



R&R Weekly Column
By Brunello Rosa



Policy Inconsistencies Will Continue To Buffet Financial Markets

Last week, the October-November round of major central bank meetings came to an end. As discussed in our previews and reviews, the [Federal Reserve increased its policy target range by 75bps, as had widely been expected](#). Market participants were exposed to mixed signals from the Fed. On the one hand, the Fed reassured them that, in December, a discussion would start within the FOMC regarding whether and when to reduce the pace of tightening, taking into account the cumulative actions that have been taken since March 2022. On the other hand, the FOMC statement suggested that the terminal rate would be higher than previously had been expected by market participants. The market reacted with a see-saw price action, with a net effect of there being losses in equity and bond prices.

The [Bank of England also had to provide mixed signals to the market](#), while increasing the Bank Rate by 75bps as well. It re-started QT and promised more rate hikes, but also said that the terminal rate would be lower than currently expected by the market. Again, market prices were volatile following the release of news by the central bank.

These are only two examples of how policy news has been buffeting financial markets in the last few months. More specifically, the UK staged an example of how monetary and fiscal policy may end up on a collision course, with the result of causing a financial market rout, around the time of the Truss-Kwarteng mini-budget and the LDI debacle.

But there is a more subtle inconsistency within monetary policy itself that is causing trouble for central bankers all around the world, namely the potential conflict between *price stability* and *financial stability*.

Virtually all central banks around the world, perhaps with the exception of the Bank of Japan, are fighting inflation to restore price stability, with a combination of higher policy rates, balance sheet policies (such as Quantitative Tightening) and to a certain extent *forward guidance* (provided by the forecasts of terminal policy rates, for example).

At the same time, rising rates and tightening financial conditions risk causing financial instability episodes, which would force central banks to stop their policy normalisation cycles, or even to stop their tightening cycles. In a sort of unofficial way, most central banks are now heading towards a division of labour between interest rates (devoted to price stability) and balance sheet policies (aimed at financial stability). The ECB offers the perfect example of this: while increasing interest rates, the ECB continues to provide a backstop to the eurozone bond market by re-investing the proceeds of maturing bonds in full. And even when the ECB does start its QT program, the TPI facility will ensure that bonds can be selectively purchased in order to avoid financial instability episodes emerging.

The Federal Reserve has recently formalised this trade-off between price stability and financial stability with the introduction of a new theoretical framework. [In this framework](#), a new rate (called r^{**} , the rate above which a financial instability episode may be triggered) is defined besides the traditional r^* (the rate at which monetary policy is neither stimulating nor restricting economic growth). If r^{**} is lower than r^* , the central banks will need to stop its pursuit of price stability sooner than its desired neutral level, in order to avoid financial instability. But even if r^{**} is above r^* , the central bank may need to stop its tightening cycle, if its desired terminal rate is above the neutral rate.

These examples show how policy inconsistencies are here to stay, and that they will continue to determine market dynamics in coming months.

Our Recent Publications

- ✿ [Russian Economy: An Economic Shock From Which It Will Be Hard to Recover](#), by London Politica, 4 November 2022
- ✿ [Flash Review: BOE Increases Rates While Forecasting A Prolonged Recession in the UK](#), by Brunello Rosa and Nato Balavadze, 3 November 2022
- ✿ [Flash Review: After Another Jumbo Hike, The Fed Signals A Higher Terminal Rate In Spite of A Slower Pace of Tightening](#), by Brunello Rosa and Nato Balavadze, 2 November 2022

- ✿ [Flash Preview: BoE To Increase Rates by \(At Least\) 75bps in November](#), by Brunello Rosa, Nouriel Roubini and Nato Balavadze, 2 November 2022
- ✿ [Preview: Fed To Continue With Another Jumbo Hike While Signaling a Slowdown in the Pace of Rate Hikes Ahead and a Higher Terminal Rate](#), by Nouriel Roubini, Brunello Rosa and Nato Balavadze, 1 November 2022
- ✿ [Review: ECB Delivers Another Jumbo Rate Hike, And Promises More Tightening Ahead](#), by Brunello Rosa and Nato Balavadze, 27 October 2022

Looking Ahead

The Week Ahead: US Inflation To Cool Off; YoY Retail Sales To Recover Slightly In EZ; UK QoQ GDP To Contract

In the US, in October, headline and core inflation are likely to ease off to 8.0% y-o-y (*p*: 8.2%) and 6.5% y-o-y (*p*: 6.6%).

In the EZ, in September, retail sales are expected to recover slightly to -1.3% y-o-y (*p*: -2.0%) and 0.3% m-o-m (*p*: -0.3%).

In the UK, in Q3, GDP is seen shrinking by 0.5% q-o-q (*p*: 0.2%), whereas the economy is expected to slow down to 2.1% y-o-y (*p*: 4.4%). September's IP is likely to recover slightly to -4.4% y-o-y (*p*: -6.7%).

The Quarter Ahead: IAEA Found No Traces Of 'Dirty Bomb'; Battle In Kherson Continues; North Korea Launched Missiles

IAEA found no traces of 'dirty bomb' in Ukraine. The United Nations nuclear watchdog inspected three sites at Ukraine's request in response to Russian allegations that Ukrainians plan to use a 'dirty bomb' in its own territory. The G7 warned in a statement that Russia would face 'severe consequences' for any use of chemical, biological or nuclear weapons.

Kherson braces for a battle. Putin has approved the evacuation of civilians from parts of Russian-occupied Kherson in Ukraine. Ukrainian military forces have been advancing on the strategic port city and retaking a city would be a major victory in the war. In the meantime, Russian attacks left 4.5m people without power.

Last week North Korea conducted a record number of missile launches, bringing the total number of missiles fired to more than 60 so far this year. The latest missile launch came after the United States and South Korea continued its joint military exercise.

Trump is expected to announce his candidacy for the 2024 US presidential election this month. In Iowa, Trump suggested that he will run for president. Other potential Republican presidential candidates include Florida Governor Ron DeSantis, ex-Vice President Mike Pence and ex-UN envoy Nikki Haley.

Last Week's Review

Real Economy: Unemployment Rose In US; EZ Inflation Surged; EZ QoQ GDP Advanced By Less; PMIs Fell In DMs

In the US, in October, unemployment rate increased to 3.7% (*c*: 3.6%; *p*: 3.5%). NFPs rose by 261K (*c*: 200K; *p*: 315K). Manufacturing PMI rose to 50.4 (*c*: 49.9; *p*: 52), whereas services PMI fell to 47.8 (*c*: 46.6; *p*: 49.3). Composite PMI declined to 47.8 (*c*: 47.3; *p*: 49.5).

In the EZ, in Q3, the economy slowed down to 0.2% q-o-q (*p*: 0.8%) and 2.1% y-o-y (*p*: 4.1%) as expected. In October, the headline and core inflation surged by 10.7% y-o-y (*c*: 10.2%; *p*: 9.9%) and 5.0% y-o-y (*c*: 4.9%; *p*: 4.8%). In October, manufacturing and services PMI fell to 46.4 (*c*: 46.6; *p*: 48.4) and 48.6 (*c*: 48.2; *p*: 48.8). Composite PMI is fell too to 47.3 (*c*: 47.1; *p*: 48.1). September's unemployment rate remained unchanged at 6.6% as expected (*p*: 6.7%).

In the UK, October's manufacturing and services PMI fell to 46.2 (*c*: 45.8; *p*: 48.4) and 48.8 (*c*: 47.5; *p*: 50) respectively. Composite PMI decreased to 48.2 (*c*: 47.2; *p*: 49.1).

CBs remained hawkish. In the US, the Fed raised its Fed funds range by 75 bps to 3.75% - 4.0%. In the UK, the BoE increased its Bank Rate by 75bps to 3.0%.

Financial Markets: Stocks Were Up, Whereas S&P 500 Was Down; Yields Rose; Dollar Is Up; Oil and Gold Are Up

Market Drivers: The market was exposed to mixed signals: dovish Fed statement and hawkish press conference. Investors' hopes for a Fed pivot faded and U.S. stocks fell as a result. In Europe, shares rose, as investors received the signal that central banks might reduce its pace of rate hikes. Investor sentiment was also boosted by hopes that China might walk back its zero-COVID policies.

Global Equities: Decreased w-o-w (MSCI ACWI, -1.4%, to 580.60). The US S&P 500 index decreased (-3.3% w-o-w, to 3,770.55). In the EZ, share prices were up (Eurostoxx 50, +2.1% w-o-w, to 3,688.33). In EMs, equity prices increased (MSCI EMs, +4.7%, to 884.98). Volatility rose to 25.5 (VIX S&P 500, 52w avg.: 25.5; 10y avg.: 18.2).

Fixed Income: w-o-w, the 10-year US treasury yields rose (+15 bps to 4.16%). The 2-year US Treasury yields increased too (+24 bps to 4.66%). The German 10-year bund yield also rose (+20 bps to 2.29%).

FX: w-o-w, the US Dollar Index was up (DXY, +0.1%, to 110.7; EUR/USD -0.1%, to 0.9958). In EMs, currencies rose (MSCI EM Currency Index, +0.5% w-o-w, to 1,589.07).

Commodities: w-o-w, oil prices rose (Brent, +5.3% to 98.75 USD/b). Gold prices increased w-o-w (+2.5% to 1,685.7 USD/Oz).



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Abbreviations, Acronyms and Definitions

a	Actual	LN	Northern League, Italy
AKP	Justice and Development Party, Turkey	MSS	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