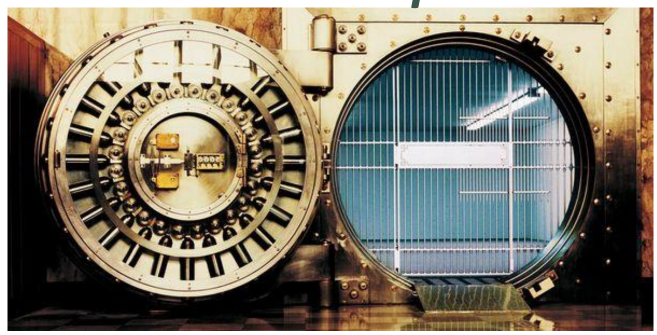
MAKING SENSE OF *THIS* WORLD

7 September 2020



R&R Weekly Column
By Brunello Rosa

Will The Fed Trigger Another Race To The Bottom?

During the latest Jackson Hole symposium of central bankers and academics, which was held for the first time in a virtual format and, therefore, was open to the broader public, Chairman of the US Federal Reserve Jerome Powell provided the main conclusions reached in the Review of the Fed's Strategy, Tools and Communication. In our recent analysis, we provide all the details of that decision.

In a nutshell, the Fed decided to introduce what has been labelled as Average Inflation Targeting (AIT), which means that the Fed will allow inflation to overshoot the 2% target for brief periods (by a limited amount), in order to make up for the lost price level during periods of target-undershooting. This system is clearly designed for the present period, during which the Fed has been undershooting the inflation target for a very long time. The new framework will therefore allow the Fed to keep rates low for longer, and to look through potential inflation spikes that may arise due to Covid-induced supply-side constraints.

Clearly, a potential side effect of this approach (typical of all "averaging" or "level-based" regimes) is what happens when there is a persistent period of above-target inflation. In theory, the Fed should then keep policy rates higher than they otherwise would, to send inflation below target for some time. In turn, that would possibly induce a marked slowdown or recession (as occurred during Paul Volcker's experience to combat spiralling inflation in the 1970-80s). Although now that seems a distant problem, it might occur at some point if stagflationary pressures were to emerge. The Fed will likely cross that bridge only when the time comes to do so.

In any case, the immediate policy implication is that the Fed will likely keep interest rates at record lows for longer than previously thought, as now the Fed can wait for inflation to be above target before increasing rates, rather than start raising rate as soon as inflation starts moving, consistently and convincingly, *towards* the target level. This has clear market implications for bond and equity prices (likely to be supported by the lower rates), credit spreads (likely to remain more compressed than would otherwise be the case) and for the US dollar, which will likely stay as weak as it currently is, and remain so in the future as well. Long-term yields have briefly edged up on the announcement of the Fed's approach, as the implied breakeven inflation level embedded into them rose, together with inflation expectations.

The real question is how all other central banks (in the G10, but also in EMs), will react to this move by the Fed. They will not be able to afford staying put: when the "mothership" that is the US Federal Reserve moves, all others will have to react, and move in the very same direction. The real risk is therefore that a new race to the bottom will now ensue, of interest rates and other accommodative monetary policies. Such a process may be additionally likely as the other central banks seek to prevent their own currencies appreciating versus the dollar, in the middle of the most severe economic contraction since the Great Depression.

The first G10 central bank to meet after the Fed announcement was the Reserve Bank of Australia (RBA). As discussed in our review of the policy meeting, the RBA decided to leave its policy rates unchanged, but did increase the size of its credit easing facilities. This week, the Governing Councils of the ECB and of the Bank of Canada will each meet. As discussed in our previews, we expect both central banks to keep their policy stances broadly unchanged, while keeping a clear easing bias and adding a dovish twist as a response to the Fed's policy review.

In the next few months, these and other central banks will meet. The risk is that another significant round of policy easing, carried out by a number of central banks, is just around the corner.

Our Recent Publications

- Flash Preview – ECB To Remain Highly Accommodating In Response to the Fed's Strategy Review, *by Brunello Rosa and Fawaz Sulaiman Al Mughrabi, 4 September 2020*
- Flash Preview – Bank of Canada To Remain on Hold, With A Dovish Twist In September, *by Brunello Rosa and Karmen Meneses, 4 September 2020*
- Flash Review – RBA Boosts Credit Easing and Keeps The Door Open To More Monetary Accommodation, *by Brunello Rosa and Fawaz Al Mughrabi, 1 September 2020*
- Flash Preview: RBA To Mull (And Possibly Implement) A Response To The Fed's Strategy Review, *by Brunello Rosa and Carmen Meneses, 28 August 2020*

Looking Ahead

The Week Ahead: US Inflation To Remain Subdued And Central Banks To Remain On Hold

In the US, August's CPI inflation is expected to rise to 1.2% y-o-y (*p:* 1.0%), while core-CPI inflation is likely to remain unchanged at 1.6% y-o-y.

In the EZ, Q2-GDP is forecasted to confirm a plunge of -15.0% y-o-y (*p:* -3.1%), the biggest contraction on record and the official beginning of a recession.

The ECB and BoC are both expected to keep key policy rates on hold at -0.5%, and 0.25%, respectively.

The Quarter Ahead: US-China Tensions Remain High, Brexit Uncertainties Linger; Central Banks Remain Dovish

COVID-19 vaccine testing is progressing: *i)* 91 are in the 'preclinical phase' (under active investigation in animals); *ii)* 47 entered 'phase three' (large scale efficacy tests); *iii)* 37 are undergoing clinical trials on humans; and *iv)* 3 received early or limited approval. According to the WHO, *"vaccines will only be used when they are safe and effective; mass vaccination is unlikely before the middle of 2021"*.

In the US, President Trump stated he is *"ready to help resolve the India-China dispute over the mountain border in the western Himalayas"*, adding that the two countries were *"going at it much more strongly than a lot of people even understand".* The US national security adviser said *"China is actively seeking to interfere in the US election and influence domestic politics"*–without providing details.

In the EU, as Brexit trade talks stall, the battered UK economy risks severe supply disruptions: transportation companies providing the UK with food and medicine alerted *"the country is not prepared for the end of free trade with the EU"*.

In China, the government–the second largest non-US holder of US government debt–is expected to gradually decrease its holdings of USTs. In June, China held USD 1.074tn, down from USD 1.083tn in July; in light of rising tensions, Beijing could cut its holdings by more than 25% to about USD 800bn–triggering turmoil in global financial markets.

After the US Fed's average inflation target (AIT) announcement led to EUR appreciation, the ECB is likely to give guidance on: *i)* sustained liquidity provision; and *ii)* additional stimulus–potentially weakening the EUR.

Last Week's Review

Real Economy: A COVID-19 Second Wave Risks Hampering The Fragile Economic Recovery

In the US, in August: *i)* 1.37m jobs were added (*c:* 1.40m; *p:* 1.73m); yet, nonfarm payrolls remain 11.5m below their pre-pandemic level; *ii)* average hourly earnings rose by 4.7% y-o-y (*c:* 4.5%; *p:* 4.7%); and *iii)* the unemployment rate fell to 8.4% (*c:* 9.8%; *p:* 10.2%), marking the fourth straight month of decline after April's all-time high of 14.7%. In the week ended on August 29, the number of 'claims for unemployment benefits' fell to 881K (*c:* 950k; *p:* 101k), the lowest level since the effects of the pandemic started in March.

In the EZ, in July: *1)* retail sales rose less-than-expected by 0.4% y-o-y (*c:* 3.5%; *p:* 1.3%) - as a resurgence in the number of infections weighed on demand, after countries across the region continued to relax containment measures; and *2)* the unemployment rate rose to 7.9% (*c:* 8.0%; *p:* 7.7%), reaching the highest level since November 2018 - as the pandemic continues to impact the labor market.

In Japan, in July retail sales contracted by -2.8% y-o-y - deeper than June's -1.3% and well below market expectations of a 2.4% expansion–amid a resurgence of COVID-19 cases in some regions of the country.

During its September meeting, the RBA kept the cash rate unchanged, at a record low of 0.25%; to keep funding costs low and boost lending, it expanded to around AUD 200bn its Term Funding Facility (TFF)–established to offer at a fixed rate three-year funding to authorized deposit-taking institutions.

Financial Markets: After August Rally, Profit Taking Hits Tech Stocks. Bonds Up, Oil And Gold Fall

Market drivers: sell-off in equities, as big tech companies had become overvalued due to widespread use of derivatives.

Equities: w-o-w, global stocks fell (MSCI ACWI, -2.3%, to 573) driven by the US. The S&P 500 fell (-2.3% to 3,427), but it returned more than 7% in August–its best month since April. European shares pulled back (Eurostoxx 50, -1.7% to 3,261), in sympathy with the tech-led decline in US equities. However, news of merger talks between Spanish lenders Bankia and CaixaBank helped to curb losses.

Fixed income: w-o-w, global debt indices rose (BAML Global, +0.3% to 297.1) helped by: *i)* the equity sell-off; *ii)* month-end portfolio rebalancing; and *iii)* the Fed's debt purchases (10y UST, -1bps to 0.72).

FX: w-o-w, the USD gained against most currencies (DXY, +0.4% to 92.719; EUR/USD, -0.5% to 1.184).

***Commodities*:** oil prices fell (Brent, -5.3% to 42.7 USD/b), as coronavirus flare-ups in various parts of the world threaten a sustained rebound in oil consumption. Gold fell (-1.6% to 1,932 USD/Oz.), as improved US labor data strengthened the USD–putting pressure on safe heavens.

@RosaRoubini Rosa & Roubini Rosa&Roubini Associates

For more information, please call us on +44 (0)207 1010 718 or send us an email to info@rosa-roubini-associates.com

www.rosa-roubini-associates.com

118 Pall Mall, London SW1Y 5ED

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*