Fixed Income Weekly
FOR PROFESSIONAL INVESTORS

Busiest week of the year for Central Banks

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Key takeaways

- Market reaction to the European Central Bank meeting diametrically opposite to expectations
- Bank of England policy meeting a non-event
- Republicans shell-shocked in Alabama, but legislative agenda well on track

Full commentary

It felt like earnings season for Central Banks last week. No fewer than 20 central banks around the world deliberated on interest rates last week, with December 14 singlehandedly the busiest day for governing banks. The outcome: more of the same

The European Central Bank (ECB) kept its key lending rates and its bond-buying program unchanged at its December meeting, but raised its growth and inflation forecasts through 2020. The Governing Council's introductory statement indicated that there has been a change in the council's assessment of the economy, and the tone left readers with the impression that the ECB was leaning on the hawkish side, even if mildly so. In fact, ECB President Mario Draghi confirmed that point during his press conference, emphasizing his confidence that the economy is stronger relative to the earlier quarter.

However, the market's interpretation of the meeting was in the diametrically opposite direction. Bunds rallied, and the Euro sold off in the aftermath. We are of the opinion that the Governing Council did not discuss changing the forward guidance on interest rates or asset purchases, which inevitably gave investors the impression that nothing of significant changed. Also, the market seemingly concluded that the macro-economic assessment of the ECB did not change with regards to inflation – an economic indicator that it deems most vital in shaping the ECB's outlook. The latest set of inflation projections from the Central Bank pin inflation at 1.7% on average in 2020 – a figure well below the widely expected baseline of 2%.

The Bank of England (BoE) policy meeting was largely a non-event. The Committee voted 9-0 in favour of the current policy setting, as expected, and there was an acknowledgment of the progress in the Brexit negotiations. UK inflation rose at an annual rate of 3.1% in November, well higher than expected and the fastest pace in over five years. The BoE remains a firm believer that inflation is close to its peak and will revert to their 2% target soon. What it's worth, Gilts rallied after the meeting.

Regarding the FOMC meeting, the decision to raise rates by 25 basis points was widely expected, so most of the attention was on the press briefing and Summary of Economic Projections. As expected, the median projection revealed a stronger growth profile, a lower path for the unemployment rate and an unchanged core inflation outlook in comparison to the September projections. But what was somewhat unexpected was the unchanged projected path of the policy rate, which was expected to steepen somewhat.

Last week's market developments

Monday, December 11

- Japan Producer Price Index increased to 3.5% y.o.y. for November

Tuesday, December 12

- UK CPI increased to 0.3% m.o.m. n.s.a. for November.
- Japan machine orders increased to 5.0% m.o.m. s.a. for October
- US PPI final demand remained at 0.4% m.o.m. s.a. for November

Wednesday, December 13

- German CPI remained at 0.3% m.o.m. for November
- UK unemployment rate remained at 4.3% s.a. for October

Thursday, December 14

- German manufacturing PMI increased to 63.3 s.a. for December
- Eurozone manufacturing PMI increased 60.6 s.a. for December
- UK official bank rate remained at 0.5% for December
- US initial jobless claims decreased to 225k s.a. for December
- US manufacturing PMI increased to 55.0 s.a. for December

Friday, December 15

- US industrial production decreased 0.2% m.o.m. s.a. for November
- US manufacturing survey general business conditions decreased to 18.0 s.a. for December

Source: Bloomberg, data as of December 18, 2017

In U.S. politics, Democrats pulled a rabbit out of a hat in deeply conservative Alabama, but the victory has little significance to the Republican legislative agenda. In the coming week, both the House and the Senate will vote on the unified tax bill that has emerged from the joint House-Senate conference committee. The latest edition of the proposed bill lowers the tax rate for the highest individual earners and makes a larger portion of the child tax credit full refundable, among other changes. From the point of view of businesses, the tax bill establishes a 21 percent corporate tax rates, and settles at 15.5 percent tax on undeclared offshore liquid holdings (8 percent on all other offshore holdings). We remain of the opinion that the proposed tax cuts will merely front load growth, resulting in higher growth over the next 2-3 years, but will limited effect on trend growth. Lower corporate tax rates and a move to a territorial tax system will create incentives for corporations to invest in the US, as does immediate and full expensing for equipment investment. But these effects may ultimately be limited – corporations currently enjoy very low costs of capital and have not taken meaningful advantage of this over recent years, so it is unclear why a further lowering of after-tax investment costs will make a large difference for the CapEx outlook. This view was larger echoed by Fed Chair, Janen Yellen, as well – they represent a mild aggregate demand shock with little long-term impact on aggregate supply.

Please note, this is the last addition of the Fixed Income Weekly. To read more about our investment insights please refer to our bi-weekly publication, the Intelligence Report.

Central Bank Watch

	Last move	Date of move	Current policy rate	Implied 3-Month Rate on December 2017 Interest Rate Futures Contract	Next meeting
Fed	+25 basis points	December 13, 2017	1.00% - 1.50%	1.30%	January 31
ECB	-5 basis points	March 10, 2016	0.00%	-0.17%	January 25
BoJ	-20 basis points	February 16, 2016	-0.10% - 0.00%	0.06%	December 21
BoE	+25 basis points	November 2, 2017	0.50%	0.51%	February 8

Source: Bloomberg; data as of December 18, 2017

This week's market developments

Monday, December 18

- No data to report

Tuesday, December 19

- US housing starts are expected to decrease to 1250k s.a.a.r. for November
- Japans Industrial Activity Index is expected to increase to 0.3% m.o.m. s.a. for October

Wednesday, December 20

- US existing home sales is expected to increase to 5.53m s.a.a.r. for November

Thursday, December 21

- US GDP is expected to remain at 3.3% q.o.q. s.a.a.r. for Q3
- Canadian CPI is expected to increase to 0.2% m.o.m. n.s.a. for November
- US initial jobless claims are expected to increase to 233k s.a. for December
- Eurozone consumer confidence indicator is expected to increase to 0.2 for December

Friday, December 22

- France's GDP is expected to remain at 0.5% q.o.q. for Q3
- UK GDP is expected to remain at 0.4% q.o.q. for Q3
- US personal consumption and expenditures are expected to increase to 0.5% m.o.m. s.a. for November
- US durable goods new orders are expected to increase to 2.0% m.o.m. s.a. for November

Source: Bloomberg, data as of December 18, 2017