AQUILA FLASH

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Central Banks lose control of the equity markets

Responding to the financial crisis of 2008/2009 industrialized country central banks flooded the markets with liquidity to an extent that has never been seen before. For seven years the equity markets flourished in the liquidity environment thus created but since the middle of 2015 equities have decoupled from the flood of money still coming from the central banks.

In the US equities are now responding to developments in the macro data.
Since 2008 the Fed's balance sheet has expanded by a factor of five in the context of Fed bond buying programs Q1, Q2 and Q3. Over the same period the S&P 500 equity index has more than doubled. But since the middle of 2015, the US equity market has moved increasingly in line with developments in the macro data. In September the US stock market fell sharply as an uncertain economic situation led the Fed to hold off from raising interest rates. More recently, we note that the implicit easing of monetary policy over the last 4 weeks has not been able to move equities higher. The present circumstance – whereby the mixed flow of macro data mean that no interest rate rises are now expected this year – has been interpreted negatively. A year ago, poor macro data was viewed as implying a better outlook for markets as it meant that monetary policy would remain easy for longer. Today, poor macro data are taken simply for what they are.

Hopes of further easing from the ECB only provided a short-term boost to equities.
While the ECB's balance sheet has not expanded since the middle of 2008 as rapidly as that of the Fed, its current bond-buying program – involving EUR 60bn. worth of bond purchases a month – is undeniably aggressive. ECB bond purchases certainly boosted European stocks in the early months of 2015 but when the central bank failed to match investor expectations in December of last year the market reaction was sour. At the press conference following January's policy meeting ECB President Draghi sought once more to boost investor sentiment in that he encouraged expectations of a further easing of monetary policy in March. The immediate market response was positive, with Germany's DAX index rising around 5% in the following four trading days. But this positive impulse soon waned with equities resuming their previous downward trend.

The market boost from the Bank of Japan's latest easing moves did not last long.
By some distance, the Bank of Japan is the most aggressive of the world's major central banks. Thus, the Japanese central bank is pursuing until further notice a securities purchase program equivalent of 15% of Japanese GDP on an annual basis and its balance sheet is already equivalent to 60% of Japanese GDP. Since the start of Japan's QE program in the spring of 2013 the Nikkei equity index has risen around 70%. On January 29, 2016 the Bank of Japan surprised markets with a further move in the direction of monetary easing

– namely, the introduction of a negative interest rate. The immediate reaction of the markets was positive with Japanese stocks rising nearly 5% over the following 3 trading days. But then the reaction set in. Indeed, the Tokyo stock market has fallen sharply so far in February.

China's central bank now has less room for maneuver.
In November 2014 the Chinese central bank or People's Bank of China cut rates for the first time in 2 years. That move was the first in a series, whereby the sixth and latest reduction occurred in October 2015. Although the Chinese stock market rose strongly until June 2015, its subsequent crash was detached from the monetary policy of China's central bank. The People's Bank finds itself caught between two conflicting objectives. On the one hand, it wants to boost the economy with an expansionary monetary policy. On the other, there is a need to stabilize the yuan and to prevent a vicious cycle of capital outflows and a weakening currency from spiraling out of control. The fact that George Soros, who humiliated the Bank of England and the UK government in 1992, is now betting against the yuan does not make the task of the People's Bank any easier. The securing of an orderly decline of the yuan through the sales of foreign reserves is restrictive from a demand perspective and limits the ability of China's central bank to boost the economy through monetary policy.

We are sticking with our neutral weighting in equities.
Our observations suggest that the effectiveness of monetary policy in boosting the equity markets has declined sharply since the middle of last year. Indeed monetary policy seems now to be quite ineffective in this respect. With each announced measure of monetary expansion having at best a short-term impact, central banks are no longer able to control the equity markets which move increasingly in line with macro data – a trend which we welcome. With data for the first four weeks of this year coming in on the weak side, investors have fallen prey to anxieties about weak growth or even recession. But we remain of the opinion that the data do not point to a recession – neither in the US, nor in Europe, nor indeed in China. Rather we believe that the world economy will in the end achieve modest growth during 2016. This, together with a continuing flood of liquidity into the markets, leads us to expect a rather weak performance from equities this year coupled with higher volatility - but no crash. With this outlook, we stick with our neutral weighting in equities.