily tight*" relationship between policy makers and financial markets. Economics chief Claudio Borio says the linkages in part explain the Federal Reserve's decision to put interest-rate hikes on hold. "*Financial markets scrutinize central banks' every word and deed, taking them as the cue for their ups and downs and seeking perennial comfort. Central banks, in turn, scrutinize financial markets to better understand what the future holds for the economy, as markets both reflect and influence activity -- a complex and delicate task*."

The main concern now is that the close data dependence approach means reactive central banks, potentially whipsawed by market movements and necessities, whilst clear direction becomes rare or absent! More importantly, both the Fed and the ECB cannot isolate themselves totally from politicians' impulsiveness, vanity and cronyism (Trump, May, Salvini and others come quickly to mind) – which could sooner or later tank the global economy. Central bankers may pretend they are able to calibrate this delicate extraction, but this must be seen as a white lie and a necessary bluff to keep financial markets and traders reassured – at least for now!

Last, but not least, this afternoon brings the release of the all-important US payroll release* (4:30 pm Bahrain time). Bloomberg consensus is for February payrolls to have risen by a healthy 180,000 (following a spectacular 304,000 jump in NFP for the month of January). It will also be worth keeping a close eye on the other important elements of the report, namely the unemployment rate (expected to drop to 3.9% from last month's 4.0% print), average hourly earnings (likely to rise by a strong +0.3% mom & +3.3% yoy), the participation rate (expected unchanged at 63.2%) and average weekly hours (expected unchanged at 34.5 hours). The recent rally in bond markets (10-year UST last trading at a depressed 2.63%) would suggest that investors are positioned for a weaker job number on fears that the recent slowing in global growth and continuing uncertainties relating to the US-China trade talks would sooner or later take their toll and result in weaker payroll data. Guess we will have a better feel on that in the next 3 hours!!

**The US economy added only 20,000 new jobs for the month of February, well below the 180k consensus expectation, though bad news from Friday's employment report was constrained largely to the headline. The unemployment rate dipped to 3.8%, from 4.0% in January, and wages rose by an above-consensus 0.4% mom (+3.4% yoy) – the fastest annual increase witnessed since 2009 .*

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