Keeping it slack

A few weeks into the Trump Presidency, bond markets in America jumped with yields spiking from 1.7 per cent in November 2016 to 2.5 per cent a few weeks later. Markets anticipated a reversal of the interest rate cycle with expectations of higher economic growth driven by a combination of tax cuts and a spending stimulus. This was based on promises during Mr Trump's election campaign and subsequently reinforced by his new administration. With a rise in the payroll and falling unemployment, the United States Federal Reserve hiked interest rates by 50 basis points in two separate tranches, with prospects of further hikes during the year. Economic output was expected to climb from 1.8 per cent in 2016 to 2.9 per cent this year.

Across the Atlantic, analysts began to convince themselves that the European Central Bank would taper its bond purchases with an upbeat outlook within the Eurozone both on growth and price deflation. In Japan too, with a strong recovery in exports, economic output was expected to rise from 0.7 per cent last year to 1.2 per cent in 2017, accompanied by some hardening of prices. But in the months, that followed a slightly different picture seems to have emerged, where underlying weaknesses of price deflation and fragility in the recovery process, remain entrenched.

Whilst the hike in US dollar rates by the Fed in June was expected by the markets, they have no longer priced in sharper hardening in the rest of the year. The ECB too is moving cautiously with underlying inflation falling to 0.9 per cent in May, far removed from a target of 2 per cent. It must naturally be concerned as to the impact of a sudden rise in bond yields, especially on a wobbly economy like Italy, which is burdened with huge sovereign debt, a forbidding problem of bad loans in the banking system, high unemployment and puny growth. At its recent meeting in June, the ECB kept rates constant and reiterated that its monthly asset purchases will continue at €60 billion until at least December. In Japan too, with inflation dropping to 0.2 per cent in March, the Bank of Japan is unlikely to alter its tack on monetary easing in a hurry and bond purchases will continue for some time to come. With the collective balance sheets of large central banks on an expansion path, monetary policy will remain loose for a while yet or until 2019, as some analysts have now begun to believe.

In China, the world's second largest economy, the primary risks stem from large amounts of debt which rose steadily from 150 per cent of GDP in 2007 to over 280 per cent now. With a slowing economy and falling exports, the People's Bank of China is now increasingly cautious, clamping down on money supply to the shadow banking system, which is prone to risky exposures. Credit growth has slipped from 16 per cent in 2016 to about 13 per cent now with expectations of a further decline in the near term. The risks in China are heavily weighed on the downside and Fed officials together with their peers in the ECB must keep these considerations in mind before affecting radical changes in their stance.

> In America, markets are no longer pricing in sharper hardening in the rest of the year while in Europe, the ECB kept rates constant and reiterated that its monthly asset purchases will continue at €60 billion until at least December.

As if in reflection of such beliefs, US bond markets have tempered their earlier flurry with yields moderating to 2.1 per cent. Markets therefore anticipate short term interest rates to remain muted over the coming year. These developments will encourage money flows into emerging markets through the carry trade and we therefore expect greater liquidity and a marginal strengthening of currencies. The rupee, which gained 5.5 per cent since January 2017, may rise further. This would provide some room to the Reserve Bank of India to reduce interest rates in the coming months. ■

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