CUSTOMER TREASURY SERVICES

Economist's Weekly Market View

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Central banks may act early to stem slowdown in growth

Monetary easing has come very much back on to central banks radars. We have seen rates cut in Australia and India in the past week, while there have been hints of policy easing from the Federal Reserve. US markets are pricing in more than 75bps of Fed rate cuts in the next year, starting this summer. Rate hike expectations have evaporated in Europe and markets are now beginning to look for a small rate cut from the ECB and Bank of England.

Expectations of more accommodative monetary policies have seen strong gains by bond markets. Ten year US Treasury yields have fallen by 120bps since last autumn, while ten year bund yields have declined by over 80bps to record lows of around -0.25%. Stock markets have also been buoyed, with US and European markets up by around 10% this year.

The strong gains by both bond and stock markets may seem odd, but it is because markets expect central banks to act pre-emptively to stave off the risk of a sharp slowdown in activity. The softening in global growth in the past year has been largely confined to a marked slowdown in international trade and an associated weakening of activity in manufacturing.

The escalation in trade tensions in the past month and a further deterioration in business surveys has put central banks on high alert, as they are concerned that the slowdown in manufacturing could spread to other parts of the economy and labour markets.

With interest rates very low, central bankers may feel that they need to move quickly to shore up growth as they have very little in the locker to counteract a sharp downturn in activity. Very low inflation allows central banks something of a free bet in terms of policy easing.

They still face a bit of a dilemma, though, as risks to global growth, such as trade tensions, could get resolved very quickly, as we saw at the weekend in relation to the US-Mexico dispute. Nonetheless, markets expect that central banks, especially the Fed, will err on the side of caution and ease policy.

The strength of equities and with futures contracts pointing to rate hikes further down the road, suggests that markets believe a steep downturn in activity will be avoided. If this indeed proves to be the case, then the rally in bond markets looks overdone, especially in Europe, where any policy easing is likely to be very limited.

In this regard, the ECB indicated after last week's Governing Council meeting that it intends to keep rates at their current levels until at least mid-2020. However, ECB President Draghi confirmed that the Council did discuss various options for easing policy further, including a rate cut. The ECB seems concerned that if the weakness in manufacturing persists, then it could start to impact other sectors of the economy.

Given the downside risk to growth, if there is a change in rates by the ECB in the near term, it is likely to be a rate cut. However, the scope to reduce rates much further is very limited given that the key deposit rate is already at -0.4%. Thus, if the ECB decides to ease policy anytime soon, it may will be via re-activating its QE bond purchases programme rather than cutting rates.

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