Forget the Fed. Focus on Coordinated Global Tightening

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2017 has been a great year for investors. Global equities are higher. Volatility is non-existent. Heck, even left-for-dead fixed income has posted positive returns. However, there is an undercurrent belief that we are on shaky ground. Mr. Market has shrugged off stretched valuations, political dysfunction, and increasing global debt. This begs the question: what could derail the financial markets? In our opinion, we can't shake the potential impact of global monetary policy missteps.

The Fed has set the monetary policy blueprint for developed nations. Financial crisis? Cut interest rates. Uneven growth and low inflation? Buy bonds to keep rates low. Still stuck in a rut? Keep interest rates lower for longer.

The merits and consequences of suppressed interest rates are inconclusive. Sure, the global economy has been able to scrap out steady, slow growth. Global financial markets have rebounded with limited disruptions. However, the true test is how we get home from a monetary journey that doesn't have a roadmap.

The market is hyper-focused on the Fed, but we believe the obsession is misguided. The Fed interest rate hikes haven't disrupted the apple cart because the ECB, BOJ, BOE are in full accommodative mode. The new state of "normalcy" will be challenged when the appetite for central bank policy is exhausted. This is where global monetary coordination becomes complicated and unprecedented.

Federal Reserve (Fed) – Slowly increasing the Fed funds rate and reducing the size of its balance sheet. **Still accommodative with a bias toward tightening.**

European Central Bank (ECB) – Paring back stimulus and beginning to scale back asset purchases in 2018. **Still accommodative.**

Bank of Japan (BOJ) – Massive asset purchase program $700 billion/year. **Aggressively accommodative.**

Bank of England (BOE) – Recently increased the Bank Rate by 0.25%. Continuing bond purchase program. Policy complicated by ongoing Brexit negotiation with the European Union. **Still accommodative with bias toward tightening.**

What happens to financial markets when global banks start to increase borrowing costs? The unwinding process has the potential to be choppy with many false starts. Central banks will have to balance investor expectations with fluid economic data. Historically, forecasting inflation and growth has proven difficult for the Fed and other central banks.

"Just remember that 10 of the last 13 Fed hiking cycles have been miscalculations that ended in recession."
– David Rosenberg, Chief Strategist at Gluskin Sheff.

From ECB Chairman Mario Draghi's 2012 statement of "whatever it takes" to Shinzo Abe's unprecedented asset purchase program it is evident that central bankers have huge influence over global markets.

Fed tightening has been absorbed by financial markets without much disruption due to easy money policies from the ECB, BOJ, BOE. Europe and England have already cleared the path for normalization/tightening. In our opinion, a coordinated global tightening effort could signal a turn in risk appetite for investors. ■

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