



Will Central Banks Keep Fueling the Rally?

Two (and a half) possible scenarios.

March 2019

Central banks have become notably more dovish during the first few months of this year, prompting a risk rally. Were they right to soften their policies? I believe so. A major reason for last year's volatility, including the sell-off in the fourth quarter, was concern over excessive monetary tightening. Simultaneous tightening from the Federal Reserve and the People's Bank of China during a period of sluggish global growth and heightened economic uncertainty prompted widespread jitters and led to heavy waves of selling in November and December.

The banks were slow to react to this. This is perhaps understandable given that the role of central banks is to set policy for the long term and it does not inspire confidence if they are too reactive. On the other hand, if the leading central banks had softened their policies slightly earlier, they probably would not have had to soften policy so much. Given what transpired, though, it is difficult to see them becoming more hawkish again anytime soon.

What happens now? I see two main possible scenarios and a third "outlier" scenario. The first scenario is that the combined stimulus efforts from the U.S., China, and the eurozone cause global growth to rebound. This



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extends the current risk rally, leading to higher neutral interest rates and a bear-steepening of yield curves (when long-term rates increase at a faster rate than short-term rates). Later this year, as U.S. fiscal stimulus begins to wear off, the dollar weakens, and commodity prices rise. This could prolong the risk rally by another six to 12 months.

The second scenario is that the stimulus being pumped into the global economy is sufficient to prevent a recession this year, but insufficient to rekindle animal spirits. Curves remain flat, and the economic cycle is not extended. The probability of a recession in 2020 rises significantly and, as U.S. fiscal stimulus wanes, the market begins to price in Fed rate cuts, resulting in a bull-steepening yield curve (when short-term rates fall faster than long-term rates). In this scenario, commodity-linked assets would fall and the U.S. dollar would probably strengthen.

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The outlier scenario is that the Fed engineers a stealth easing, getting bill rates to decline well below the overnight indexed swap rate—without actually cutting rates. This would support growth, weaken the dollar and help to refresh the economic cycle. But I doubt the Fed would be this creative.

The first scenario remains the most likely, in my view. The combination of stronger Chinese credit growth in January, declines in market-implied volatility, and higher commodity prices (e.g., copper) suggest that the risk rally will continue

for at least a few more months and that conditions remain supportive for credit markets. Around Christmas, we took off most of the credit hedges in our Global Multi-Sector Bond and Diversified Income Bond portfolios and adopted a more aggressive stance on risk in the U.S., Europe, and emerging markets. This remains our stance today. So far, the evidence suggests that our outlook for the year is playing out and that risk assets will continue to perform. But we are ready to adjust our portfolio quickly if the data begin to suggest otherwise.

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