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Hawk to Dove

Last year, investors were worried about slowing global growth that could be exacerbated by higher interest rates. Investors felt that Fed Chairman Jerome Powell's view that interest rates should be raised 2 more times in 2019 and that the unwinding of the Fed's balance sheet is on "autopilot" was going to be a crucial policy mistake. Some analysts said that Powell's hawkish stance shows that he is "tone deaf" and "data independent". With Powell sticking to his guns and citing strong growth in previous quarters amidst weakening growth forecasts, stock markets experienced a vicious correction towards the end of 2018. Fortunately, markets made a strong reversal at the start of the year as hawks transformed into doves.

What are hawks and doves?

We are not talking about actual birds here, nor are we referring to a transformation similar to an ugly duckling turning into a beautiful swan. What we are referring to is the monetary policy stance of certain central banks. Hawks are central bank officials who want to prevent an economy from overheating by tightening monetary policy, such as through raising interest rates faster, unwinding the central bank's balance sheet ahead of schedule or raising the reserve ratio for banks. On the other hands, doves prefer to stimulate growth by loosening monetary policy, essentially the reverse of what hawks want to do.

Powell's dramatic pivot

Fortunately, Powell had a dramatic pivot after the Christmas Eve stock market rout. From using hawkish language, he said that he will be "patient and flexible" regarding monetary policy and that interest rates "are just below neutral". He added that he will now "listen to markets" for signals.

In the past weeks, we have seen more evidence that the world seems to be slowing down after 2 years of synchronized global growth. In a statement last week, Fed Chairman Powell said that "now we see a situation where the European economy has slowed substantially and so has the Chinese economy. Just as strong global growth was a tailwind, weaker global growth can be a headwind to our economy." Thus, just 3 months after saying he was planning to hike interest rates 2 times this year, Powell continued his dovish pivot by saying that the Fed is keeping benchmark rates unchanged at 2.25-2.50% for the rest of 2019.

Draghi expands stimulus program

Earlier this month, not only did European Central Bank (ECB) President Mario Draghi decide to keep interest rates unchanged, but he also restarted the ECB's previous stimulus program – LTRO, which stands for Longer Term Refinancing Operations. The goal of LTRO is to encourage banks to lend more in order to stimulate economic growth. Draghi justified this by saying that "the persistence of uncertainties related to geopolitical factors, the threat of protectionism and vulnerabilities in emerging markets appears to be leaving marks on economic sentiment." Thus, the ECB's policy stance will be "more accommodative in order to increase the EU's resilience."

China implements both fiscal and monetary stimulus

After downgrading its growth forecast, China announced both fiscal and monetary stimulus measures to boost China's slowing economy. For instance, the People's Bank of China (PBoC) has been injecting liquidity into the banking system, at one point putting in $83 billion in just one day. The required reserve ratio has also been cut 5 times since 2018 to allow banks to lend more. The government also reduced corporate taxes, VAT and other fees by an aggregate $298 billion. This double barreled approach shows the seriousness of government in preventing a sharp slowdown in the Chinese economy.

Stock markets welcomed dovishness of central banks…

Stock markets welcomed this newfound dovishness of central banks, so equity markets went higher after these announcements were made. The S&P 500 and Euro Stoxx 50 were both up as much as 14% YTD. The Shanghai Composite was even stronger, gaining as much as 25% in 2019.

… but global economic growth still stubbornly slow

Despite the strong performance of equity markets, bond markets were signaling that the global economy is slowing down. This can be seen in the stubbornly low yields of long term US Treasuries and the negative yield of 10-year German bunds. Even central bank statements were flagging the sharp deceleration in economic growth. This is a paradox where you have a strong equity market yet declining long term bond yields.

US yield curve inverts for the first time since 2007

Unfortunately, the bullishness that accompanied Powell's pivot turned out to be short-lived. For the first time since 2007, the US 3-month Treasury yield exceeded the US 10-year Treasury yield, creating the so-called inverted yield curve. This is a widely watched recession signal which indicates that investors are expecting a sharp slowdown in global growth.

The inversion of the yield curve triggered a shift in sentiment for equities. Last Friday, the Dow Jones index shed 460 points, with some major stocks losing more than 5%. This was the US' worst 1-day performance since the start of this year.

Too little, too late?

The consistently low yields of long term bonds and the vicious drop in equity prices last Friday are signs that many investors doubt whether the central banks still have enough ammunition to reignite global growth. The Fed may have misjudged how weak the global economy has become, with their pivot from hawk to dove being too little, too late.

Will the central banks win?

While a sharp global slowdown is a risk that hobbled stock markets last year, it was also the reason why central banks chose to delay policy normalization. Only time will tell the impact of Powell's dovish pivot, the ECB's expansion of its stimulus and China's double-barreled approach of fiscal and monetary stimulus. However, it is clear that central banks are once again taking action. If they succeed in preventing a recession or sharp slowdown, central banks may be able to prolong the life of this 10-year bull market. Similar to 2008 though, there will be doubts over whether central banks can win, especially this late in the economic cycle. Until the outcome becomes clear, expect markets to remain volatile and tricky, testing even the most seasoned investors.

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