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# Monetary policy of central banks is tightening up

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Volatility has increased on the markets. The main reason for this has not occurred often in the past years: statements by the central bankers according to which the extremely expansive monetary policy will be reeled in. Are we going through a trend reversal?

## Trend reversal

Actually, a change had occurred already in October 2014: back then, the US central bank (Fed) had completed the third bond purchase programme. About a year later, i.e. in December 2015 to be precise, the Fed funds rate was raised for the first time in a while. Other central banks such as the European Central Bank (ECB), on the other hand, continued to loosen their monetary policies. The last expansionary step so far has been taken by the Bank of England, when it cut the key-lending rate in August 2016. Subsequently, however, signs were accumulating that suggested that no further stimulus measures would be taken in the developed economies anymore and that the very supportive monetary stance would be reversed slowly but surely. For example, the Fed raised its Fed fund rates in December, March, and June, while the ECB reduced its bond purchase programme in April.

## Teaching points

What are the teaching points from this rundown?**A change of the monetary policy from loosening to tightening does not necessarily have to come with negative implications for the capital market,** as exemplified by the fact that the performance of many asset classes since 2014 has been a very solid one.

## Accompanying the economic recovery

Move forward to today – in the past weeks, some important central banks have tightened their forward guidance, i.e. the guidance of expectations regarding the future monetary policy. ECB President Mario Draghi has probably held the most important speech in this context. His core statement was that the economic recovery needed only lower levels of monetary support than currently in place. The ECB is optimistic about its monetary policy working and its ability to achieve its inflation target of slightly below 2% in the medium term. But since the rise in inflation from -0.6% at the beginning of 2015 to most recently +1.4% is neither self-supporting nor sustainable, the monetary policy necessarily has to remain very expansive (i.e. low key-lending rates). Monetary parameters have to be adjusted very cautiously.

## Forward Guidance

We are currently experiencing the implementation of said cautious adjustment: prior to taking steps to tighten the policy, the ECB warns the market participants so as to be able to assess the effects (forward guidance). The ECB now deems the economic risk (i.e. the risk bias) as balanced and has abandoned its proclivity towards further interest rate cuts (easing bias). According to the minutes of the recent ECB meeting that was published on 6 July, the absence of the proclivity towards the expansion of the bond purchase programme had been discussed too. In short, the ECB is preparing the market participants for the announcement of a reduction of the bond purchase programme. As a result, the yields of Eurozone government bonds have increased. For example, the benchmark yield, i.e. the yield of the German 10Y government bond increased from 0.23% around the middle of June to 0.58% on 7 July.

## Conclusion

**As long as the central bank policies are “only” accompanying the economic upswing (less dovish) but not stifling it (hawkish), the environment remains generally favourable for risky asset classes.** However, transitional periods might see a rise in volatility.




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