Is the 2% target a holy grail?

Or an accident of history…

- **Stay short 10yr OAT** (opened at 73bps, 9bps in the money).
- **Initiate a short 5Yr Australia bond at 2.20%.**
- **Take profit in long EUR/GBP** (opened at 87.00, 2.7% gain).
- **UK 5/10 bond steepener** at 57bps (8bps gain). **Take profit in the 1y1y receiver at 70bps** (opened at 80bps, 10bps gain).
- **Long SX5E at 3500.**
- **Looking to re-enter short USD via long EUR and a basket of AUD, NZD and SEK on a hawkish Fed.**

1. The 2% target was an accident of history, rather than the holy grail policy-makers portray

Understanding monetary policy history is necessary to grasp the current policy-makers dilemma…

The Central Banker job has greatly evolved over the past centuries:

- The gold standard: Initially, **monetary policy consisted in stabilizing exchange rates.** At the beginning of the last century, most currency's value was linked to the price of gold in a monetary system better known as the gold standard. The unfortunate side effect of having to raise rates to defend exchange rates highlighted the pro-cyclical flaw of the system which eventually triggered the 1930s depression.

The gold standard was abandoned by Britain in 1931 and the US followed suit in 1933. After WW2, the gold exchange standard was established by the “Bretton Woods Agreements”; under this system, many currencies were fixed to the USD, which itself was fixed to gold. In 1971, the gold standard was fully abandoned and the **fiat money system** emerged as the greenback lost its link to gold. In 1976, the new fiat money system was officially adopted with the removal of the link to gold in the USD’s definition.

- The Phillips curve experiment: As employment became a top priority after the depression, the **Phillips curve relationship - which posits a trade-off between inflation and employment - had its hour of glory.** Companies are constrained by wage rigidities which leads to layoffs in downturns. With high inflation, the theory is that real labor costs can fall whilst wages remain constant; labour demand remains supported at the expense of higher inflation. The main pitfall of this new monetary paradigm is that workers soon figured out they were being cheated. Inflation expectations caught up with reality and the "buy now pay later" consumer philosophy quickly emerged whilst inflationary pressures snowballed. This culminated in the "stagflation" of the 1970s.

- The emergence of the inflation target: It soon became evident that the **monetary policy path needed to be predictable in order to boost an economy's long term growth potential.** A target, linked to the health of the economy, was needed to allow an automatic stabilisation mechanism to develop: when clouds gathered on the macro horizon, markets and the public would expect increased accommodation and the resulting boost in aggregate demand would work as a balancing mass.

Inflation, which at the time was closely linked to domestic macro forces and aggregate demand and readily observable soon emerged as the holly anchor.

On August 15, 1978, Volker told the FOMC: *"I think it's important particularly in view of the international situation that we correct the misapprehensions about our lack of concern over inflation".*

In 1990, the Central Bank of New Zealand was the first to adopt an inflation target.

- Why the 2% target?: The answer lies in the minutes of a fascinating FOMC meeting held in July 2016 (https://www.federalreserve.gov/monetarypolicy/files/FOMC19960703meeting.pdf).

Greenspan argued that price stability is a "*state in which expected changes in the general price level do not effectively alter business or household decisions".*

The initial hunch was to set a target between 0 and 1, however:

- Yellen argued: *"To my mind the most important argument for some low inflation rate is the 'greasing-the-wheels argument' "*.
- She also argued that *"a little inflation permits real interest rates to become negative on the rare occasions when required to counter a recession".*

In other words, Yellen argued that keeping inflation too low had under-appreciated risks:

The 'greasing the wheel argument' relates to the fact that a little inflation lowers un-employment by facilitating adjustments in relative pay in a world where individuals deeply dislike nominal pay cuts. A little inflation gives companies the ability to adjust real wages – rather than employment levels – to cushion economic shocks.

The second constraint raised by Yellen as a potential future issue worth considering was rigidities surrounding the Zero Lower Bound on official interest rates. Higher inflation levels allow for negative real rates in response to recessions.

The main pushback on pursuing a higher inflation target (still valid today) from Jordan:

"If the central bank had an objective of reducing the purchasing power of the dollar to 13 cents or 7 cents over the next century, which would you prefer? I would expect the majority of the responses to be, why are you going to reduce it at all?"

(The difference between 13 cents and 7 cents is the difference between a 2 percent rate of inflation and a 3 percent rate of inflation over 100 years).

At the time of the meeting, inflation was running at 3% and consensus agreed to try and get to 2% as an experiment. Shortly after… **In what can be considered as an historical accident, the 2% inflation target became the monetary policy's holy grail. It was formally adopted by most countries in the following decade.**

- The Fed adopted the unofficial 2% inflation target which only became official in 2012.
- The ECB initially set its target as "below 2%" in 1998, but changed it 5 years later to "below but close to 2% over the medium term". At the time, the main argument was to facilitate convergence between the different members. Due to the impossibility for disequilibria to rebalance through exchange rates, monetary policy needed to allow for more flexibility on relative real wages. As discussed above, only higher inflation (2% rather than 0%) can afford this flexibility.

I hope you found this quick historical reminder on monetary policy setting through the ages interesting. The point I want to drive home is that 2 decades later, inflation-targeting may not be making as much sense as in the 90s when Central Banks were effectively trying to find the most credible way to achieve price stability in a bid to promote long term growth. A full understanding of the rationale behind the decision to set a 2% inflation target is necessary to understand the growing concerns amongst policy makers of pursuing an arbitrary inflation target at the possible expense of financial stability, especially when this target can no longer be considered a fair reflection of the health of an economy.

2. The downside of excessive stability…

With deflationary risks kept at bay and low inflation reflecting supply concerns, can the arbitrary 2% conquest undermine future growth prospects?

I would like to come back to the infamous June 25th's BIS report (http://www.bis.org/publ/arpdf/ar2017e.pdf), which preceded Draghi's hawkish turn in Sintra. A speech that was followed by hawkish turns at the Bank of Canada, Australia, Sweden and England.

The crux of the concerns raised in the report is that *"even if inflation does not rise, keeping interest rates too low for long could raise financial stability and macroeconomic risks further down the road, as debt continues to pile up and risk-taking in financial markets gathers steam. How policymakers address these trade-offs will be critical for the prospects of a sustainable expansion".*

The debate has now moved from Yellen's 1996 concerns on **the under-appreciated risk of low inflation** – a concern that sounds prescient after the experience of the Global Financial Crisis – to the **under-appreciated risk of attempting to reach an**

arbitrary inflation target at the cost of favouring market's distortions and allowing leverage to thrive.

The BIS report goes on to state that **gradualism and transparency on the normalisation journey are desirable:** *"Gradualism allows central banks to test the waters, seeking to avoid abrupt market adjustments and policy reversals. Transparency about the future policy path aims to remove one important source of uncertainty. Transparency may also go hand in hand with the gradual release of information about that path, in order to avoid sudden asset price adjustments, given the markets' tendency to telescope the future into today's prices".*

However, the report continues with a stark warning that **gradualism and transparency are no panacea:** "*Gradualism naturally increases the risk of falling behind the curve, be it in terms of the build-up of inflationary pressures or of debt globally and transparency about the path of central bank measures may unintentionally encourage greater risk-taking in markets".*

"By reducing the uncertainty surrounding the announced path and hence compressing risk premia, transparency may induce market participants to leverage up in their search for yield. The experience of the 2004-06 episode of raising the federal funds rate "at a measured pace" seems consistent with this possibility. In addition, risk-taking would be strengthened by any perception that the central bank would step in to calm short-term volatility and adverse market moves."

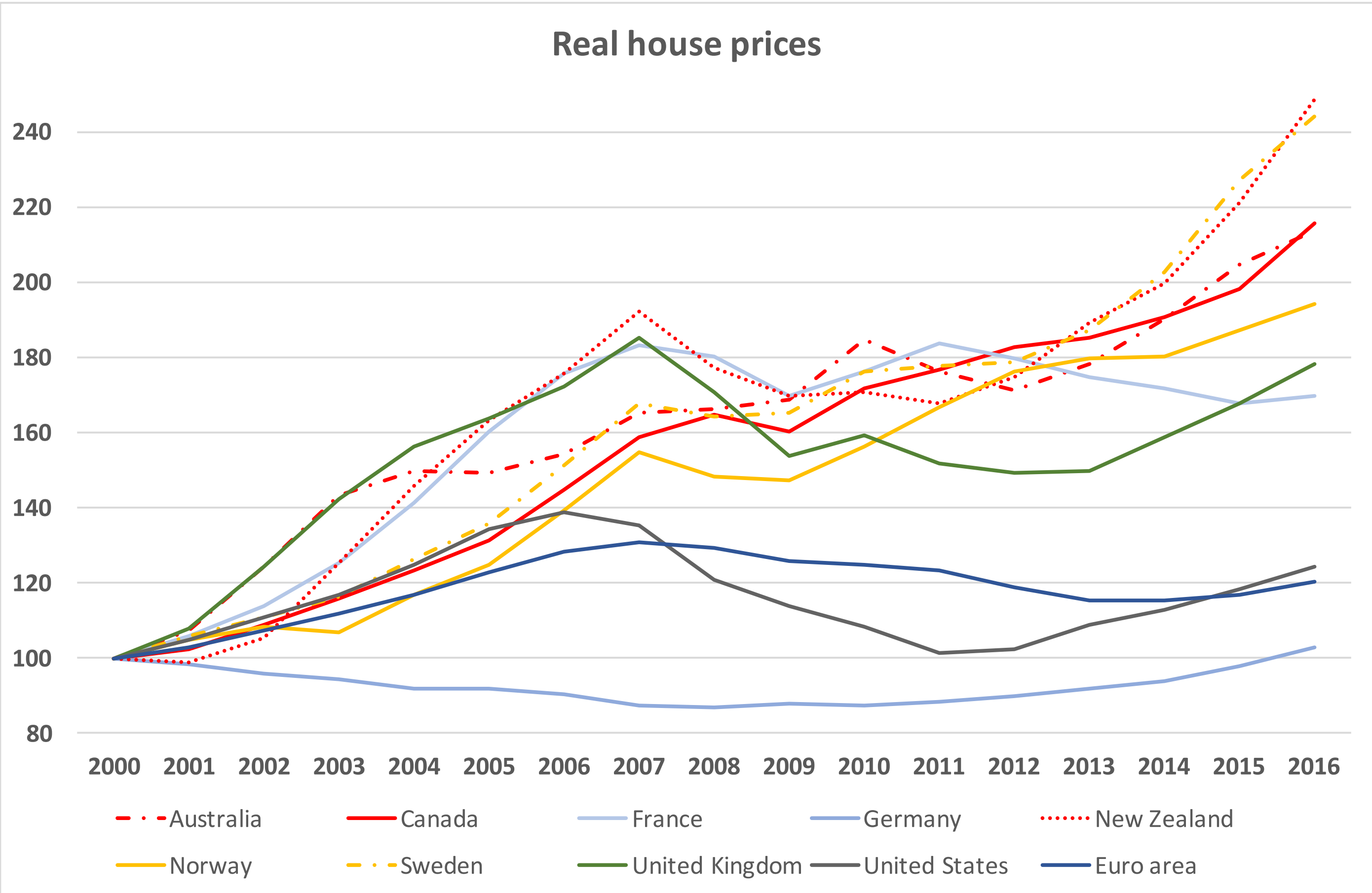
This report will possibly mark a paradigm shift away from focusing on data and inflation to focusing on financial stability (note that the BIS has over the years gained its credibility gallons by predicting the 2007/8 credit crisis, the respected institution does influence policy-makers)**. With deflationary risks curtailed, financial**

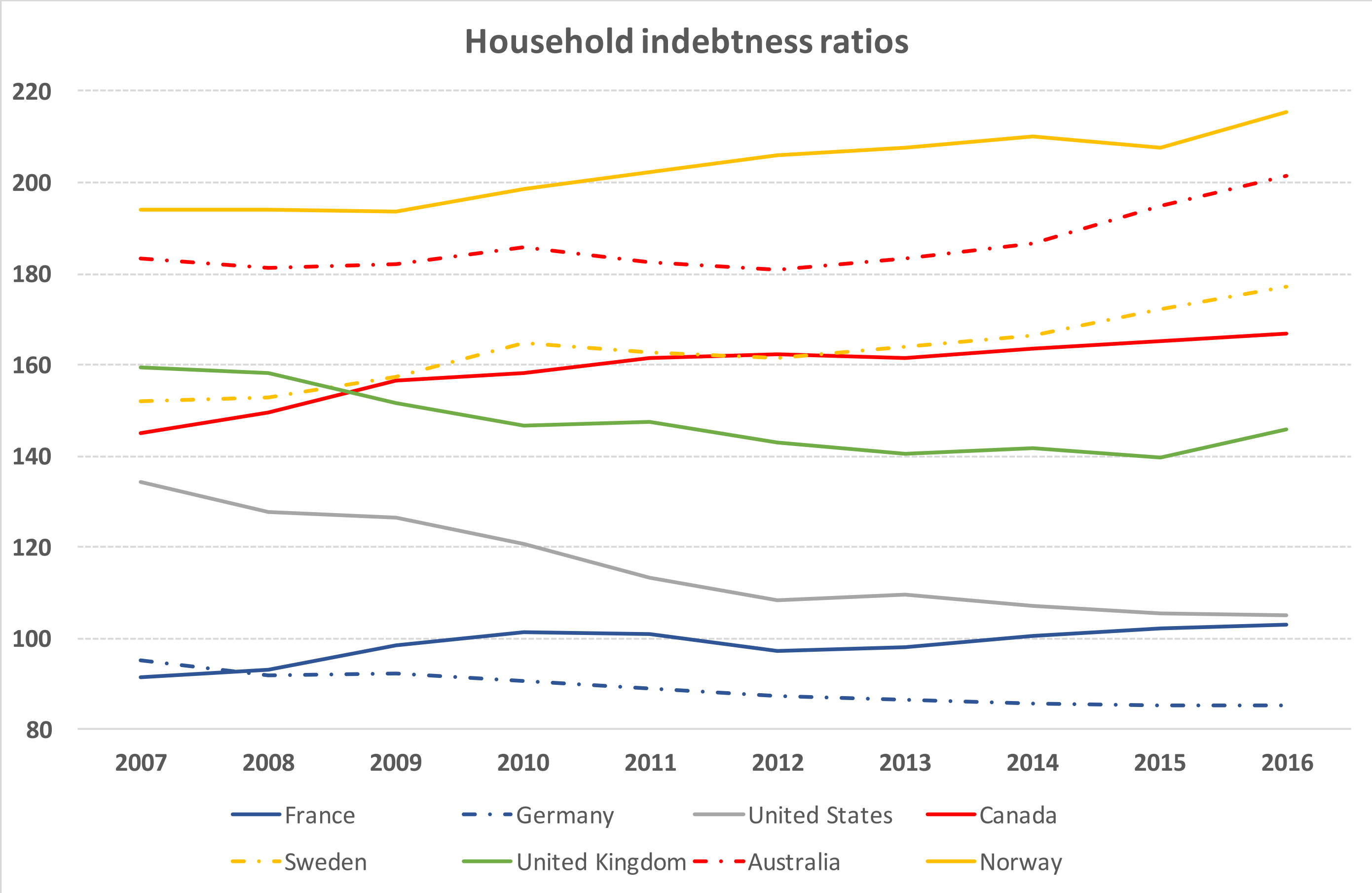
stability may overtake price stability as the holy grail in the pursuit of long term growth maximization.

In his media briefing note on the same day, Claudio Borio warns that *"leading indicators of financial distress point to financial booms that in a number of economies look qualitatively similar to those that preceded the GFC".* He adds that *"the countries affected comprise a number of emerging markets and <u>some advanced economies largely spared by the GFC where protracted strong credit expansion, often alongside rising property prices, signals the build-up of risks</u>".*

In an effort to find the BIS's culprits and turn Mr Borio's comments into actual trades (which after all is my job!), I have put a few charts together:

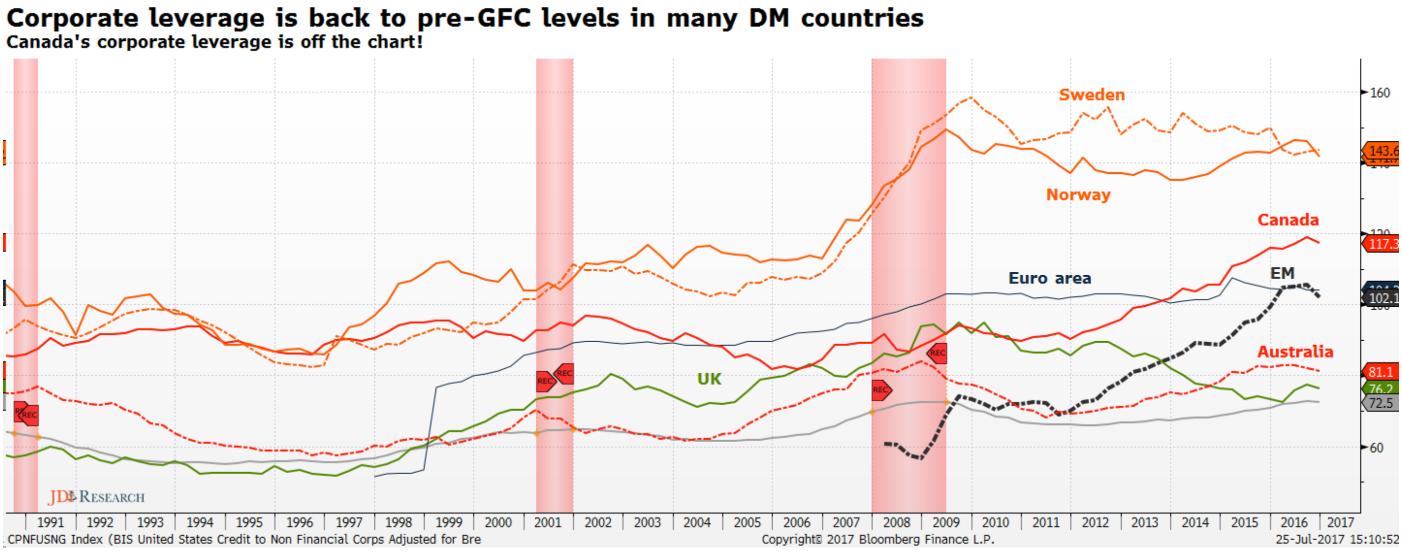
<u>Away from the epicentre of the recent credit crunch, plenty of housing bubbles:</u>





In my book, the main culprits are Canada, Sweden, Australia, New Zealand and Norway where years of trying to avoid FX appreciation with the excuse of inflation-targeting has led to an artificially high level of monetary policy accommodation that promoted the formation of housing bubbles and caused a sharp increase in leverage.

Corporate leverage is also back to pre-GFC levels in the above mentionned countries with Canada stands out as particularly naughty:



3. Do not fade the paradigm shift away from inflation targeting towards financial stability…

"Concerted" hawkish moves are a lot less painful than idiosyncratic moves and this is what makes the recent policy shift more credible.

Since the BIS meetings, we have seen Central Banks flocking to the hawkish side:

- On June 27th, **Draghi's speech in Sintra** was first in a series of hawkish moves. I have delved into this speech in great details in a report dated June 28th, "The beginning of the end of inflation targeting". The bottom line is that the ECB will be patient about inflation returning to target as long as the undershoot does not reflect the health of the European economy or aggregate demand.

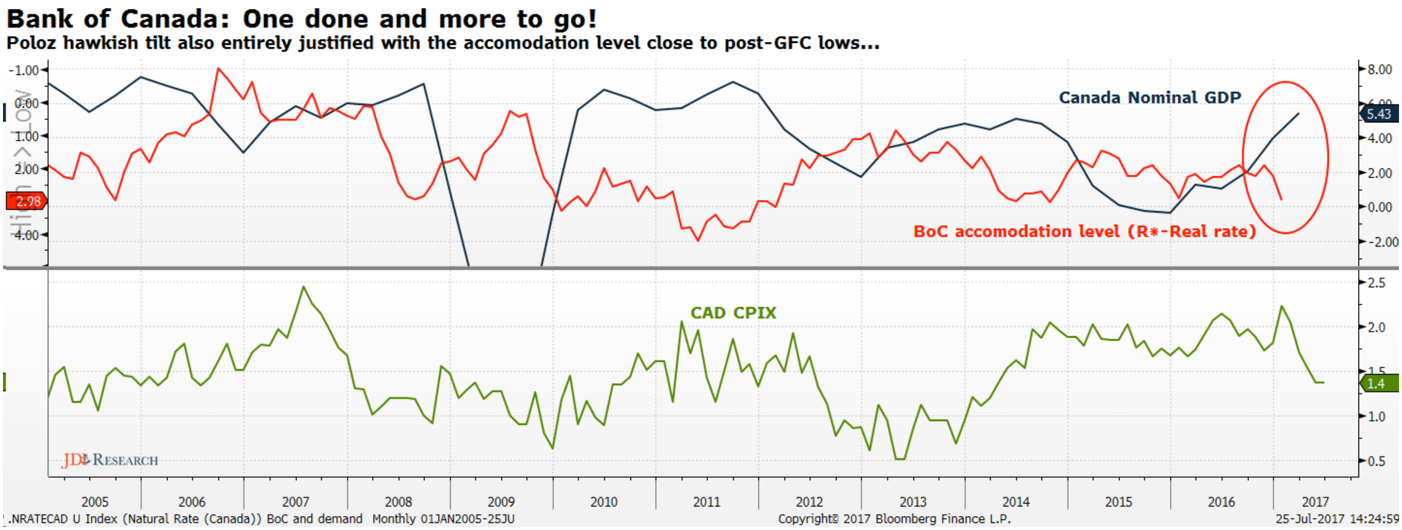
E: juliette.declercq@jdiresearch.com **W:** www.jdiresearch.com **T:** +44 (0) 7769724879

Re-inforcing Draghi's message, ECB's Nowotny stated on July 4th that *"Inflation-targeting should include a certain flexibility"*.

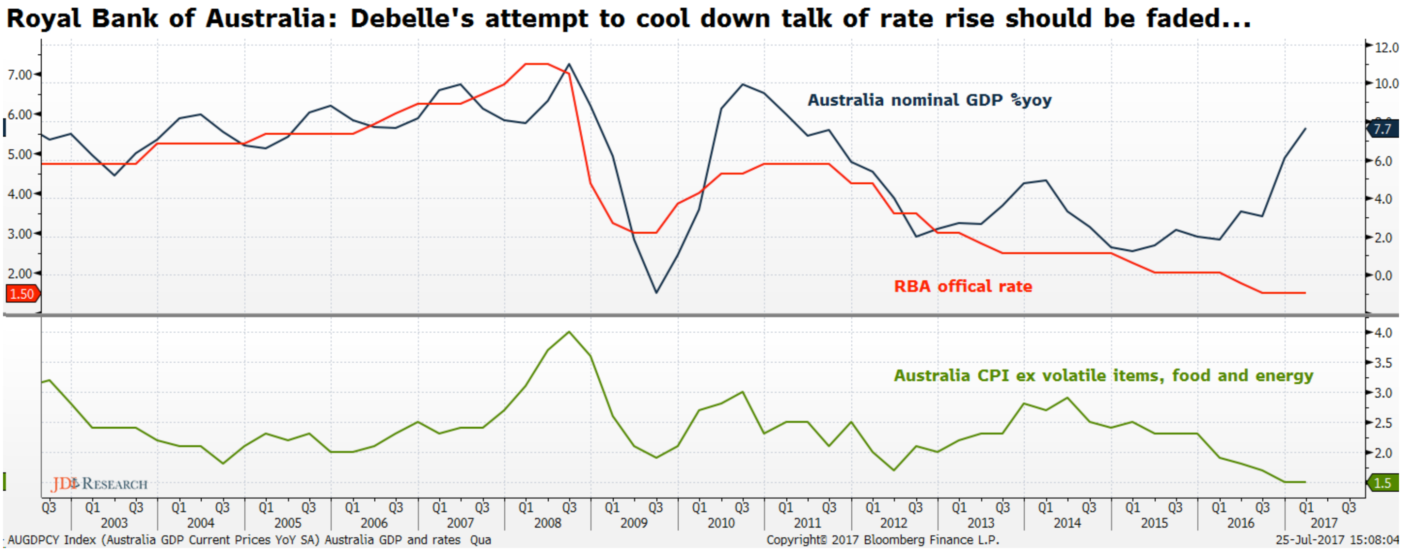
- On July 5th, **Bank of Korea's governor said that Draghi's hawkish remarks could be interpreted as a *"sign of policy shift"*** and hinted that DM governors warned at the BIS meetings that *"ultra-low policy rates and QE were set for change".*

- **BoE** Haldane started arguing for a partial removal of post Brexit emergency easing whilst governor Carney made a U-turn on his dovish assessment in a matter of days.

- **The Bank of Canada also veered to the hawkish side and followed through with a hike last week.** It also revised up its growth forecasts for 2017 and 2018 and signaled that further hikes were in store despite the recent CPI undershoot:



- **The RBA minutes disclosed that there had been a discussion about the "neutral rate"** which concluded that it was perhaps 2% higher than the current official interest level:



- At a June conference gathering current and former policymakers, **former BoJ head Shirkawa**: *"My worry with setting a precise number is that it can crowd out other very important considerations, such as financial stability".* At this gathering, respected and influential ECB's Nowotny, had asked whether there should *"be an easing of the 2% inflation goal in the sense of setting a range instead of a clear-cut target".*

- ***Riksbank's Ingves*** *recently proposed that "central banks should also have the explicit responsibility for financial stability".*

To be clear, I am not calling for concerted action but an initial hunch can blossom into a paradigm shift with the general conviction level increasing; "groupthink" is not limited to market players. Crucially also, as Riskbank's Ingves rightly pointed out, the ***"hawk-ish tone of other Central Banks afforded them the ability to be more hawkish".***

Undeniably, **concurrent rate hikes are a lot less painful than isolated tightening due to the lesser effect on the currency and this is what makes this hawkish episode credible.** Arguably, monetary policies have been kept too easy in New Zealand, Australia, Canada, Sweden and Norway for fear of excessive FX strength nipping growth in the bud, with limited risks of idiosyncratic FX moves, this may be about to change.

4. Do not expect policy-makers to come clean about the hawkish shift …

… But it does not mean the shift is less real… Fade the denials

I have no doubt about policy-makers' focus shifting away from the 2% inflation target toward robust growth and the risk that ultra-accommodative monetary policies could backfire and threaten long term growth prospects via market distortions and excessive leverage. Bear in mind also (despite my notorious gloomy inflation view since February) that inflation is the mother of all lagging indicators. On JDI charts, I normally use a 12 to 15months lag. I note that inflation has often peaked globally well into a recession. It is therefore sensible for policymakers to be patient about inflation.

However, Yellen's 1996 concerns about too low levels of inflation are still valid: 1) due to nominal wage rigidities, a low level of inflation means that the level of employment is more likely to be the adjustment variable for businesses in a downturn and 2) rigidities surrounding the Zero Lower Bound on official interest rates mean that higher inflation levels allow for negative real rates in response to recessions.

➔ **This means that we should expect the global monetary shift to be a covert operation policy-makers are extremely unlikely to come clean about: giving up the inflation target altogether would risk shocking markets and de-anchoring inflation expectations, making the already elusive 2% target**

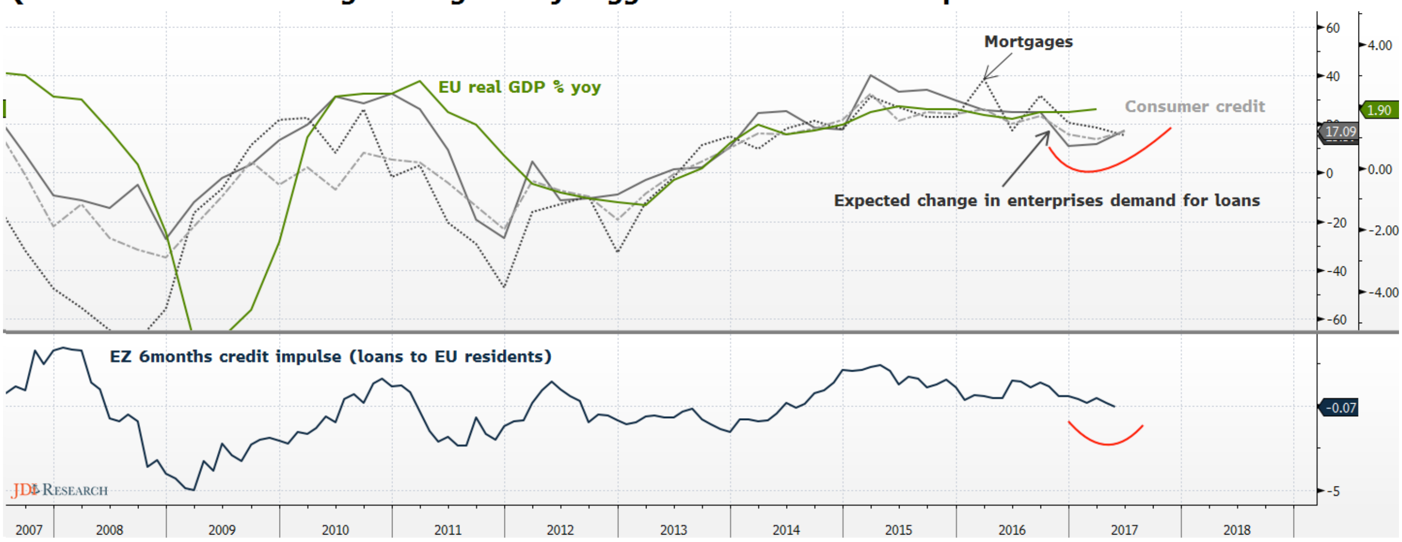
unachievable. The upshot is that a we should expect "two steps forward, one step back" narratives and be more tactical than in H1 2017.

- **It is in this context that last week's "dovish" ECB should be understood.** I like to explain Draghi's motto as "Reculer pour mieux sauter", which best translates as "making a strategic withdrawal to better leap forward" but this will most likely apply to other policy-makers.

My take is that last week's meeting was a red herring; certainly - as Draghi stated - the governing council's last wish is to trigger "*an unwanted tightening of the financing conditions that (...) may even jeopardize the recovery*", however I remain convinced that the ECB is moving away from a strict (and absurd?) 2% inflation target.

In this vein, the recent upbeat ECB bank lending survey is a further sign that the credit impulse is likely to find a temporary bottom and propel European aggregate demand and growth even higher. The credit channel is what matters in Europe and worries about the effect of a stronger EUR on growth are overblown, especially in the context of a global rather than idiosyncratic repricing.

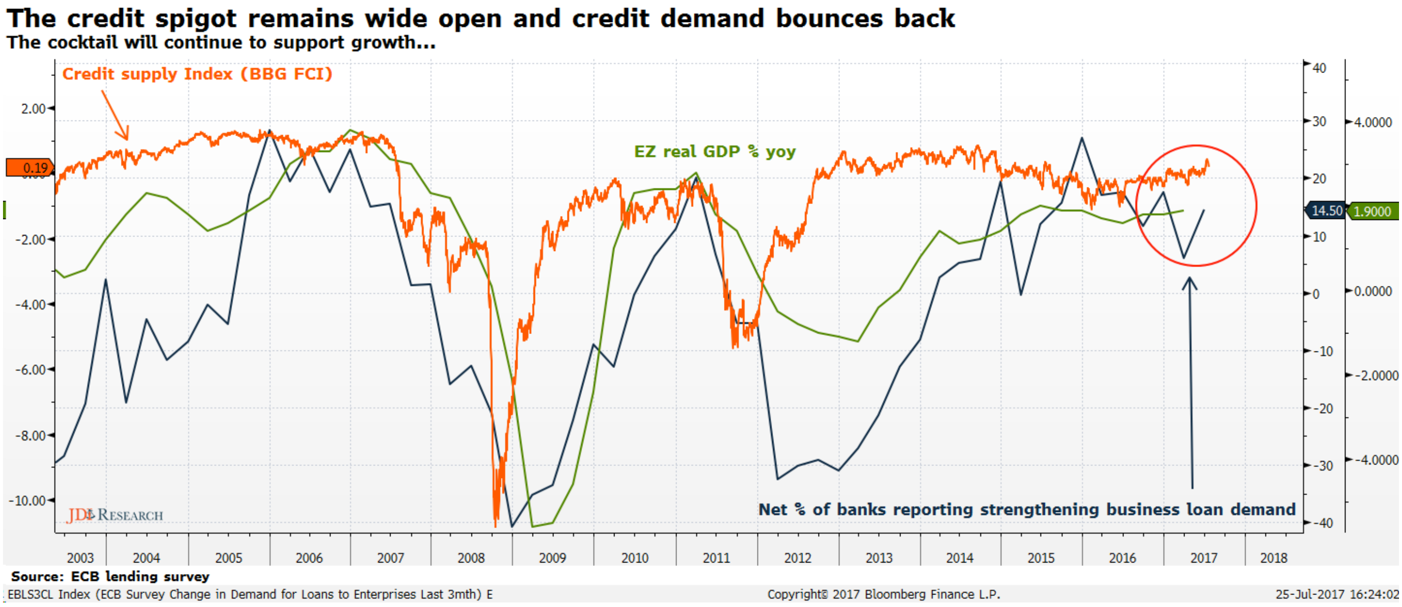
Q2's ECB forward looking lending survey suggests that the credit impulse has bottomed



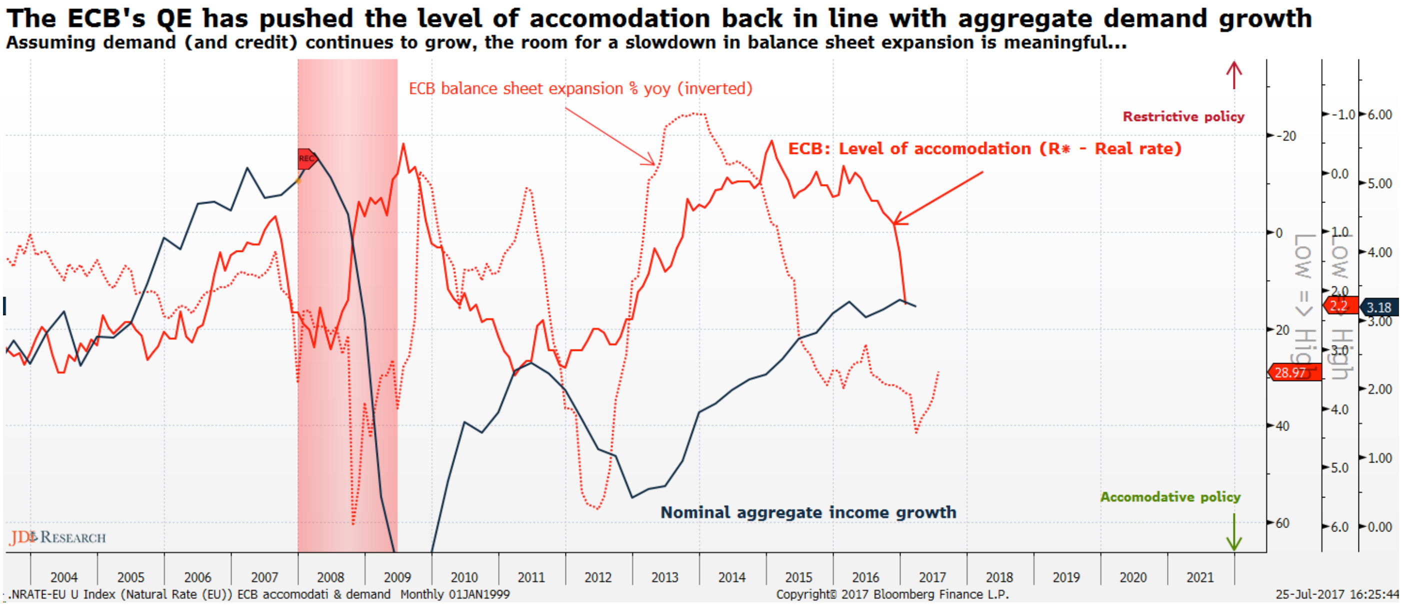
Source: ECB lending survey

EBLS3CL Index (ECB Survey Change in Demand for Loans to Enterprises Last 3mth) C

25-Jul-2017 16:23:00



The upshot is that even if the tapering announcement is delayed, my view on core European Fixed Income is unchanged; the next step towards balance sheet normalization will be taken by the end of the year and QE purchases be scaled back to EUR40bn (from EUR60bn). This is a move that would be consistent with robust aggregate income growth, a strengthening credit impulse and the recent sharp easing in monetary conditions consistent with higher inflation expectations and lower real rates now that the threat of deflation has faded away:



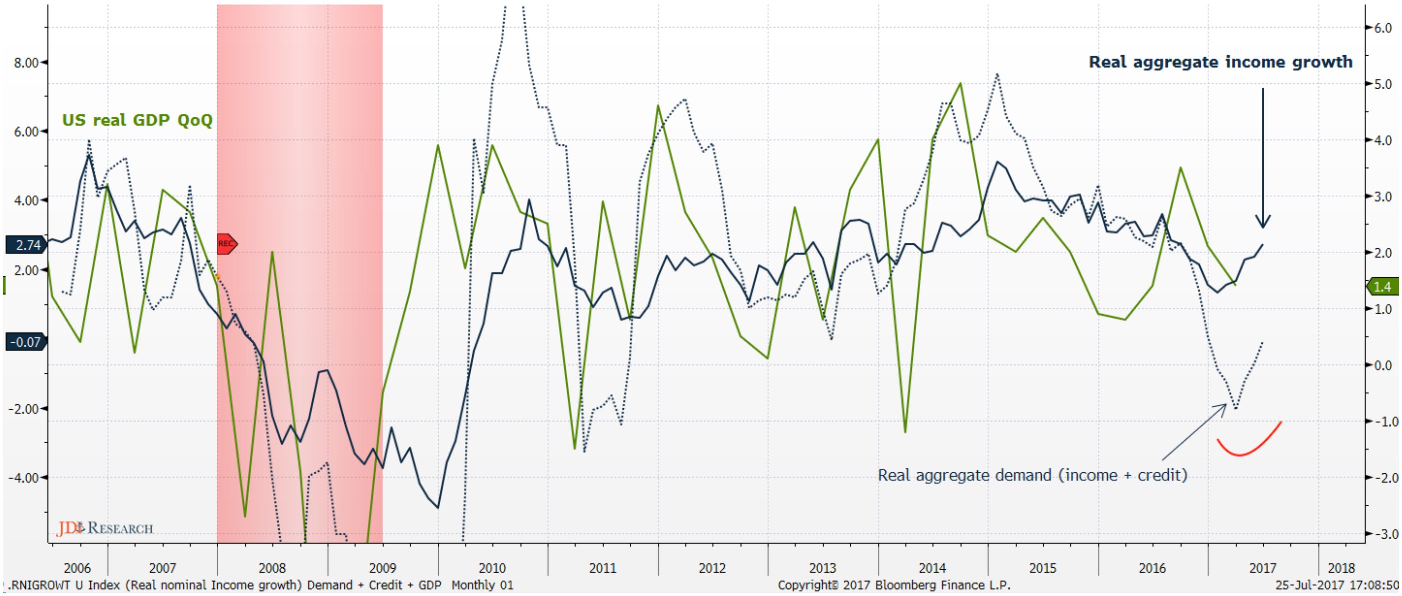
- **The BoJ kicked the can further down the road:**

Last week, the BoJ revised its inflation forecast down and pushed out the timing for inflation to reach the 2% target to "sometime in 2019". It also expressed an upbeat view on growth and confidence that tight labor markets would eventually generate inflation. The BoJ did not allude to any new policy. However, let us not forget that the zero-yield target was in part instituted to slow the pace of QE purchases; a move that has been successful with the annualized pace of balance sheet expansion falling below JPY60tn. Due to scarcity concerns, Quantitative tightening is the only way forward.

- **Fed unlikely to be deterred by the soft inflation backdrop on the balance sheet unwind and a further hike:**

Fed likely to follow through with the unwinding of the balance sheet regardless of the inflation trajectory. The move should be announced at the September meeting and could be signaled in today's FOMC statement in a move that would be considered by markets as hawkish. As per my last report, despite all domestic headwinds, I expect US growth to remain supported thanks to the weakening USD, lower exogenous inflation allowing a pick-up in purchasing power and a strong global backdrop (Europe especially). This should give extra breathing space to the Fed and allow for one more hike this year in tandem with the balance sheet announcement:

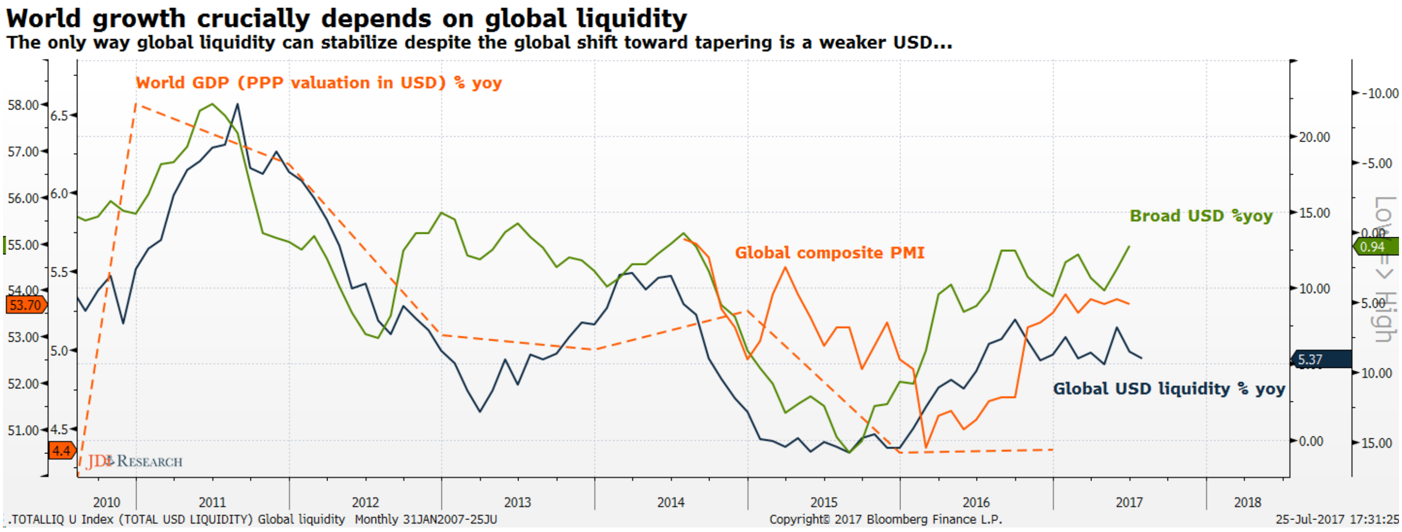
US growth will bounce but a sustainable move beyond 2% relies heavily on a credit flow recovery



5. Will global liquidity tighten sharply, leading to a substantial risk sell-off?

Not yet …

In a previous JDI report entitled "A risk free world?" and dated May 10th, I argued that the **only way for global liquidity to continue to grow *despite* slower QE purchases is if the dollar continues to weaken, thus reflating the USD value of the *existing* liquidity:**



This is exactly what is happening this year and one of the reason for my **continued non-consensus constructive view on risk. The global hawkish shift means that macro and monetary convergence between the US and the rest of the world has further to go.** This entails ample room for the USD to continue softening in a move that will keep the US economy afloat and global liquidity stable. Once the USD stops weakening and convergence is complete, European and global growth will inevitably falter and this will most likely be concurrent with the next US recession. At that point, the Fed - with the most ammunition to counter a recession - will trigger renewed monetary divergence, this time in favor of the EUR and JPY (where there is little room for policy easing in the next downturn): The USD will only fall further.

The global hawkish shift means that the US vs ROW convergence trade can continue
The USD will remain the main loser...

- ➔ All in all, Central Banks' focus is clearly moving away from inflation to the risks of ultra-accommodative policies over-stimulating credit demand and distorting markets. Whatever Draghi said - for fear of triggering a taper tantrum amidst low Summer liquidity -, the plans to slowdown the pace of global balance sheets expansion (>$4tn in 2016/2017) will not be derailed this year. Amidst robust global growth led by the European recovery, this is likely to cause a fixed income repricing through higher term premia, which I continue to believe is best **expressed via short 10yr OAT and a 5s10s UK gilt steepener. To add to a high conviction theme, I would like to add a short 5yr Australia @ 2.20.**

- ➔ On the EUR, I have seen many pundits scratching their heads as to the reason why fixed income markets took the ECB meeting as dovish whilst EUR supposedly priced a hawkish outcome. I note that the dynamic was nothing else than the one I described since April as a reason to be bullish EUR despite the relatively dovish ECB; the economy is healthy enough to weather tapering (as confirmed by Draghi in Sintra) and that means that dovish ECB outcomes are simply fuel to a European economy on fire. The Euro has been driven by the increasing real yield in the forward space and the better return on investment prospects they reflect rather than spot real yield differentials. The ECB is caught in a heads you win, tails I lose dilemma whereby both hawkish and dovish rhetoric cause the EUR to strengthen. I have been focused on recommending long EUR vs GBP and recommend taking profit. I will look to re-enter long EUR vs USD.

Conclusion:

- **Monetary policy has evolved across the ages and after 2 decades of inflation-targeting, it may be time for evolution. The 2% target was an accident of history not the holy grail policymakers portray.**
- **With deflationary risks curtailed, financial stability may overtake price stability as the holy grail in the pursuit of an economy's long term growth potential maximization.**
- **Do not expect this move to be widely publicized as Yellen's 1996 risk of ultra-low inflation remains. Policy-makers motto could be "reculer pour mieux sauter".**
- **Policy-makers denial attempts should be faded.**
- **Do not expect a sharp tightening in global liquidity as long as the USD stays soft.**

Juliette Declercq

juliette.declercq@jdiresearch.com

(+44) 7769724879

The above is only meant to be a roadmap to help CIOs navigate risks more safely. Specific levels and trades can be discussed separately on BBG or phone.