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Weekly commentary

"Much Ado About Nothing"

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Key takeaways

- Global yields and credit spreads remained in relatively tight ranges while global equities weakened modestly due in part to the lack of further global central bank easing.
- The theme of diminished central bank effectiveness played an important role in the Q1 volatility spike and a re-emergence of this theme would destabilize financial assets and economic activity.
- The FOMC indicated less concern about financial market volatility and weakness in global growth in this week's statement, leaving open the possibility of a rate hike in June.

Full commentary

In Shakespeare's time, the "Nothing" in his Much Ado About Nothing play title would have been pronounced "Noting," which referred to the characters actions of observing, listening, and writing or noting. This week, market participants were heavily engaged in this "noting" behavior in an attempt to determine the next moves from the Federal Reserve (Fed), the Bank of Japan (BoJ), and the Reserve Bank of New Zealand (RBNZ). By the end of the week, market participants were mildly disappointed when all three central banks actually did nothing. As a result, global yields and credit spreads remained in relatively tight ranges while global equities weakened modestly due in part to the lack of further global central bank easing.

Arguably, the most important central bank inaction of the week came from the BoJ. Following deteriorating growth including -0.3% quarter-on-quarter GDP growth and a -0.1% National CPI release earlier in the week, market participants expected additional easing measures ranging from increased exchange-traded funds purchases and Japanese government bond purchases to a more negative deposit rate or an expanded loan support program at negative rates. We expected that they would embrace a domestic credit easing strategy along the lines of the European Central Bank's (ECB) recent actions and refrain from focusing on lower risk free real rates to avoid currency weakness. An increase in equity, corporate bond and Real Estate Investment Trust (REIT) purchases along with a more aggressive lending facility would have eased domestic financial conditions and likely had little impact on the yen. While we believe some yen weakness would help boost inflation, central banks have generally shied away from competitive devaluations since the apparent G20 detente agreement in mid-February. Moreover, if the BoJ acts to weaken the yen, Japan risks losing US Congressional ratification of the Trans-Pacific Partnership trade deal, a key lever for Prime Minister Abe's third arrow structural reform.

The BoJ was in a difficult situation; however, the decision to do nothing may prove to be a policy error with serious consequences, particularly if perceptions that the BoJ and perhaps central banks more broadly, have lost either the will or means to act. The theme of diminished central bank effectiveness played an important role in the first quarter volatility spike and a re-emergence of this theme would destabilize financial assets and economic activity. We believe that continued yen strength or further declines in inflation expectations will reinforce these perceptions. In the near term, Japan must rely on fiscal policy in the form of supplementary budgets and wide speculation regarding a delay of the upcoming consumption tax increase. However, fiscal multipliers are typically low and raising debt to GDP from 250% to 260% is unlikely to spur growth in our opinion. Moreover, a move away from Ministry of Finance's medium term fiscal framework could exacerbate debt dynamic concerns and possibly put upward pressure on the currency.

The Federal Open Market Committee (FOMC) indicated less concern about financial market volatility and weakness in global growth in this week's statement, leaving open the possibility of a rate hike in June. Despite a considerable easing of financial conditions since the March meeting and marginal improvement in high frequency data, we expected the Committee to retain the sentence noting that "global economic and financial developments continue to pose risks", given the structural challenges in many emerging markets, Europe and Japan. While they removed it, they expanded the sentence on monitoring inflation to read, "The Committee continues to closely monitor inflation indicators and global economic and financial developments." In our view, the change is subtle and reflects a modest upgrade in their assessment, reflecting reduced market volatility and the impact of easier ECB policy while recognizing that global growth remains fragile and financial conditions could again tighten.

This week's market developments

Monday, April 25

- US New Home Sales decreased to 511,000 (s.a.a.r) for March

Tuesday, April 26

- US Durable Goods Orders growth (preliminary estimate) increased to 0.8% m.o.m (s.a.) for March
- Markit US Services PMI (preliminary estimate) increased to 52.1 for April
- US Consumer Confidence Index decreased to 94.2 for April

Wednesday, April 27

- UK GDP growth (advance estimate) decreased to 0.4% q.o.q. for the First Quarter
- Japan Industrial Production growth (preliminary estimate) increased to3.6% m.o.m. (s.a.)

Thursday, April 28

- US GDP growth (advance estimate) decreased to 0.5% q.o.q. (s.a.a.r) for the First Quarter

Friday, April 29

- Eurozone GDP growth (advance estimate) increased to 0.5% q.o.q. (s.a.) for the First Quarter
- US Personal Income growth increased to 0.4% m.o.m. (s.a.) for March
- US Personal Spending growth remained at 0.1% m.o.m. (s.a.) for March

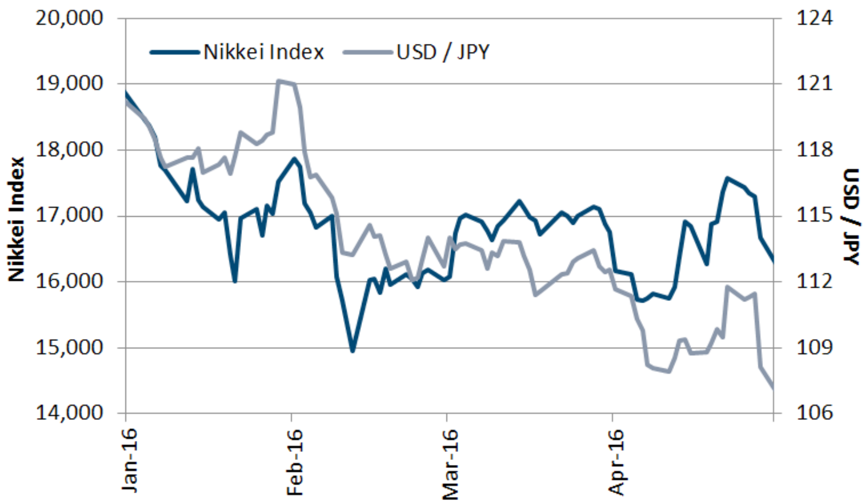
Source: Bloomberg, as of end April 29, 2016

As expected, they did mark down their characterization of economic activity. The preliminary first quarter U.S. GDP data released this week provided more detail on the recent economic weakness. GDP growth fell from 1.4% in fourth quarter to 0.5% in first quarter. Non-residential private fixed investment contracted by 5.9% (quarter-over-quarter seasonally adjusted annual rate) with much of weakness concentrated in non-residential structures and equipment. While the contraction in structures was largely energy related the contraction in equipment investment continues to be broad-based. Moreover, despite ongoing labour market strength, personal consumption expenditure growth has now decelerated for three straight quarters.

The plot of *Much Ado About Nothing* is based upon deliberate deceptions, some malevolent and others benign. While we do not believe any central bank would deliberately deceive the markets, it is inevitable that their actions will either be interpreted as constructive, benign, and at times harmful. One need only observe the currency strength in Japan and New Zealand as well as the decline in global equities to conclude this week's collective inaction was not constructive. It is too soon to tell but given the structural impediments to growth and inflation, we anticipate more easing from the RBNZ and the BOJ this year and a rate increase from the FOMC in September or December.

Chart of the week

Nikkei Index and yen evolution to date



Source: Bloomberg

Central Bank watch

	Last move	Date of move	Current policy rate	Implied 3m rate on March 2016 Interest Rates Futures Contract	Next meeting
Fed	+25 basis points	December 16, 2015	0.25 % - 0.50 %	0.39 %	June 15, 2016
ECB	-5 basis points	March 10, 2016	0.00 %	-0.19 %	June 2, 2016
BoJ	-20 basis points	February 16, 2016	-0.10 % - 0.00%	0.05 %	June 16, 2016
BoE	-50 basis points	March 5, 2009	0.50 %	0.60 %	May 12, 2016

Source: Bloomberg

Next week's market developments

Monday, May 2

- Markit Eurozone Manufacturing PMI (final estimate) is expected to remain at 51.5 (s.a.) for April
- Markit US Manufacturing PMI (final estimate) is expected to remain at 50.8 (s.a.) for April
- US ISM Manufacturing Index is expected to decrease to 51.4 (s.a.) for April

Tuesday, May 3

- Markit UK Manufacturing PMI is expected to increase to 51.2 (s.a.) for April

Wednesday, May 4

- Markit Eurozone Services PMI (final estimate) is expected to remain at 53.2 (s.a.) for April
- Markit US Services PMI (final estimate) is expected to remain at 52.1 (s.a.) for April
- US Factory Orders growth is expected to decrease to 0.6% m.o.m. (s.a.) for March
- US Durable Goods Orders growth (final estimate) is expected to remain at 0.8% m.o.m. (s.a.)

Thursday, May 5

- US Initial Jobless Claims are expected to increase to 260,000 for the week

Friday, May 6

- US Change in Nonfarm Payrolls is expected to be 200,000 m.o.m. (s.a.) for April
- US Unemployment Rate is expected to decrease to 4.9% (s.a.) for April

Source: Bloomberg, as of end April 29, 2016