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MAKING SENSE OF *THIS* WORLD

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R&R Weekly Column
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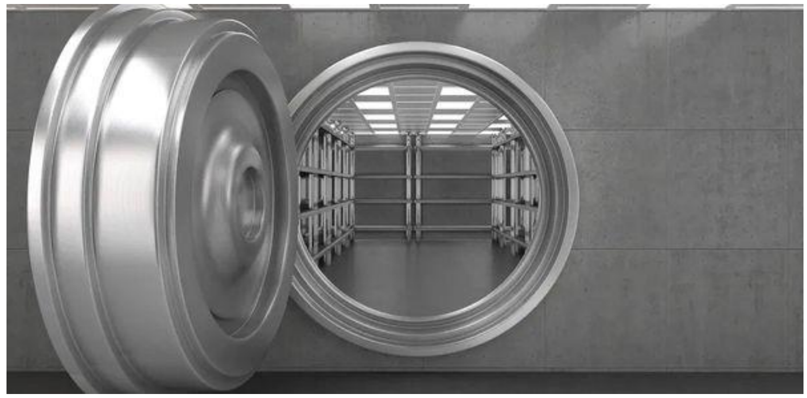

Central Banks on Divergent Paths in the Post-Pandemic Environment

As the Covid-19 pandemic hit in 2020, a synchronous wave of monetary easing took place in the world. Whether or not the pandemic would prove to have a negative effect on aggregate supply (as in fact did occur, as supply was constrained by lockdowns and severe restrictions), there was certainly a shock to aggregate demand, which needed to be supported by coordinated fiscal and monetary accommodation. In both DMs and EMs, central banks adopted a mix of policy rate cuts, asset purchases (in this case also by EM central banks), various forms of *forward guidance*, and *credit-easing* measures to stem the economic downturn due to the pandemic.

In the DM world, G10 central banks resorted to the various instruments that had been created during the Global Financial Crisis (GFC) of 2008-09, and expanded these instruments further (for example, the ECB's PEPP). Most central banks have brought their policy rate to the zero-lower bound (ZLB), or even closer to the effective lower bound (ELB), if the latter was in negative territory. In the G10 space, the biggest policy innovations have been, in our opinion, the following: 1) the yield curve control (YCC) at the short end by the Reserve Bank of Australia, to reinforce an otherwise not-very-credible forward guidance; 2) the maturity extension of asset purchases, along with a reduction of the quantity purchased by the Bank of Canada; and 3) the new deposit tearing system adopted by the Bank of Japan, allowing the central bank to reduce the deposit rate further into negative territory while protecting bank profitability. A number of central banks have also started to embrace policies accompanying the fight to limit climate change, primarily the ECB, BOE and BOJ.

In EMs, many central banks cut their policy rates to their all-time lows, to levels that have always been more typical for G10 central banks. Some of them, for example the Banks of Israel, India, and South Korea (among others) even started QE programs, in spite of the inherent risks of FX stability, loss of credibility and fiscal dominance that those programs entail.

One year later in H1 2021, with the pandemic being gradually gotten under control, central banks have to decide what to do next. In the G10 space, there are three groups of central banks. Those which have started (or have announced they will start) reducing the pace of accommodation (chiefly the Bank of Canada, which started tapering QE in April, and Norges Bank, which announced it will raise rates in September). Then there are those which are carrying out their latest round of accommodation yet are ready to start considering a reduction of their easing stance (chiefly the US Federal Reserve). Finally there are those which are still finishing their latest accommodation programs and cannot afford to start thinking about tapering, namely the ECB, BOJ, and BOE.

In EMs, a number of central banks have already started reversing their easing policies, and have raised rates. According to Reuters, there were already ten rate hikes that took place by the end of May, by central banks in countries such as Russia, Turkey, Indonesia, Brazil, and South Africa. These increases are to defend their currencies against the US dollar, which has been weak for years, and to stem inflation deriving from a rise in commodity prices and the reopening of economies.

As BoJ Governor Kuroda said during his last press conference: it is not unusual for central banks to have divergent policy stances. And from these divergences, a number of interesting trading opportunities may emerge.

Our Recent Publications

- Flash Preview: Bank Of England To Leave Policy Stance Unchanged, *by Brunello Rosa and Karmen Meneses, 18 June 2021*
- Flash Review: Bank of Japan Extends The Covid-Relief Programs And Engages On Climate Change, *by Brunello Rosa and Karmen Meneses, 18 June 2021*
- Flash Review: Norges Bank Set To Be The First G10 Central Bank To Hike in This Cycle, *by Brunello Rosa and Karmen Meneses, 17 June 2021*
- Flash Review: Federal Reserve Keeps Stance Unchanged, But Signals Earlier Potential Rate Liftoff, *by Brunello Rosa, 16 June 2021*
- Flash Preview – US Federal Reserve: Too Early to Think About Tapering, Changing First Hike Timing and Declaring Victory on AIT, *by Nouriel Roubini and Fawaz Sulaiman Al Mughrabi, 14 June 2021*
- **GEOPOLITICAL CORNER:** Saudi Arabia is in a Race to Renew Itself, *by John C. Hulsman, 15 June 2021*

Looking Ahead

The Week Ahead: DMs' Manufacturing PMIs To Soften While EZ's And Japan's Services PMIs Are Expected To Improve

In DMs, manufacturing PMIs are expected to soften, as*: i)* US indicators point to a gentle slowdown (*c:* 61.0; *p:* 62.1); *ii)* EZ data are likely to deteriorate *(c:* 62.1; *p:* 63.1; while *ii)* Japan's figures are expected to stay subdued (*c:* 53.1; *p:* 53.0).

In the US, services PMIs are likely to remain stable (*c:* 70.0; *p:* 70.4);

In the EZ and Japan services PMIs are expected to improve (EZ, *c:* 57.6; *p:*55.2 - Japan, *c:* 47.0; *p:* 46.5).

The Quarter Ahead: Inflationary Pressures Linger; US Fed Signals Earlier-Than-Expected Rate Hike; Geopolitical Tensions Rise

Globally, in H2-2021, global output and demand are likely to keep rebounding strongly, driven by: *1)* continued fiscal and monetary policy support; and *2)* the steady rollout of vaccines. Inflation's current rise is likely to prove cyclical. CB' policy rates are expected to remain low, and financial markets are likely to be supported by sustained asset purchases.

Globally, key risks are: *1)* DM governments returning to a more cautious fiscal stance; *2)* a negative credit impulse in China; and *3)* pandemic-related structural economic damage.

At the Geneva summit last week, US President Joe Biden and Russian President Vladimir Putin agreed to discuss several topics, including *"alleged cyberattacks and human rights violations that have strained relations between Russia and the United States"*. After the summit, President Biden characterized the meeting as "positive," and President Putin called it "constructive."

China is New Zealand's largest trade partner. Amid rising tension between China, Australia and New Zealand, New Zealand's trade minister stated *"we will continue to expand our trading relationship with China"* while we *"aim to agree on free trade deals with the UK and the EU this year in a bid to diversify its export markets"*.

Most US Fed officials expect a rate rise in late-2023, against earlier predictions of *"a first rate hike expected in 2024"*, because the US economy *"recovered strongly from the pandemic and consumer price inflation hit an annual rate of 5% in May"*. Fed chair Powell hinted at an upcoming tapering, stating that officials were *"talking about reducing the Fed's USD 120bn-a-month asset purchases"*, which have boosted financial markets since March 2020.

Last Week's Review

Real Economy: Slow And Bumpy Global Recovery; Inflation Pressures Build Worldwide

In the US, May retail sales declined by -1.3% m-o-m (*p:* -0.9%) and slowed to 28.1% y-o-y (*p:* 53.4.2%), as Americans shifted spending to services – driven by: *i)* the reopening of the economy; *ii)* a pick-up in travel; and *iii)* a base effect from last year.

In the EZ, core inflation increased to 1.0% y-o-y (*p:* 0.7%), while the inflation rate reached 2.0% y-o-y (*p:* 1.6%), reflecting a sharp rebound in demand, due to the economy's re-opening.

In Japan, May's core inflation rate rose by 0.1% y-o-y, while headline inflation eased to -0.1% y-o-y (*p:* -0.4%).

In Japan and Norway, both BoJ and Norges Bank left their interest rate unchanged as expected at -0.1% and 0.00%, respectively. Norges bank signaled that the first post-pandemic rate hike is *"likely to come in September 2021"*.

Financial Markets: Stocks Trended Downwards; Bonds Remain Flat; USD Posted Strong Gains

***Market drivers*:** Stocks retreated w-o-w, as the US Fed hinted at raising interest rates by late 2023, sooner than previously anticipated. Sentiment veered towards pessimism, as investors remain focused on careful portfolio positioning, capital preservation, and liquidity management.

Global equities fell w-o-w (MSCI ACWI, -0.6%, to 715); commodities and value stocks were particularly hit. In the *US*, indices ended the week sharply lower as investors worried about of an even more hawkish monetary stance, as on Friday, Federal Reserve Bank of St. Louis leader James Bullard said he expects *"the first rate increase even sooner, in late 2022"*.The S&P 500 Index fell (-0.6% w-o-w, to 4,222). In the *EZ*, equities deepened losses after the hawkish Fed comments (Eurostoxx 50, - 1.0%, to 4,083).

Fixed Income: w-o-w global bonds remained flat (BAML Global, -0.2% to 293.9) and UST yields fell (-1 bps, to 1.44%).

FX: w-o-w, the USD rose, strengthening against the EUR (DXY, +1.8%, to 92.225; EUR/USD -2.0%, to 1.186), mostly driven by the US Fed's hawkish shift in tone.

Commodities: Oil prices rose (Brent, 0.8% to 73.3 USD/b), after OPEC sources stated the producer group *"expected limited US oil output growth this year, despite rising prices"*. Gold prices fell significantly (-6.0% to 1,763 USD/Oz), amid USD strength and prospects of inflation-taming monetary tightening.

Farah Aladsani *contributed to this Viewsletter.*

The picture in the front page comes from this website

Abbreviations, Acronyms and Definitions

a	*Actual*	*LN*	*Northern League, Italy*
AKP	*Justice and Development Party, Turkey*	*M5S*	*Five Star Movement, Italy*
ann.	*annualized*	*m-o-m*	*Month-on-month*
ARS	*Argentinian Peso*	*mb*	*Million barrels*
avg.	*Average*	*mb/d*	*Million barrels per day*
bn	*Billion*	*MENA*	*Middle East and North Africa*
BoC	*Bank of Canada*	*MHP*	*Nationalist Movement Party, Turkey*
BoE	*Bank of England*	*mn*	*Million*
BoJ	*Bank of Japan*	*MPC*	*Monetary Policy Committee*
bpd	*Barrels per day*	*NAFTA*	*North-American Free Trade Agreement*
bps	*Basis points*	*NATO*	*North Atlantic Treaty Organization*
BS	*Balance sheet*	*OECD*	*Organization for Economic Cooperation and Development*
c	*Consensus*	*Opec*	*Organization of Petroleum Exporting Countries*
C/A	*Current account*	*p*	*Previous*
CB	*Central bank*	*P2P*	*Peer-to-peer*
CBB	*Central Bank of Bahrain*	*PBoC*	*People's Bank of China*
CBK	*Central Bank of Kuwait*	*PCE*	*Personal Consumption Expenditures*
CBT	*Central Bank of Turkey*	*PE*	*Price to earnings ratio*
CDU	*Christian Democratic Union, Germany*	*PM*	*Prime minister*
CNY	*Chinese Yuan*	*PMI*	*Purchasing managers' index*
CPI	*Consumer Price Index*	*pps*	*Percentage points*
DJIA	*Dow Jones Industrial Average Index*	*pw*	*Previous week*
DJEM	*Dow Jones Emerging Markets Index*	*QCB*	*Qatar Central Bank*
d-o-d	*Day-on-day*	*QAR*	*Qatari Riyal*
DXY	*US Dollar Index*	*QE*	*Quantitative easing*
EC	*European Commission*	*q-o-q*	*Quarter-on-quarter*
ECB	*European Central Bank*	*RE*	*Real estate*
ECJ	*European Court of Justice*	*RBA*	*Reserve Bank of Australia*
EIA	*US Energy Information Agency*	*RRR*	*Reserve Requirement Ratio*
EM	*Emerging Markets*	*RUB*	*Russian Rouble*
EP	*European Parliament*	*SWF*	*Sovereign Wealth Fund*
EPS	*Earnings per share*	*tn*	*Trillion*
EU	*European Union*	*TRY*	*Turkish Lira*
EUR	*Euro*	*UAE*	*United Arab Emirates*
EZ	*Eurozone*	*UK*	*United Kingdom*
Fed	*US Federal Reserve*	*US*	*United States*
FOMC	*US Federal Open Market Committee*	*USD*	*United States Dollar*
FRB	*US Federal Reserve Board*	*USD/b*	*USD per barrel*
FX	*Foreign exchange*	*UST*	*US Treasury bills/bonds*
FY	*Fiscal Year*	*VAT*	*Value added tax*
GCC	*Gulf Cooperation Council*	*VIX*	*Chicago Board Options Exchange Volatility Index*
GBP	*British pound*	*WTI*	*West Texas Intermediate*
GDP	*Gross domestic product*	*WTO*	*World Trade Organisation*
IMF	*International Monetary Fund*	*w*	*Week*
INR	*Indian Rupee*	*w-o-w*	*Week-on-week*
IPO	*Initial public offering*	*y*	*Year*
IRR	*Iranian Rial*	*y-o-y*	*Year-on-year*
JPY	*Japanese yen*	*y-t-d*	*Year-to-date*
k	thousand	*ZAR*	*South African Rand*
KSA	*Kingdom of Saudi Arabia*	*2y; 10y*	*2-year; 10-year*