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Fixed Income Commentary

The Prisoner's Dilemma of Central Banks

Global central bank monetary accommodation continues to overwhelm financial market valuations. Yet, amidst a backdrop of anemic global economic growth and decreasing inflation pressures – as evidenced by the large correction in commodities in April – developed economy central banks are becoming even more ambitious in their monetary policy objectives. If global economic slack was truly due to a lack of aggregate demand, then one would expect more real economic growth to result. For the most part this has not happened, as asset prices have increased without an improvement in economic data. As a result, the current situation of global monetary policy has increasingly taken the form of a Prisoner's Dilemma from game theory. Furthermore, central banks are finding that their current policy choice has contrasting short-term and long-term consequences.

In a world of high unemployment and persistently weak growth, developed economy central banks are seeing their monetary policy options as follows:

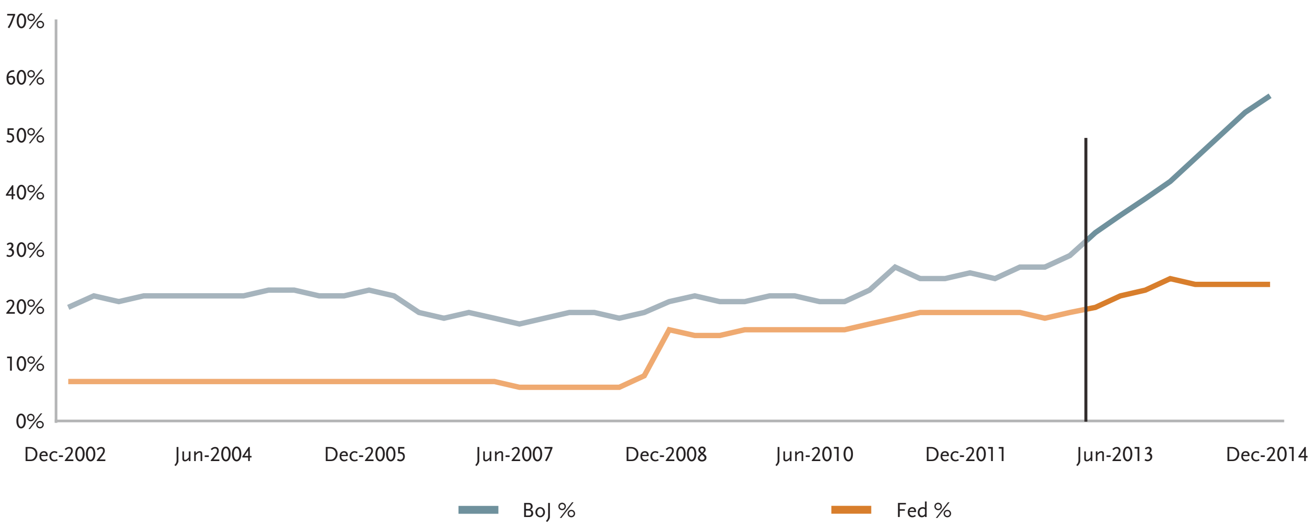
Monetary Policy Dilemma	Other Central Banks Are Aggressive	Other Central Banks Are Passive
Be Aggressive	chance of real Keynesian growth (inflation down the road)	stronger relative growth (weaker exchange rate)
Be Passive	weaker relative growth (stronger exchange rate)	depression and loss of potential (free market clearing levels)

Despite loud objections by free market supporters that it would be more optimal for all central banks to refrain from market manipulation, being aggressive is a strictly dominant near-term strategy, meaning it is optimal regardless of the strategy choice of other central banks. This can be applied to all developed economy central banks, including the Bank of Japan, the European Central Bank, and the Federal Reserve. While the ECB only officially has a price stability mandate and not a growth mandate, the slower growth that results from being passive could cause deflation pressures which would threaten price stability. Near-term results will also continue to be emphasized as long as decisions are being made by elected officials and their corresponding central bank appointments, who require short-term results for job security. There is no doubt that fiscal gridlock is also acting to constrain economic expansion, but the reality is that central banks are the last resort to do the heavy lifting for the global economy, and commodities seem to be indicating that cost-push inflation is not a near-term concern.

The current developed central bank monetary policy game plan is therefore one of strictly dominant near-term strategy – **be aggressive** – in both guidance and action. In recent weeks the BoJ, the ECB, and the Fed have all followed through on this philosophy.

The Bank of Japan acted by opening the floodgates for aggressive asset purchases. After enduring almost two lost decades, President Abe and Bank of Japan Governor Kuroda realize that aggressive action might be their country's final chance to avoid a deflationary growth trap, as global economic growth continues to disappoint. Specifically, the BoJ will be expanding its balance sheet from ¥167 trillion today (34% GDP) to ¥220 trillion by the end of 2013 and ¥290 trillion by the end of 2014 (57% GDP). This pace is much faster than that of the Fed, which currently has a balance sheet to GDP ratio of 21% and is on pace to get to roughly 25% by the end of 2013 (shown below). The aggression is working, as the Nikkei has increased 50% and the Yen has depreciated 20-30% in the last 6 months. While this is a promising start, ultimately it remains unclear if asset purchases alone can create real economic growth in an elderly population demographic that has grown accustomed to life without inflation. The BoJ will therefore be forced to continue its aggression in order to ultimately achieve its 2% inflation target. If domestic assets start moving aggressively out of Japan, global asset prices could be significantly affected. For now, this hasn't materialized however as despite increased yield volatility Japanese 10-year yields still remain under 0.90%. Regardless, Kuroda has shown his hand, and the BoJ chips are clearly not coming off the global central bank poker table.

Central Bank Balance Sheet as % of GDP



Source: Bloomberg

The European Central Bank got aggressive by announcing a 0.25% refinancing rate cut to 0.50% at their May 2 meeting. While a 0.25 bps cut might seem trivial, it is important in the fact that it brings them closer to the point at which other non-standard monetary policy actions will be put more actively on the table. ECB President Mario Draghi also shocked many during his questioning when he hinted at a future deposit rate cut to negative territory (currently at 0%). This continues Draghi policy of talking aggressively – a policy that was most powerfully used when he announced during the most recent crisis that he would "do whatever it takes" to save the Euro. Draghi was also instrumental in tightening peripheral European sovereign spreads on the announcement of the Outright Monetary Transactions program even though no bonds have been purchased.

The aggressive talk in Europe wasn't limited to Draghi however, as Angela Merkel also shocked many with her speech at the German Savings Bank Day in Dresden, where she lamented the broken transmission mechanism of monetary policy, and stated a possible need for higher interest rates in Germany and lower rates in periphery countries. While her comments were not consistent with Bundesbank ideology, Merkel is also gearing up for an important German election in September as an Alternative for Germany party seeks to gain political power with Euro-sceptical views. While low rates punish German savers, they also are a huge advantage for German corporates that fund off the sovereign levels, which makes her comments very surprising.

In the United States, the Federal Reserve showed continued aggression by shifting speculation of QE tapering to a more balanced meeting statement, which read: "the Committee is prepared to increase or reduce the pace of its purchases." With inflation pressures having been lessened by the commodity market sell-off and economic growth remaining tepid at best, the core power circle at the Fed of Bernanke, Yellen, and Dudley remains fully committed to pushing forward with balance sheet expansion.

The S&P 500 is making new all-time highs, corporate profit margins remain wide, and the housing market continues its miraculous comeback, but this seems to be largely a function of copious amounts of liquidity reaching for higher yield/returns. The clearest domestic example of this might have been the Apple corporate debt deal that was brought to market to overwhelming demand as a $52 billion order book was put in for a $17 billion total deal.

Unfortunately, asset price strength is only translating into tepid corporate hiring. April's employment report was better than expected, but the U.S. unemployment rate at 7.5% is still high, with a significant number of workers having left the labor force.

One might logically conclude that central banks are therefore increasingly "pushing on a string." This is especially true given that zero rates and quantitative easing policies can cause painful side effects. Namely they penalize savers, provide cover for reckless fiscal policies, increase wealth inequality, prop up zombie companies, and obscure free market clearing levels.

Minnesota Fed President Narayana Kocherlakota probably responded to this criticism best however when he stated, "the Committee has to weigh the certainty of a costly deviation from its dual mandate objectives against the benefit of reducing the probability of an even larger deviation from those objectives." Given that the Fed is currently failing on both its price and employment mandates, it seems increasingly likely that the Fed will maintain its current pace of asset purchasing well into 2014.

This makes assigning "fair value" to financial assets of all variety very difficult. 10-year Treasury yields at 1.90% are not projected to keep pace with inflation, but they don't look so completely ridiculous when compared to French, Canadian, and UK 10-year yields at the same levels – not to mention German 10-year yields at 1.40% (or Japanese yields sub 0.90%). None of these sovereign yields promise attractive long-term real returns, yet the dark clouds of financial repression continue to spread across the global fixed income landscape. Investors should take note of this reality and proceed with caution.

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