THE OMNIVEST MARKET VIEW

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Central Bank Watch

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Next week the Federal Reserve, the Bank of Japan, the Bank of England and the European Central Bank (ECB) are all scheduled to hold separate meetings in order to set policy rates. And while it is unlikely that there will be any significant change in policy for any of these Central Banks, there is an outside risk that the ECB may make a move in order to calm European debt and equity markets.

On July 5th, the Central Bank of Denmark made a substantial cut in interest rates from 0.45% to 0.20% and lowered deposit rates from 0.05% to -0.20% in order to damp upper pressure on the Danish krone following the ECB's 25 basis points (bps) cut. By taking policy rates to close to 0% and pushing deposit rates below zero, the move by Denmark may have opened the window for the ECB to take action at their meeting next week.

There is also a modest chance that the Federal Reserve reduces the deposit rate it pays to banks for holding reserves. This is particularly important because banks have parked around $1.6 trillion of excess reserves at the Central Bank earning 0.25% while the rest of us are earning close to 0%. By bringing the deposit rate to less than 0%, banks would likely turn on their lending spigots to consumers. Taking action now would also buy the Federal Reserve time until mid-September to assess whether the US economy is moving sideways, decelerating or accelerating again from its current stall speed.

The tool of lowering the Federal Reserve's deposit rate that it pays to banks eliminates the risk associated with the Fed expanding its already bloated balance sheet.

The potential benefit of making such an unexpected move would be welcomed by most financial markets with the exception of the US Treasury market. By stimulating lending, the private sector would feel the impact almost immediately. However, the Treasury market would likely retreat from these ultra low- yield levels as the Federal Reserve broadens the tools that it is willing to use.

The recent rise of market volatility may also be tempered if the Fed were to move next week. August is a month of illiquidity as most investors take time off globally. While the ECB lowered interest rates by 25 bps during their July 5th meeting, they too may want to ease further knowing that Europeans take an extended holiday break during the month of August.

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