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A DOVISH TURN OF ECB AND FED

WHY AND WHAT DOES IT MEAN FOR US?

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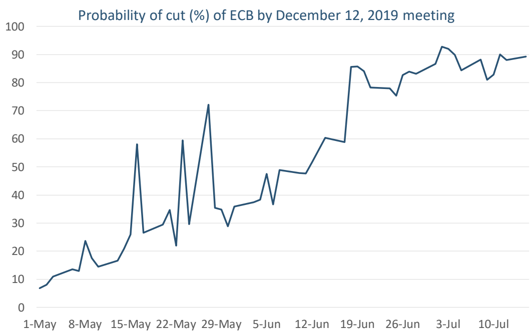
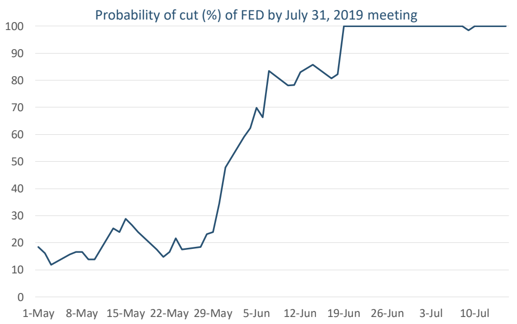
Both ECB and FED turned distinctly dovish recently,…

…although each one for a different, if not exactly commendable, reason.

The effects on EURCZK will not be large, however.

A wave of dovishness engulfed the two major central banks – FED and ECB – in the last couple of months. One illustration is given by the picture below that shows the time evolution of probability of hike for this week's meeting (for FED) or for the last meeting of 2019 (which will be held on December 12) for ECB.





SOURCE: Bloomberg (ticker WIRP)

The probability of FED cut, well below 20% as recently as at the end of April, shot to 100% by the second half of June. For ECB, the probability that there will be further lowering of already negative interest rates by December of this year, practically non-existent at the end of April, rose to 90% by the end of June. Although one should be accustomed to the fickleness of markets by now, this was still quite a swing.

What caused it, then? Well, as is usual, central banks did. FED changed the rhetoric quite dramatically in last couple of months. Although if one go by post-meeting statements of FED the changes may not look too large between May 1, 2019 meeting and June 19, 2019 meeting (compare the statements here ↗), with the latter only admitting that market-based measures of inflation expectations had declined and that "*uncertainties about the outlook increased*", there were powerful dovish signals sent throughout the period. That James Bullard voted for a cut at June 19, 2019 meeting may be written off as a dovish aberration, but comments of FED's chairman Powell in last weeks certainly cannot. When asked at the press conference after June meeting, FED's chairman couldn't rule out the 50 bps. cut (see page 10 below here ↗), saying merely that the FOMC members hadn't "*really engaged with question* [of whether to cut by 25bps or by 50bps] *yet*" and adding, for what it is worth, that "*ounce of prevention is worth a pound of cure*". And in mid-July, Powell sent a strong signal that cut was coming, saying, in front of Congress, that "*many Fed officials now believe a weakening global economy and rising trade tensions have strengthened the case for a rate cut*".

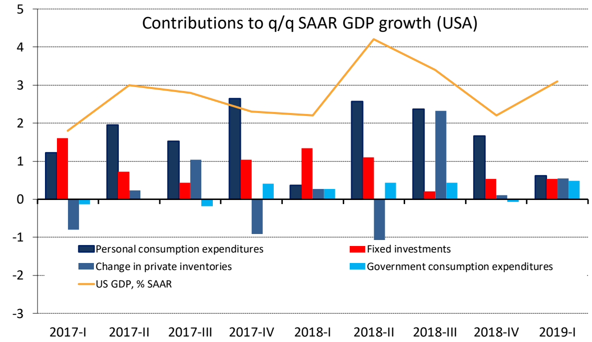
ECB did even faster turnaround. Do you recall how in December of last year, when terminating the asset purchase program, Draghi, pointing to the supposedly strengthening economy, wouldn't guarantee the stability of interest rates past the end of 1st half of this year, leaving the market hoping, or fearing as the case might have been, that hike may come in the 2nd? Well, at the beginning of June, it poured its portion of the dovish oil on the pyre. At its meeting in early June, the forward guidance, having in the meantime (in March) changed to "no earlier than the end of 2019", changed again to rates being stable "*at least through the first half of 2020*."

And this extension of the forward guidance wasn't the only dovish message from the June ECB meeting. As a matter of fact, it wasn't even the most dovish one. That award went to the confirmation, of Draghi, that discussion at ECB about how to deliver on the prior promises to "*act in the case of adverse contingencies*" got more "*granular*". What that Greenspan-speak meant was, as Draghi explained, that "*several members raised the possibility of further rate cuts* [and that]*..other members raised the possibility of restarting the asset purchase program, or further extensions in the forward guidance*." He obviously wouldn't elaborate on what those "contingencies" would be, saying the discussion just "*started*". But, hey, 6 months after the end of QE, the QE was put firmly back on table. This must have been the second fastest turn in monetary-policy stance in recent years, second only after CNB decided to go for full hike couple of months after it ended the interventions in 2017.

Now, the question is, why so? Has the economic outlook worsened? If you go by what Draghi and Powell said, it must have worsened notably. Both central bankers pointed to rising trade risks. True, the December 2018 China-US truce collapsed and US raised the tariffs on additional USD 200 bn. worth of Chinese goods from 10% to 25% in May, but backtracked on the promise to raise tariffs further on additional USD 300 bn. worth of goods. And, also, these risks have been with us pretty much since Trump came to power. Yes, it is worse to have USD 400 bn. worth of goods hit by tariffs than USD 200 bn. worth of goods, but c'mon, talking about 50 bps. cut for that reason?? Really?

Truth is, the economic situation didn't change. And where it did, it certainly wasn't for worse. Take US first.

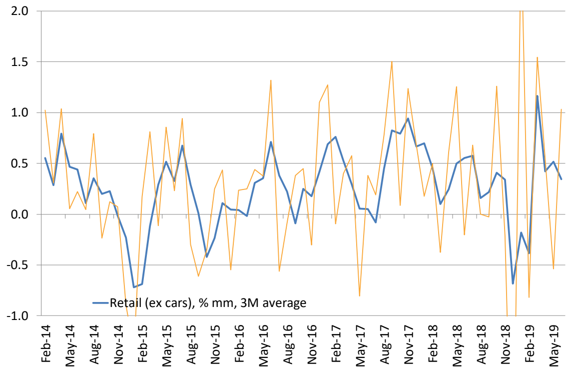
GDP growth in 1Q19 was solid 3.1% y/y, with aggregate demand strong across all major components: personal consumption contributed 0.6 pp., fixed investments 1.1 pp., net export 0.9 pp and inventories 0.6 pp.



SOURCE: bea.gov, table 1.1.2

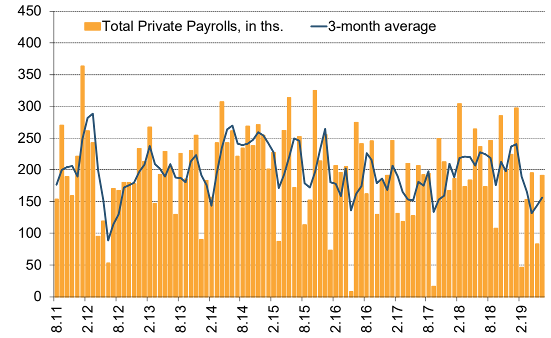
Yes, this is looking in the mirror, but still – 1Q19 was indisputably strong quarter. And remember: this was already after Trump raised tariffs on China twice in 2018 so whatever real effect of "trade war fear" was must have already been reflected in the data.

Monthly data throughout the second quarter showed only minor slowdown. **Retail sales without cars added 1.5% q/q** in the 2nd quarter and are thus 3% up y/y in the first half of the year. I wouldn't call that weakening of demand.

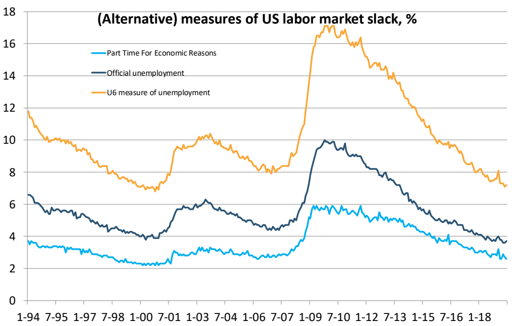


SOURCE: http://www.census.gov/retail/marts/www/adv4400a.txt

No wonder: **labor market remains strong**. Thanks to strong creation rate of new jobs and 50-year low of the destruction rate for the jobs, the unemployment rates (both official and alternative, including U6 measure which includes all those underemployed for this or that reason) are close to or at multi-decade lows.

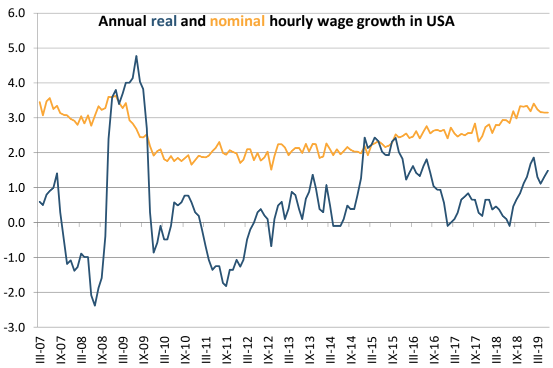


SOURCE: BLS.gov, Series Id: CES0500000001



SOURCE: http://www.bls.gov/webapps/legacy/cpsatab15.htm.

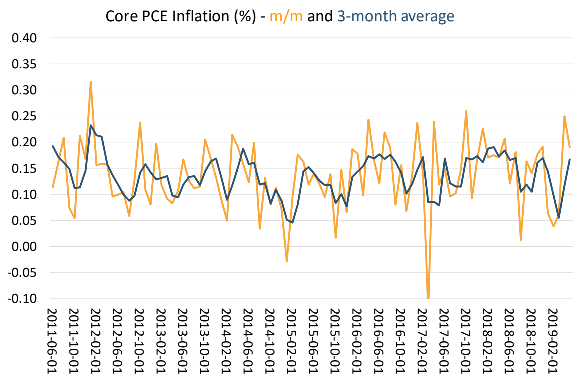
Nominal wage growth is, consequently, strongest in a decade.



SOURCE: BLS.gov, Series Id: CES0500000003 and CES0500000013

Yes, one can dismiss labor market data as lagging the economy, but apart from industry no weakness is seen in any of the sectors. **Industry did slow down noticeably this year**, but remember: industry incl. construction only employs about 13% of all workers (manufacturing only about 8%, less than what these were three years back when Trump began making America great again by supposedly bringing the outsourced industry back).

Turning to inflation also doesn't reveal the rise of disinflationary pressures. Sure, there was deceleration of monthly inflation in the first quarter of the year, but by 2Q19 the dynamics returned to about 1.9-2% annualized rate. Which is right on target.



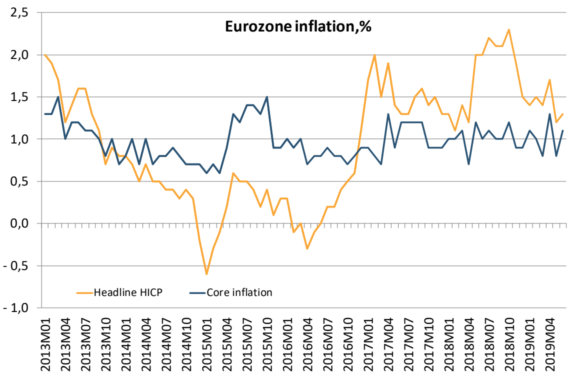
SOURCE: https://research.stlouisfed.org/fred2/series/PCEPILFE#

None of the above says there is no slowdown, or recession on the horizon. Recession, in fact, is long overdue: current US expansion is now the longest of record, with total of 121 months of growth, surpassing the 120-month expansion between 1991 and 2001. But it is hard to find evidence for looming recession in the data. FED could easily say that it expects recession soon even if data don't yet show one, and no one will blame him. But pointing to "data" and "risks" as a justification for cutting is weak.

So, why's FED seeing the glass almost empty when I see it at least half-full? The reason, I suspect, is Trump. Having been at the receiving end of the Trump's endless Twitter tirades↗↗, FED in my view is trying to minimize the reasons to remain there. And this newly found dovishness that came out of nowhere is the reflection of that. **FOMC is, I believe, trying to appease the Republican frontrunner**.

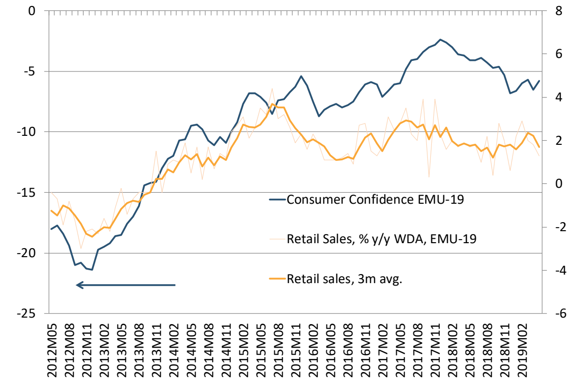
In **Eurozone**, the turnaround was equally rapid, but for different reason. Gone are, as was mentioned above, the hawkish hints of December. What ECB is doing by its recent 'repositioning' is admitting that what it did / said in recent 6 months was a mistake that must be corrected. It is, to put it bluntly, coming to grips with reality.

As I've always said it would. There was absolutely no reason for the optimism of ECB displayed in December 2018. Recall December 2018 statement ↗ which said that "*the underlying strength of domestic demand continues to underpin the euro area expansion and gradually rising inflation pressures*" and that this *„supports our confidence that the sustained convergence of inflation to our aim will proceed and will be maintained even after the end of our net asset purchases."* Well, no: (core) inflation didn't converge to anything since December. Actually, it hasn't gone anywhere since 2013, having been between 0.7% and 1.2% most of that time. It is true that headline inflation (in which ECB target is specified) did go up, but 'sustained' convergence of headline inflation is unthinkable without core inflation being sustainably close to the target, not at 1% as has been the case.



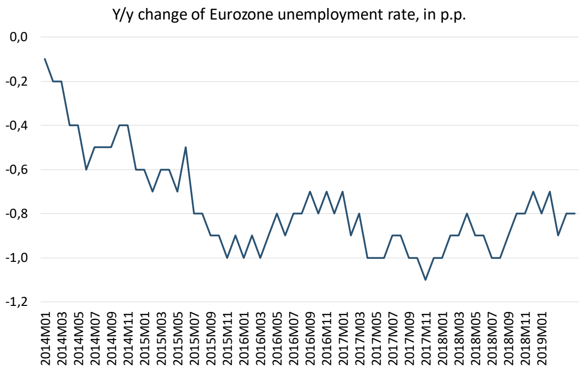
SOURCE: Eurostat ↗

The "*strength of domestic demand*" referred to by ECB was a joke and clear evidence that central banks wanted to see the glass full when it in fact was almost empty. Look no further than at the retail sales which didn't grow faster than 2% y/y (!) since the end of 2017. That certainly doesn't look like reflection of *"strength of the domestic demand*".



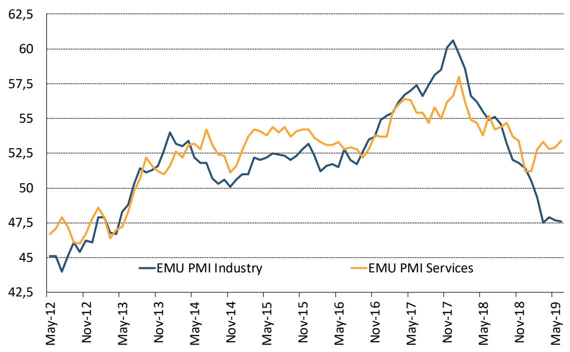
SOURCE: Eurostat for retail sales ↗, EC for confidence ↗

The slowdown in the rate of improvement of the labor market that was evident in the 2nd half of 2019 also wasn't exactly supporting the expectation of accelerating inflationary pressures.



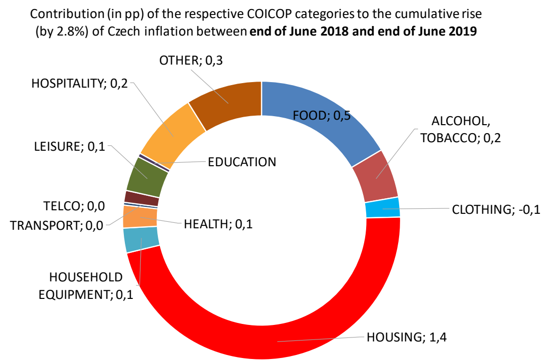
SOURCE: Eurostat ↗

One doesn't even need to add the fact that at the end of last year the industry was showing unmistakable signs of impending weakness to see that the optimism displayed at December 2018 meeting of ECB was, to say the least, unwarranted. With the inflationary reality becoming painfully evident even in Frankfurt and with FED succumbing to the pressure of Trump, thereby threatening to send EURUSD up, ECB didn't have any other choice but turn dovish this year.



SOURCE: Bloomberg

- So, FED is trying to appease Trump, ECB is correcting its previous mistakes. What does it mean for us? **In theory, CZK should get stronger** as CNB hasn't shown any signs of succumbing to the same dovish mentality as ECB and FED, i.e. as expected interest rate differential widened. This happened – EURCZK slid to 25.45, the lowest since September 2018. But the fact that CZK is overbought (legacy of the interventions) prevented further strengthening of the domestic currency.
- And it will work the same way in the foreseeable future. In other words, I don't expect stronger CZK this year just because ECB and FED turned dovish recently. Where the benefit is more visible is in hedging costs: all those hedging foreign revenues into CZK will now benefit more than before as forward points for both EURCZK and CZKUSD moved up. But they should hurry up. **Because, how long will the CNB resist the dovish waves from abroad when ¾ of Czech elevated inflation are due to just food and housing, which is hardly indicative of broad inflationary pressures that CNB so frequently invokes?**



SOURCE: Czech Statistical Office

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