Central Bank Policy and its Effects on Global Financial Markets

Federal Reserve (Fed): Over the past year or so, the Federal Reserve has taken a convincing hawkish stance on monetary policy implementation through the raising of interest rates. Over the last year, the federal funds rate was hovering just over 1.40%. Today, the federal funds rate sits at 2.40%, or a 100-basis point increase in rates. Over this time period, various asset classes have performed exceptionally well. The USD has appreciated in value in part because of the extraction of money from emerging markets and the current dollar-denominated debt crisis that has been occurring. As a result, investors brought capital back to the United States in the midst of a rising interest rate environment. In theory, as interest rate go up, the cost of capital also increases for companies, specifically if there are large amounts of debt that must be rolled-over. However, even at the current rates of 2.25-2.50%, the cost of borrowing is still quite relatively cheap. Most companies within domestic financial markets have been continuing the beat EPS estimates. Recently, there has been a bewilderment that has occurred between inflation rates and interest rates in the United States. The Fed’s current inflation target of 2.00% has not been met and is currently below that rate sitting at 1.6%. As interest rates have been increasing, inflation is supposed to be capped. However, inflation is surprisingly low considering the fact that the Fed has now transitioned their view to a data-dependent approach. Low inflation number are not a bad implication to the economy; however, it will be interesting to see low inflation encouraging spending and borrowing while simultaneously having a data-dependent Fed that is leaning more on the hawkish side.

European Central Bank (ECB): Over the short and medium-term time horizon, the European Central Bank’s monetary policy focus has been primarily around the ability to maintain price stability. The European Central Bank aims to maintain the current inflation rate at, or below, 2.00%. The ECB has undergone a timely quantitative easing program and the ECB has bought more than two trillion dollars in government bonds. In December of last year, the ECB has concluded that it will end QE while continuing to keep interest rates at record lows. Quantitative easing is a form of expansionary monetary policy whereby a central bank comes in and purchases a predetermined amount of government securities with the intent of providing liquidity within the financial system as well as lowering interest rates. Recently, the ECB has lowered its growth projections for economic growth, however they are not drastic enough to alter the ECB from continuing their reinvestment program. By continuing this, they are in line to meet their 2.00% inflation target, which is 40 basis-points above its current level. The European markets have been performing quite well, however, it is not performing at an optimal standard due to the uncertainty that lurks throughout Europe. If the ECB can come out with a clear and concise monetary policy schedule going forward, I think there will be more capital inflow into European markets.

Bank of Japan (BoJ): Much like the European Central Bank, the BoJ has been in a two-decade long process of monetary easing. However, the primary goal of the BoJ is to ease the country out of a long an infertile deflationary economy. Fast forward twenty years and the Bank of Japan is facing a
significant headwind. This headwind is the fact that banks are not profitable and hesitant to lend capital. When an environment of extremely low interest rates, in this case -0.10%, bank earnings are hurt due to the effects of shrinking interest margins. Or, the differential between how much banks can charge borrowers and the amount they must pay depositors. Over 70% of Japanese regional banks have posted net losses and profit declines within financial markets is a direct result of these thin margins. Financial markets were not very responsive throughout Japan's first round of QE, however, when the BoJ first introduced QQE (quantitative and qualitative monetary easing), they purchased an additional 80 trillion in yen purchases which was not very effective. In 2014, they introduced a second round of QQE, known as QQE2, which causes Japanese equity markets to grow by about 33%.

**People’s Bank of China (PBOC):** Similar to its central bank counterparts within the advanced economy space, the PBOC’s monetary policy focus and stance falls within a dual mandate of price stability as well as the promotion of growth. However, the PBOC’s mechanics of operation in relation to economic growth differ from more conventional monetary policy implementations. The PBOC does not rely on a specific benchmark that influences the economies asset prices, exchange rates, and borrowing costs. Instead, the PBOC uses an assortment of various tools to control interest rates. This causes growth projections to be a blurry and misinterpreted. Additionally, the PBOC will come up with new monetary policy tools to replace old ones. The recent monetary policy stance for the PBOC is to maintain cautious monetary policy practices while simultaneously keeping the Chinese Yuan stable with the intent of providing continuous and abundant liquidity within the marketplace. Financial markets within China, such as the Shanghai Composite, have not been performing well at all. In the past year or so, Chinese equity returns were the worst in a decade, with a 24.6% decline in prices. The price declines were primarily a result of ongoing trade disputes with Washington, however, the domestic Chinese economy has also been taking hits. Recently, China’s official PMI numbers came in at 49.4, which was lower than the estimate of 49.9. This indicates a period of contractionary growth within the domestic economy.