

# Global Strategy: Bulletin

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## Markets Roiled By Sudden Policy Shifts...

- In 2015, the U.S. dollar surged 12% and the U.S. economy (particularly labor markets) showed just muted aggregate impact into the new-year. Monetary policy “divergence” was expected to continue in earnest in 2016. However, the Fed has pushed back against even this limited restraint, noting that fading expectations for U.S. monetary tightening have stabilized markets of late.
- The G-20 meeting of late February in Shanghai was likely much more consequential than headlines and the communique of the time suggested as central bankers vowed to support growth but fight the impact of divergence.
- The ECB subsequently designed its March easing to support domestic credit growth and minimize impact in the exchange rate. Where does this then leave Japan, which in 2014 announced QE coupled with a foreign currency asset purchase program through its government pension fund?
- Divergence has been an excessive focus of investors who should see that internal credit easing is the more significant monetary policy impact within large economies, even as it (like it or not) spills across borders too.
- Investors may be confused by new central bank warnings of downside risks, but the impact of persistent central bank actions in markets hasn't suddenly become zero.

## ...And Erase Policy Divergence

They're at it again. The most important central banks from a global perspective want to further support and strengthen the world economic expansion with easy monetary policy. However, they've managed to confuse and even scare investors in the process.

What's caused the most difficulty in understanding their bullish intentions is their desire to simultaneously arrest the financial impact of “policy divergence.” In other words, support growth, but don't achieve the impact with beggar thy neighbor foreign exchange impact (a zero sum game across the world). Yet it's not so simple to limit the impact of credit easing to within a nation's borders.

The G-20 meeting of late February in Shanghai was likely much more consequential than the headlines and the communique of the time suggested. Officials – likely chastened by China's currency turmoil – vowed to avoid “competitive devaluations,” yet use monetary and fiscal policy to support growth where warranted. The European Central Bank subsequently designed its March easing steps to support domestic credit growth and minimize impact through the Euro's exchange rate. The Federal Reserve rather suddenly shifted down its expected tightening path this year largely on international concerns. Where then, does this leave Japan, which in 2014 announced QE coupled with a foreign currency asset purchase program through its government pension fund?

Japan's currency has appreciated 8.7% against the U.S. dollar just this year and 9% against a trade-weighted basket of currencies over the past 12 months. Left un-arrested, the economic impact for Japan could be larger than the 2014 consumption tax hike, which briefly caused its economy to contract (see figure 1).

With demand for zero-yield Japanese currency surging, negative interest rates likely have a lower bound at -1% (or above) in both Japan and elsewhere. While some further cuts to deposit rates deeper into negative territory are possible, world policymakers are pressuring peers to avoid steps that appear aimed at achieving easing through exchange rates.

The Bank of Japan already owns more than half of outstanding Japanese government bonds. In this situation, it could mean new easing steps may target corporate bonds, loans and equities. Japan may also accelerate government spending and discuss pushing off the consumption tax hike scheduled for 2017 in order to build confidence. Yet while the probability has increased, there are no guarantees that recent turmoil will generate immediate action.

**Figure 1. Japanese GDP and Nominal JPY Trade Weighted Exchange Rate**



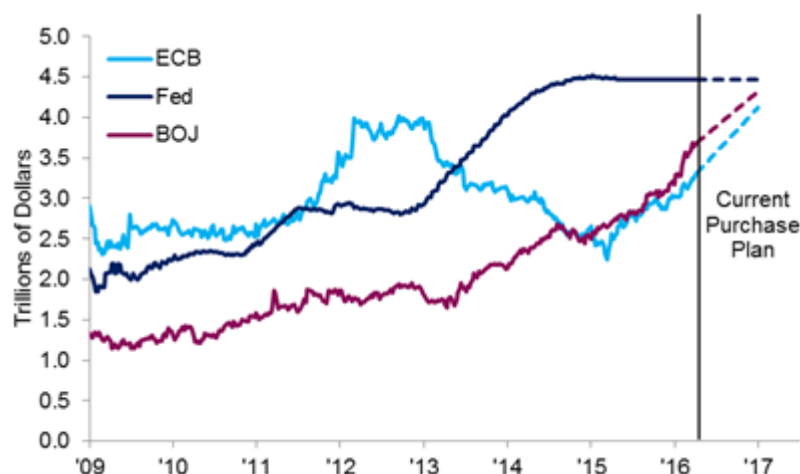
Sources: Bloomberg as of April 8, 2016.

Coming into 2016, we expected policy divergence to continue pressuring the yen, but noted that counter-trend movements could be long and painful in many markets. In this, we viewed additional Fed tightening as only a very partial driver of the currency market divergence. We also viewed negative interest rates outside the U.S. as merely a “lower, lower bound.”

What would drive further divergence and eventual new highs in the U.S. dollar would be the persistence of easing abroad, which conceivably could last for the remainder of this decade, though with the U.S. eventually rejoining other central banks in easing (see figure 2).

The velocity of base money in Japan, as elsewhere, can vary considerably. However, significant base money creation in Japan is a vastly different monetary policy than that of the preceding two decades of deflation. After moving to the most radical easing path in its history – asset purchases equal to 9% of Eurozone GDP, ECB Chief Economist Peter Praet put it this week, if conditions worsened, “our measures could be recalibrated once more.”

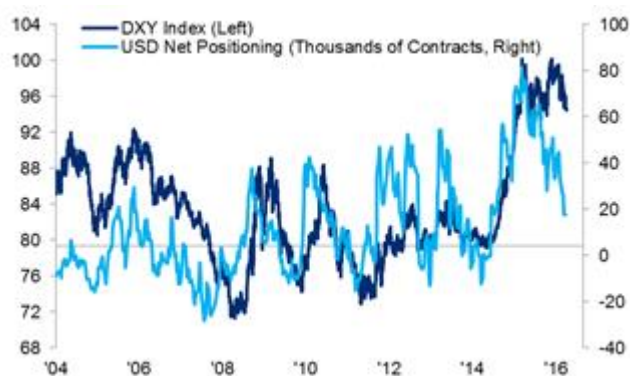
**Figure 2. ECB, Fed and BoJ Balance Sheets**



Sources: Bloomberg as of April 8, 2016. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events.

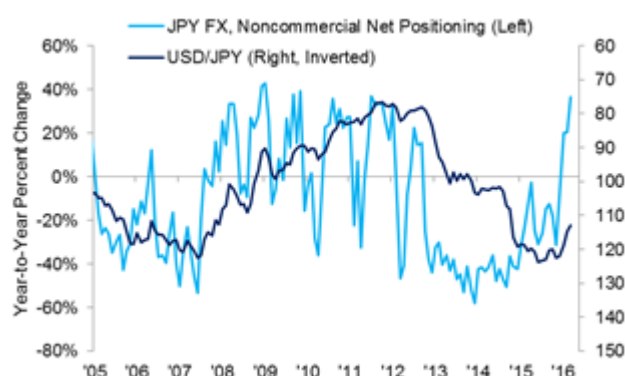
As figures 3-4 show, the unusually strong consensus views in markets as suggested by investor positioning data, has made so-called “pain trades” – counter-fundamental movements, or ones that investors positioned against – particularly extreme and lasting. The lopsided consensus itself may be a consequence of our unusual, central-bank-guided markets. However, this has very limited impact on the fundamentals themselves and the long-term course of asset prices.

**Figure 3. Net Long USD FX Positioning and DXY**



Source: Haver Analytics and FactSet as of April 8, 2016. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future returns. Real results may vary.

**Figure 4. Net Long JPY FX Positioning and Yen**



Sources: Haver Analytics as of April 8, 2016.

## Conclusion

As we’ve often noted, fundamentals are ultimately stronger than central banks, which haven’t prevented a history of recurring crises (see figure 5). When it seems that U.S. monetary policy is somehow handcuffed to China’s

exchange rate risks, as the most recent Federal Open Market Committee minutes suggested, it's not a builder of confidence. Yet it goes too far to suggest that the impact of monetary policy has suddenly become zero. Divergence has been an excessive focus of investors who should see that internal credit easing is the more significant monetary policy impact in large economies, even as it (like it or not) spills across borders too (see figure 6).

**Figure 5. U.S. Real GDP and Real Fed Funds Rate**



Sources: Haver Analytics as of April 8, 2016.

**Figure 6. U.S. and Euro Investment Grade Bond Spreads**



Sources: FactSet as of April 8, 2016.

**Steven Wieting**  
**Global Chief Investment Strategist**  
 +1-212-559-0499  
[Steven.wieting@citi.com](mailto:Steven.wieting@citi.com)

**Ken Peng**  
**Asia Investment Strategist**  
 +852 2868 8904  
[Ken.Peng@citi.com](mailto:Ken.Peng@citi.com)

**Malcolm Spittler**  
**Investment Analyst**  
 +1-212-559-8651  
[Malcolm.D.Spittler@citi.com](mailto:Malcolm.D.Spittler@citi.com)

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