CENTRAL BANKS, MARKETS AND THE ECONOMY: THREE TIMES WRONGFOOTED

In the US, financial conditions have eased in recent months and weighed on the effectiveness of the Fed's policy tightening. Jerome Powell recently gave the impression of not being too concerned, so markets rallied, and financial conditions eased further despite the hawkish message from the FOMC. In the Eurozone, another rate hike by the ECB and the commitment to raise rates again in March caused a huge drop in bond yields because markets expect we're getting closer to the terminal rate. It reflects a concern of not being invested in the right asset class when the guidance of central banks will change: based on past experience, one would expect that bond and equity markets would rally when central banks signal that the tightening cycle is (almost) over. However, as we have seen with the surprisingly strong US labour market report, such positioning comes with the risk of being wrongfooted by the data. What follows is huge volatility.

Financial markets are a key channel of monetary transmission. Changes of official interest rates, or expectations thereof, influence the level of government bond yields, corporate bond spreads, equity markets and the exchange rate. Together, they represent financial conditions faced by borrowers and investors whose decisions influence the real economy.

It explains why central banks and investors pay particular attention to the evolution of these financial conditions. In the US, they have eased in recent months (*charts 2-5*) despite the aggressive rate hikes by the Federal Reserve. Treasury yields, corporate bond yields and their spreads versus Treasuries have declined, equity markets have rallied, and the dollar has depreciated. Such easing of financial conditions reduces the effectiveness of official rate increases, so Fed watchers were keen to learn whether Jerome Powell would express an opinion on the topic during his latest press conference. He did so in answering a journalist's question[1] but by saying that the Fed's focus is not on short-term moves, he gave the impression of not being too concerned. Unsurprisingly, markets rallied, and financial conditions eased further (*chart 1*). Not exactly what the Federal Reserve had hoped for with its otherwise hawkish message.

The ECB is facing a similar challenge of coping with fluctuations in financial conditions and, through its communication, trying to influence them, but like the Federal Reserve, it has been wrongfooted by financial markets. Although, following the meeting on 2 February, the monetary policy statement as well as the press conference reflected an unambiguous decisiveness to increase its official rates further, there was a huge drop in bond yields in reaction to the announcement that *"we intend to raise interest rates by another 50 basis points at our next monetary policy meeting in March and we will then evaluate the subsequent path of our monetary policy."*[2] Clearly, this was interpreted as signaling an increasing likelihood that the rate hikes, if any, beyond the March meeting could come in smaller steps -like in the US- and that the terminal rate -the cyclical peak of the policy rate- was getting closer.

A third case of being wrongfooted came with the publication of the January US labour market data. Financial markets were taken completely by surprise by the strength of the report. 517,000 new jobs were created -versus a consensus forecast of 187,000-, the unemployment rate declined to 3.4% (consensus: 3.6%), weekly hours worked increased to 34.7 (consensus: 34.4) and the participation rate increased to 62.4% (consensus: 62.3%).

INTRADAY REACTION OF 10-YEAR YIELDS

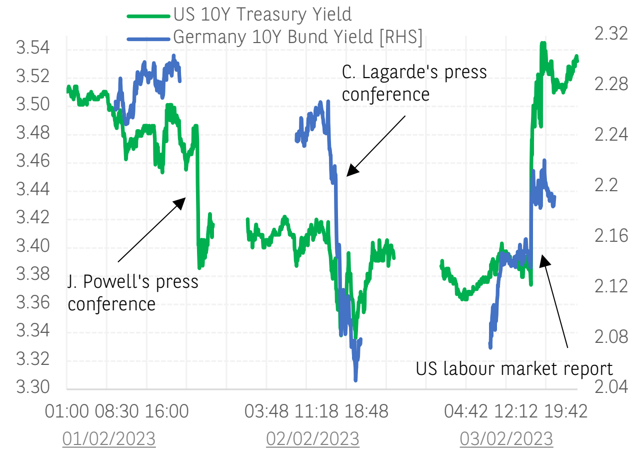

CHART 1 SOURCE: BLOOMBERG, BNP PARIBAS

In addition, another report also surprised to the upside: the ISM services index jumped to 55.2, far ahead of the consensus of 50.4. Consequently, the yield on the 10 year Treasury note moved about 15 basis points higher.

Two lessons can be learned from these recent developments. Firstly, investors are afraid of 'missing the train', i.e. not being invested sufficiently in the asset class of their choice when the guidance of central banks would change: based on past experience, one would expect that bond and equity markets would rally when central banks signal that the tightening cycle is (almost) over. Secondly, despite the slowdown in certain areas, the US economy remains, on the whole, resilient, and shows a capacity to surprise positively. Inevitably, this leads to heightened financial market volatility.

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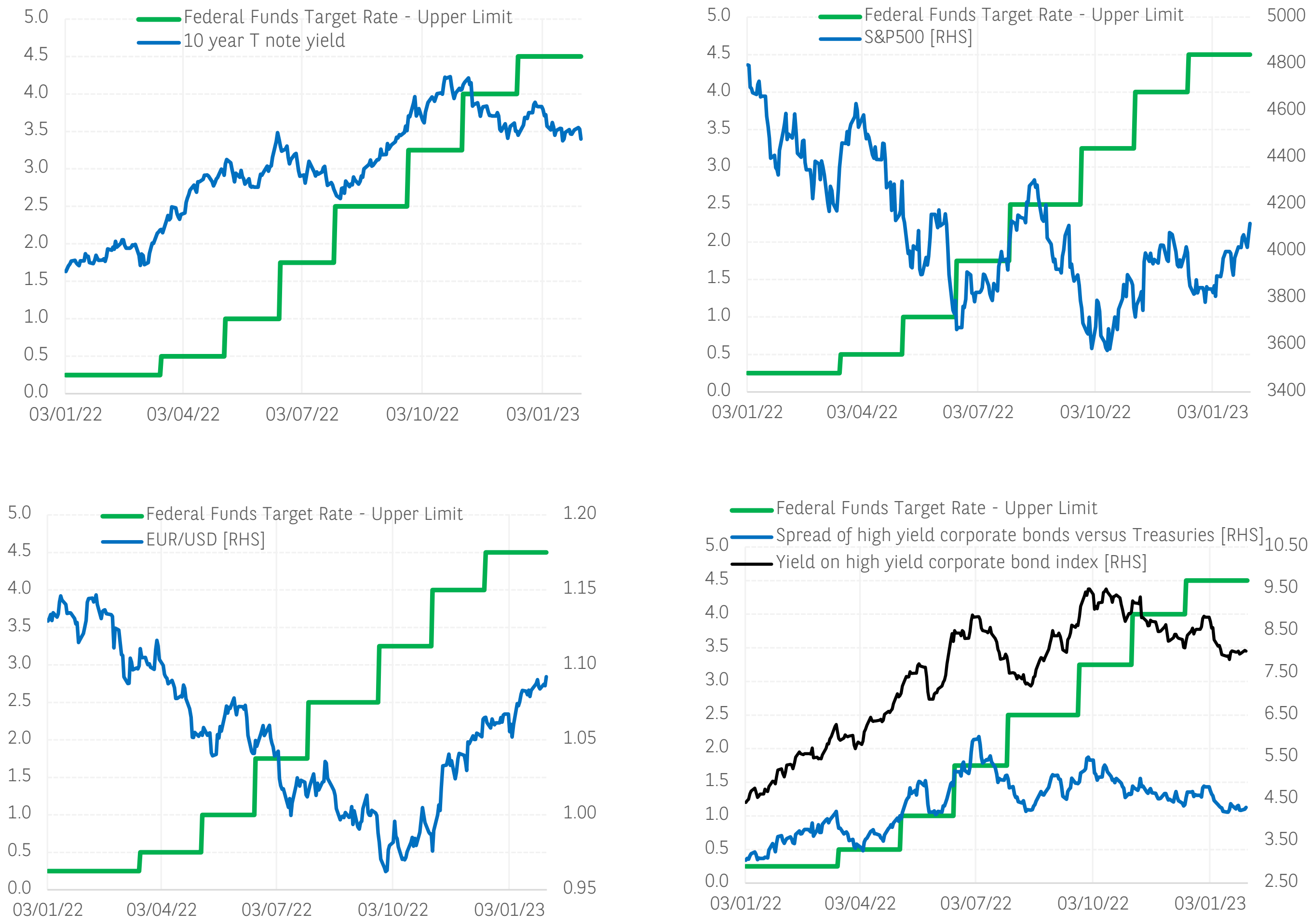
1 The question was asked by Chris Rugaber of Associated Press: "As you know financial conditions have loosened since the fall with bond yields falling, which has also brought down mortgage rates, and the stock market posted a solid gain in January. Does that make your job of combating inflation harder? And could you see lifting rates higher than you otherwise would to offset the increase in -- or to offset the easing of financial conditions?" Source: Transcript of Chair Powell's Press Conference, 1 February 2023, Federal Reserve.
2 Source : ECB, press conference of Christine Lagarde, President of the ECB, and Luis de Guindos, Vice-President of the ECB, Frankfurt am Main, 2 February 2023.

EDITORIAL

FINANCIAL CONDITIONS AND FED POLICY



CHARTS 2-5

SOURCE: REFINITIV, FED OF ST LOUIS, BNP PARIBAS

> The Fed chairman, by not expressing concern about the easing of financial conditions in recent months, provided markets with a push in the back rather than giving a pushback to the 'risk-on' sentiment.