

Major Central Banks Policy Implications for 2016

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I recently spoke with Jawad Mian, editor of “Stray Reflections,” and Richard Clarida, global strategic advisor to PIMCO and economics professor at Columbia, regarding their thoughts on policy action by the Federal Reserve (Fed), the Bank of Japan (BOJ) and the European Central Bank (ECB), as well as global implications for investing. Below I outline the key takeaways.

Fed’s Policy Normalization Mian applauds the Fed’s decisive action to embark on policy normalization. Although the recovery has been lethargic, averaging 2% yearly, he believes it is important to look at the nature of recovery and not just the numbers. Mian believes the corporate sector has regained confidence, wages have risen, the household sector has rebuilt its balance sheet to a large extent with debt to income back to 2002 levels and auto sales are back at their highs. Further, Mian believes 2% growth would ordinarily be associated with an increase of 50,000 jobs, but today we are seeing 150,000 jobs being created despite 2% growth. Given this backdrop, excessively easy monetary policy is no longer required.

U.S. Stock Market Skepticism Mian highlights that the recovery has been looked upon with disdain and there is so much distrust surrounding stock market gains. He believes the underlying economy is strong, with a growing manufacturing sector. Mian sees the large moves in the U.S. dollar distorting economic growth and variables like global reserves balances. If the U.S. economy avoids recession and China stabilizes, he sees stocks potentially outperforming bonds in 2016; he also foresees double-digit returns next year in many markets.

Europe and Japan Accelerating Policy Easing Mian believes that Europe and Japan will outperform in 2016, largely because of monetary policy divergence among the Fed, ECB and BOJ. Given that we are in the early innings of a European recovery—only 8 months old—he is most encouraged by strong lending growth. In Europe especially, the small and medium-size enterprises (SME) rely largely on banks for funding—and therefore credit growth in Europe is crucial. He mentioned that the average company in Europe has grown earnings by 15%, but total index earnings remain flat due to the large commodity and energy exposure, particularly in the U.K. and Italy. Mian’s top sector picks in Europe are Health Care and Financials, with Financials in his view that the capital raising needed to manage their deleveraging largely as being completed.

Currency Implications : Euro and Yen Clarida believes that ECB president Mario Draghi and BOJ governor Haruhiko Kuroda’s commitment to quantitative easing (QE) and the ability to do much more if needed to meet the 2% inflation target will ultimately result in a grind lower of the euro and yen against the U.S. dollar—with the expectation of the euro ultimately hitting parity. While Clarida is ultimately bullish on the U.S. dollar, he sees the gains slowing down from the recent moves. Mian also believes the euro is going to reach parity and below sometime in 2016.

China Greatly Misunderstood China’s mini currency devaluation, in hindsight, was largely a reflection of the reality of slowing economic growth and a desire to show two-way currency market

moves to the International Monetary Fund (IMF). Mian believes China has to maintain a stable currency ahead of inclusion in the Special Drawing Rights basket next year. But ultimately, a 10% devaluation is not in China's interest given that the country is running a high current account surplus, and the political fallout from such a move could be quite large. Further, a large devaluation could manifest in large deflationary shocks globally. Instead of currency policy, the People's Bank of China has other tools available, such as stimulating the economy by cutting lending rates, if needed. According to Mian, in assessing China's growth potential, many focus on old economy indicators and miss out on newer economy signals. He believes China's services sector is a larger driver of growth today than it has ever been: Wages have been growing at a single-digit pace, retail sales are strong, travel is booming and these indicators seem to point to better growth prospects ahead. **Outlook for Long-Term Yields** Mian points out that bond returns this year have been disappointing, despite a global risk-off environment driven by Greece worries, an oil crash, China's devaluation and Fed uncertainty. It is likely also that deflation risks are overblown given that long-term yields are higher on the year. His forecasts are for the 10-year bond yields to hit 3.25% and the 30-year to hit 3.6% at the end of the policy normalization cycle. Mian believes stocks are likely to do well until interest rates reach restrictive levels—what he sees as 3.25% on 10-year. At these interest rate levels, if inflation hovers around 1.5% and nominal growth 2.5%, Mian notes that this maybe the rate at which the economy begins to buckle. ***Unless otherwise stated, data source is Bloomberg, as of 12/18/15.***

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