

CAMRI Global Perspectives

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Watch What *He* Says

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Talk the Talk

In most action movies the protagonist is often asked, ‘You talk the talk, but do you walk the walk?’ This challenge is often asked of good and bad guys to back up their comments with action, and one who just talks and does not act is immediately ignored and disrespected. In financial markets the advice given to young traders about monetary policy a few decades ago was ‘watch what he does and not what he says.’ The ‘*he*’ referred to the Chairman of the Federal Reserve Board. Then, the chairman was often the only authoritative voice speaking for the Fed. However, there were several instances when the chairman publicly rebuked other committee members for speaking out of turn.

Trading has changed

In the modern world of securities trading, communication has ascended into a more powerful role. Markets are presently trading on the edge of expected information and anticipated signals from

the Fed, or other important monetary authorities, that will trigger significant market movements well ahead of their actions. When the well-advertised monetary actions finally occur, they often induce much smaller changes in securities prices since the market’s main price movement occurred in anticipation of the event. This change in market response from *moving on action* to *moving on anticipation* gave monetary officials a powerful weapon to add to their traditional tools: public speech.

Stocks and Bonds Respond Quickly to Chairman’s Comments

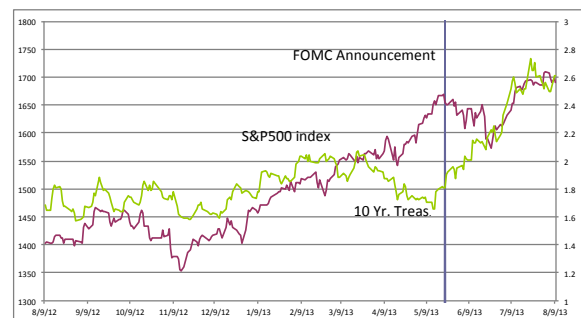


Chart 1: Stock and Bond Price Reactions

Monetary theory has also changed

In the 1950's and 1960's the key macro policy debate centered on whether monetary policy was effective or not, especially when compared with fiscal policy. Ardent advocates of monetary policy proposed rules-based policies hinging largely on targeted monetary growth rates. This debate ended in the late 1970's when then Chairman, Paul Volker, surprised the financial markets, the public, and shocked the economy when he raised the Fed Funds rate to stratospheric levels causing twin recessions and ending the pernicious inflation. Thereafter, when policy rates were subsequently lowered, a broad long-lasting economic expansion ensued, and monetary policy's effectiveness was no longer questioned. The policy debate shifted to argue over the most productive yet least destructive manner to deliver policy changes.

In the 1980's the most advanced thinking in monetary policy circles was that the Fed's actions would be most potent if they were unanticipated. Well-respected policy academicians wrote learned texts describing the advocacy of keeping policy changes secret until the final minute, and then having their impact explode on the financial markets. Anticipated actions were regarded as tepid and ineffective in producing the Fed's policy goals. At the time the empirical data supported their views: the biggest financial market price

changes occurred after and not before policy actions were announced.

Information Technology changed everything

The advances made in disseminating information through widespread usage of computers, internet services and even government reporting changed trading and price discovery to a much more sophisticated information-dominated, anticipation-oriented practice than before. Now the Fed's actions were widely anticipated: correctly or not.

The public also became more aware of the importance of monetary policy to the economy and to financial markets. The Fed's critical role in bailing out several major well-known institutions, and preventing a global collapse in international financial markets during the 2008 financial crisis elevated the Fed to the front page of the news media. The Fed and other central bankers had to adapt. The new public awareness meant that national legislatures had to demand more communication from the monetary authorities.

Therefore, policy makers began to respond to the public's need to know. In Washington and London, the heads of monetary policy now disclose the outcomes from regular policy meetings on the same day, instead of months later, in widely publicized press conferences. Speeches now follow the meetings with incremental information.

Moreover, the Federal Reserve now reveals their forecasts more frequently, and the policy meetings’ minutes are published in a more timely fashion.

A change in theory backed up the Fed’s new approach

The vast economic staff of the Federal Reserve and its 12 member banks has recently dwelled crucially upon the role expectations play in the market and for policymaking. In an important paper written at the Federal Reserve Bank of NY in 2010 concluded that, “The main lesson that we derive from the exercise is that the most effective approach to controlling inflation is through the management of expectations, rather than through actual movements of the policy instrument.”¹ This finding was a stark rejoinder to the previously-held theory about policy’s effectiveness. And it prompted a change in the Fed’s behavior. It also supported the public’s drive for more disclosure of monetary policy decisions.

A Recent Significant Example

In the years since the great credit crisis of 2008, policy rates were set near zero in most major financial centers. Faced with an impending liquidity trap, the central banks had to embark upon a new strategy: purchasing securities. This policy tool has become known as quantitative easing (QE), and is used to affect the longer maturity segment of credit markets. Buying long maturity securities pushed yields down to

unprecedented levels and induced massive portfolio shifts; from credit instruments into equities and real estate, thus boosting their prices, respectively. Lower long-term rates also stimulated mortgage refinancing which helped reduce household debt burdens. With long-term yields at record lows the financial markets were on tenterhooks, waiting for any signal that QE would end and yields on credit instruments would soar.

New Home Sales Jump After Chairman’s Warning

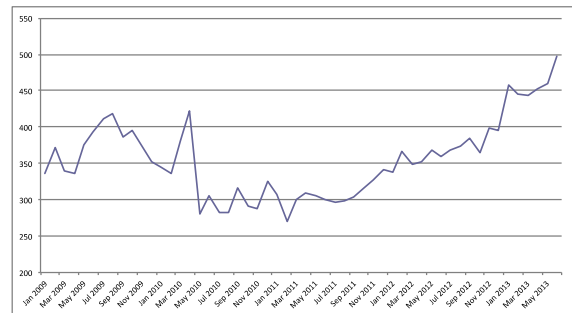


Chart 2: New Home Sales

That moment came in May 2013 when the Fed Chairman announced that the US economy was stabilizing and that QE purchases would gradually ‘taper down’. Yields on credit instruments soared immediately; they jumped 100bps (or 68%) in the following 4 weeks (see Chart 1). The Fed’s announced intensions also negatively affected stock prices around the globe: the Nikkei lost 19% and the Hang Seng index fell 14% in the subsequent month. The negative impact on US stock prices was less severe (-6%), since it also reflected the

Fed's assessment for more robust future US economic growth. To unwind some of the unintended markets' response, the Fed Chairman returned to the public podium several days later and amended his prior remarks stating that no change in QE was near. Stock markets were soothed by these remarks and eventually rebounded while bond yields stabilized. The real sector also responded to the threat of higher rates. Home sales surged (Chart 2) and mortgage refinancing increased significantly. These financial and real decisions were a direct response to a perceived policy action by the Fed. And yet, the Fed did not execute any change in policy and didn't even clarify when they would.

The latest evolution in policy: forward guidance

Monetary policy makers throughout the Western world have increasingly begun to use forward guidance as a new significant tool to affect expectations in the financial markets. The Fed began by telling markets explicitly that policy rates would remain low for a long time. Now the Bank of England and the ECB have engaged in their own forms of forward guidance. The statement that rates would remain low for an extended period of time is now being made more explicitly conditional "at least as long as" certain thresholds are reached (e.g., 6.5% unemployment rate, inflation and inflation expectations remaining well

behaved). The Fed maintains some leeway or ambiguity in this guidance because these are thresholds and not triggers, as judgment prevails over adhering to a formal rule.

¹ Policy Analysis Using DSGE Models: An Introduction, by Argia M. Sbordone, Andrea Tambalotti, Krishna Rao, and Kieran Walsh, October 2010, Volume 16, Number 2, Federal Reserve Bank of New York.

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KEY INDICATORS TABLE (AS OF 15 August 2013)								
INDEX	LEVEL (LC)	%1MO (LC)	%1MO (USD)	%1YR (LC)	%1YR (USD)	INDEX	LEVEL	%1YR
S&P500	1685.73	5.09%	5.09%	24.99%	24.99%	3MO LIBOR	0.27	-39.99
FTSE	6621.06	6.61%	6.55%	22.56%	18.71%	10YR UST	2.58	75.51
NIKKEI	13668.32	-0.06%	0.97%	60.36%	27.44%	10YR BUND	1.67	29.94
HANG SENG	21883.66	5.21%	5.22%	14.58%	14.56%	10YR SPG	4.65	-31.04
STI	3221.93	2.44%	1.94%	9.28%	6.68%	10YR SGS	2.47	76.61
EUR	1.33	2.24%		8.11%		US ISM	55.4	9.70
YEN	97.88	-1.27%		25.29%		EU PMI	50.30	14.30
CMCI	1437.08	1.75%		-7.58%		JP TANKAN	-2.00	50.00
Oil	105.03	8.77%		19.27%		CHINA IP	9.70	5.40

Source: Bloomberg

APPENDIX

GLOSSARY OF KEY TERMS (Source: Bloomberg, with tickers in parenthesis. In US\$ where applicable)

S&P500: capitalization-weighted index of the prices of 500 US large-cap stocks (SPX)

FTSE: capitalization-weighted index of the prices of the 100 largest LSE-listed stocks (UKX)

NIKKEI: capitalization-weighted index of the largest 225 stocks of the Tokyo Stock Exchange (NKY)

HANG SENG: capitalization-weighted index of companies from the Hong Kong Stock Exchange (HSI)

STI: cap-weighted index of the top 30 companies listed on the Singapore Exchange (FSSTI)

EUR: USD/EUR exchange rate: 1 EUR = xx USD (EUR)

YEN: YEN/USD exchange rate: 1 USD = xx YEN (JPY)

CMCI: Constant Maturity Commodity Index (CMCIPI)

Oil: West Texas Intermediate prices, \$ per barrel (CLK1)

3MO LIBOR: interbank lending rate for 3-month US dollar loans (US0003M)

10YR UST: 10-year US Treasury yield (IYC8 – Sovereigns)

10YR BUND: 10-year German government bond yield (IYC8 – Sovereigns)

10YR SPG: 10-year Spanish government bond yield, proxy for EU funding problems (IYC8 – Sovereigns)

10YR SGS: 10-year Singapore government bond yield (IYC8 – Sovereigns)

US ISM: US business survey of more than 300 manufacturing firms by the Institute of Supply Management that monitors employment, production inventories, new orders, etc. (NAPMPMI)

EU PMI: Purchasing Managers' index for the 17 country EU region (PMITMEZ)

JP TANKAN: Bank of Japan business survey on the outlook of Japanese capital expenditures, employment and the overall economy, quarterly index (JNTGALLI)

CHINA IP: China's Industrial Production index, with 1-month lag (CHVAIOY)

LC: Local Currency

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