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Weekly commentary

Central Banks Are Back

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Key takeaways

- The European Central Bank (ECB) did not give any guidance on what will happen when its quantitative easing program ends in March, sparking the beginning of a sustained sell-off in yields.
- The Federal Reserve may not raise rates later this month, but chances have risen markedly.
- A complacent market seems to have been unprepared for either of these events and we are left to wonder whether that adjustment has now taken place, or if Friday's price action is a sign of things to come.

Full commentary

The summer of 2016 may be remembered for a successful Olympics in Rio de Janeiro, for Brexit, for a colorful U.S. election campaign, and for a wave of terrorist attacks in Europe and the Middle East. We know that events that seem so important in the day-to-day are often lost to history, and conversely those ignored at the time can prove to be much more significant with hindsight. Even with this caveat, those choosing to take much of August off missed almost nothing of consequence in markets, with time on the beach and trips to gelaterie. Measures such as the Chicago Board Options Exchange (CBOE) Volatility Index (VIX) of the Standard & Poor's 500 Index (S&P 500) options volatility, a proxy for market risk more generally, registered their lowest sustained period of volatility in more than 10 years. That was then.

On Thursday, September 8th, the market reaction to the European Central Bank's (ECB) announcement that it would not be increasing the amount of its stimulus or further cutting interest rates, sparked the beginning of a sustained sell-off in yields. German 10-year Bonds are now yielding a positive interest rate, and US 10-year Notes rising by 14 basis points over two days. While the ECB's announcement had not been a surprise, there was evidently some disappointment at ECB President Mario Draghi's downplaying of the need to make additional purchases given that the quantitative easing program is scheduled to end in March. This reflected first the lack of volatility in August, but more materially that the program itself may need tweaking. Morgan Stanley published research estimating that €467 billion of investment-grade European corporate bonds are yielding less than zero, equating to 33% of those eligible for the corporate sector purchase program (CSPP).

Investors are still also weighing the possibility of an interest hike from the Federal Reserve to be announced at its meeting on September 21st. At time of writing, the market is giving a 24% chance that the Fed will hike low, but given that it was effectively zero in July, this represents a marked shift. For December, the probabilities approach 50/50. The Bank of Japan (BOJ) also meets on September 21st, and while there is a suggestion that the BOJ is trying to work out how best to steepen the yield curve, Japan has serially disappointed those looking for stronger policy action.

Given this rampant degree of complacency, it is not surprising that the market was vulnerable, and after largely ignoring bond moves on Thursday, September 7th, risky assets performed poorly on Friday, September 8th. The S&P 500 had not had a move greater than 1% since early July, and had its worst day since the Brexit referendum, falling 2.54%. This has also been illustrated across emerging markets and credit indices, though with less intensity than stocks.

The question is whether this fall represents an ongoing vulnerability, as markets digest the limits of quantitative easing, even as that easing drives lower yields and higher stock multiples, or whether it represents something of a small correction in markets which had ceased to price any possibility of a change in Central Bank policy. Price action on Monday, September 12th suggests more of the latter, but central bank policy is likely to change, and at the margin, to reduce liquidity. Whether the market views this as effectively good news stemming from a stronger economy or a policy mistake set to make an already fragile economy weaker remains to be seen.

This week's market developments

Monday, September 5

- Markit Eurozone Services PMI decreased to 52.8 for August
- Markit UK Services PMI increased to 52.9 for August

Tuesday, September 6

- Germany Factory Orders growth increased to 0.2% m.o.m. (s.a.) for July
- Eurozone GDP growth remained at 0.3% q.o.q. (s.a.) for the Second Quarter of 2016
- Eurozone GDP growth remained at 1.6% y.o.y. (s.a.) for the Second Quarter of 2016

Wednesday, September 7

- UK Industrial Production growth remained at 0.1% m.o.m. (s.a.) for July
- UK Manufacturing Production growth decreased to 0.8% m.o.m. (s.a.) for July
- Japan GDP growth increased to 0.2% q.o.q. (s.a.) for the Second Quarter of 2016

Thursday, September 8

- US Initial Jobless Claims decreased to 259,000 for the week of September 3

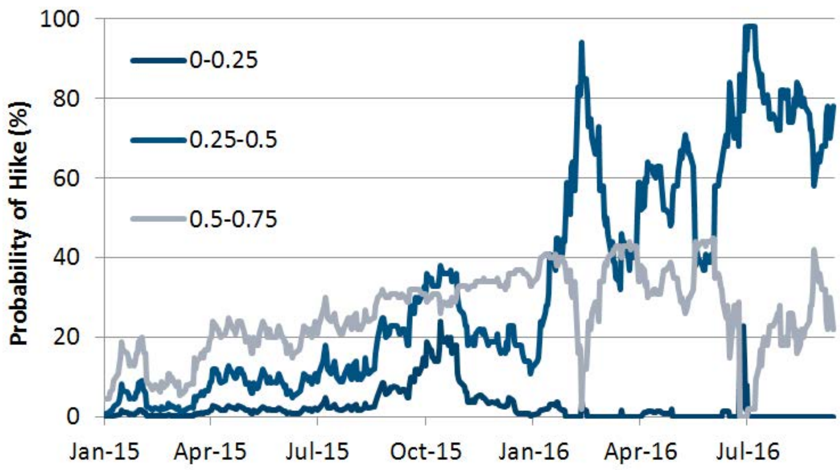
Friday, September 9

- Japan Tertiary Industry Index growth decreased to 0.3% m.o.m. (s.a.) for July
- US Wholesale Inventories growth remained at 0.0% m.o.m. (s.a.) for July 3

Source: Bloomberg, as of September 12, 2016

Chart of the week

Current Implied Federal Reserve Probabilities to September 21, 2016



Source: Bloomberg, as of September 12, 2016

Central Bank watch

	Last move	Date of move	Current policy rate	Implied 3m rate on December 2016 Interest Rates Futures Contract	Next meeting
Fed	+25 basis points	December 16, 2015	0.25 % - 0.50 %	0.50 %	September 21, 2016
ECB	-5 basis points	March 10, 2016	0.00 %	-0.21 %	October 20, 2016
BoJ	-20 basis points	February 16, 2016	-0.10 % - 0.00%	0.01 %	September 21, 2016
BoE	-25 basis points	August 4, 2016	0.25 %	0.32 %	September 15, 2016

Source: Bloomberg, as of September 12, 2016

Next week's market developments

Monday, September 12

- Japan Machine Tool Orders growth (preliminary estimate) is expected to decrease to -8.4% for August

Tuesday, September 13

- UK CPI growth is expected to increase to 0.4% m.o.m. (s.a.) for August
- UK Core CPI growth is expected to increase to 1.4% m.o.m. (s.a.) for August
- UK PPI Output growth is expected to remain at 0.3% m.o.m. for August

Wednesday, September 14

- Eurozone Industrial Production growth decreased to -1.0% m.o.m. (s.a.) for July

Thursday, September 15

- Eurozone CPI growth is expected to increase to 0.1% m.o.m. (s.a.) for August
- US Retail Sales Advance growth is expected to decrease to -0.1% m.o.m. (s.a.) for August
- US PPI Final Demand growth is expected to increase to 0.1% m.o.m. (s.a.) for August
- US Industrial Production growth is expected to decrease to -0.2% m.o.m. (s.a.) for August

Friday, September 16

- US CPI growth is expected to increase to 0.1% m.o.m. (s.a.) for August

Source: Bloomberg, as of September 12, 2016

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