FLASH: 21 MAY 2021

Central banks in the race to slow down

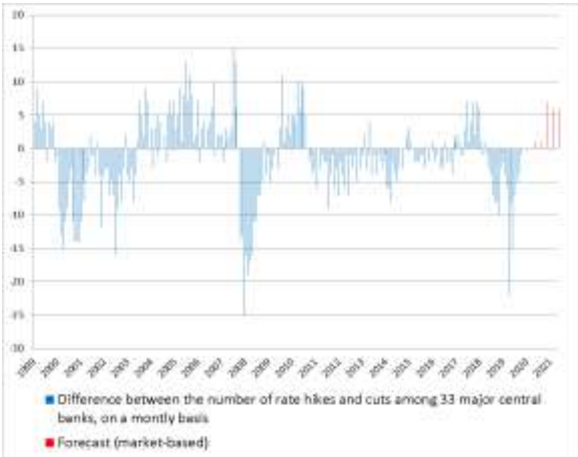
Summary

- 99% of central banks around the world cut their key interest rates in 2020 to deal with the crisis. 2021 marks the end of the cycle of policy rate cuts.
- Most central banks resumed QE (Quantitative Easing) in 2020. The first step towards normalisation of monetary policy is therefore tapering, i.e. the reduction in asset purchases. In developed countries, this has already been done in Canada and the UK.
- The reduction in emergency measures could begin in June in the eurozone, and in September in the US, in our view.
- The financial markets fear tapering. The 10-year US Treasury yield and the term premium have partially priced in this risk.
- Some central banks in emerging market countries have been forced to raise their key interest rates in the face of inflationary risk.

In 2020, policy rate cuts

In the wake of the health crisis and the subsequent economic crisis, all central banks around the world have taken steps to give a fillip to their economies. There were 207 decisions to cut key interest rates worldwide in 2020, compared with only 9 decisions to raise them.

END OF POLICY RATE CUT CYCLE IN 2021



Source : Refinitiv Datastream, BNP Paribas Wealth Management

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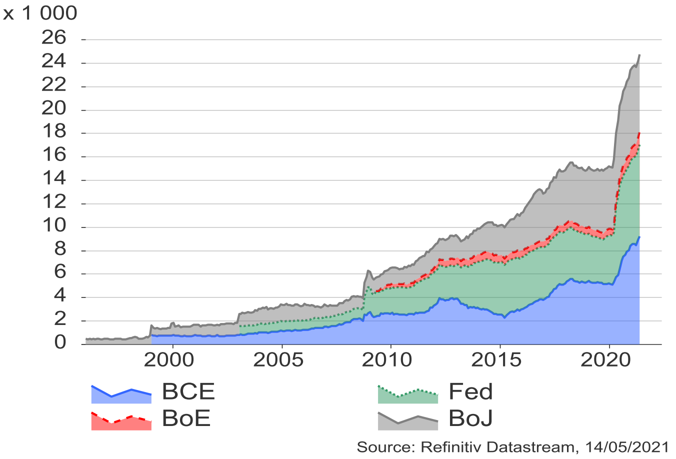
In a number of developed countries (the eurozone, the US, the UK, Japan, etc.), policy rates were already zero or even negative. So central banks resumed their quantitative easing (QE) programmes.

Definition of QE: a central bank buys assets in the markets (government bonds, corporate bonds, mortgage-backed securities, etc.), in a bid to lower medium- and long-term interest rates and, mechanically, borrowing costs. For example, companies and individuals can borrow or refinance at more affordable rates, and this effect helps to stimulate consumption and investment, leading to an economic recovery.

THE RESUMPTION OF QE HAS HELPED TO INCREASE THE SIZE OF CENTRAL BANK BALANCE SHEETS
IN BILLIONS OF DOLLARS



Source: BNP Paribas Wealth Management

In 2021, some policy rate hikes

Economic recovery is underway in developed countries thanks to the vaccination campaign and the gradual reopening of economies. Consequently central banks will embark on a very slow process of first gradually lifting emergency measures before raising policy rates.

Canada: the first developed country to announce tapering

The central Bank of Canada (BoC) announced on 21 April that it would reduce its net asset purchases (tapering) to CAD 3 billion per week, versus CAD 4 billion previously. The market did not react to the news because this had already been priced in. The BoC believes that Canada will return to its pre-Covid-19 level of activity by the second half of 2022 and it will thus raise its key interest rate at around this time.

The UK was second

The Bank of England (BoE) announced on 6 May that it would slightly scale down its net purchases of government bonds until the end of the year to reach the initial target of increasing its bond stock to GBP 895 billion by the end of 2021. Gross purchases of government bonds will drop from GBP 4.44 billion per week to GBP 3.44 billion per week between 10 May and 4 August 2021. Purchases will continue to be allocated equally between the three maturity categories (3 to 7 years; 7 to 20 years and over 20 years).

The BoE remains very cautious. We do not believe it will reduce its asset purchases more substantially as this would mean that it would reduce its targeted amount. The BoE insists that rising inflation is transitory and it will not tighten rates before there is tangible evidence of an economic recovery. The markets are expecting a rate hike around September 2022. We do not believe the Old Lady of Threadneedle Street will raise interest rates until 2023.

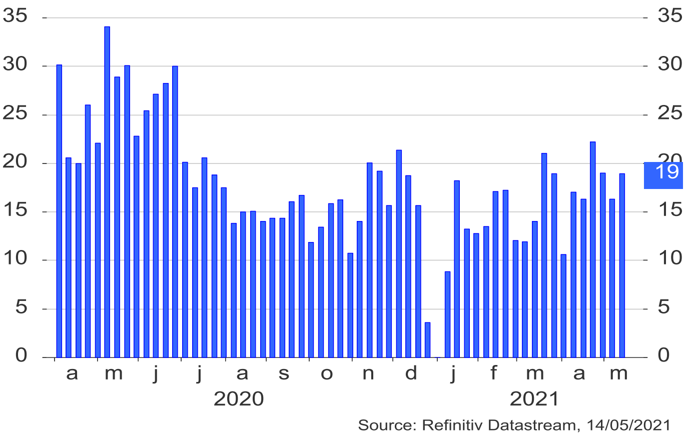
Eurozone

In addition to the QE of EUR 20 billion per month in place since September 2019 ("APP" or the "Asset Purchase Programme"), the ECB created in March 2020 a temporary QE to deal with the pandemic (the "PEPP" or the "Pandemic Emergency Purchase Programme") with an amount that was successively increased to EUR 1,850 billion to be used until at least March 2022.

Following the rise in bond yields in the first quarter of the year, the ECB decided in March to increase "substantially" its net purchases via the PEPP, in the light of still gloomy economic prospects.

In June, the ECB will announce further economic projections. These should be better than those published in March. The ECB will then find it difficult to justify its plan to keep purchases "substantially" high - even though in reality net purchases have risen only moderately in our view.

WEEKLY NET PURCHASES OF THE PEPP
IN BILLIONS OF EUROS



Source: BNP Paribas Wealth Management

We believe that the ECB will reduce its net purchases from June onwards, albeit at a slightly slower pace, so as not to use up the PEPP amount before the scheduled end date (March 2022).

Reinvestments of matured bonds will continue until at least the end of 2023, so even if flows (net purchases) dry up, the stock of accumulated bonds will allow the ECB to continue to be very active via reinvestments.

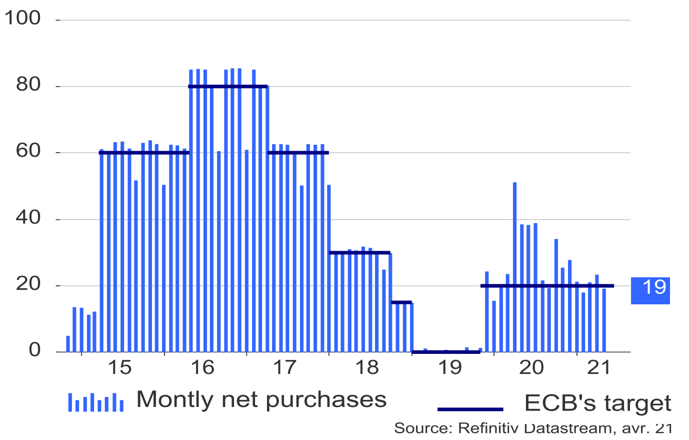
In the second half of the year, probably in September, the ECB will issue the conclusions of its strategic review, which it began more than a year ago. These conclusions should consolidate an accommodative monetary policy by moving to an inflation target of around 2% (versus "below but close to 2%" currently), which will ease the ECB's concern about a rebound in inflation in the short term.

Meanwhile, the ECB may announce that it is not renewing the PEPP beyond March 2022 as the effects of the pandemic will have largely dissipated by then.

The ECB will ensure a smooth transition after the PEPP to keep financial conditions favourable. Therefore we cannot rule out the possibility of the ECB stepping up QE from EUR 20 billion to EUR 40 billion per month as of March 2022, while changing some of its parameters to make it more flexible, in line with the PEPP which will not exist by then.

The next step will be the increase in key rates, perhaps towards the end of 2023.

NET MONTHLY PURCHASES OF THE APP
(UNRELATED TO THE PANDEMIC)
IN BILLIONS OF EUROS



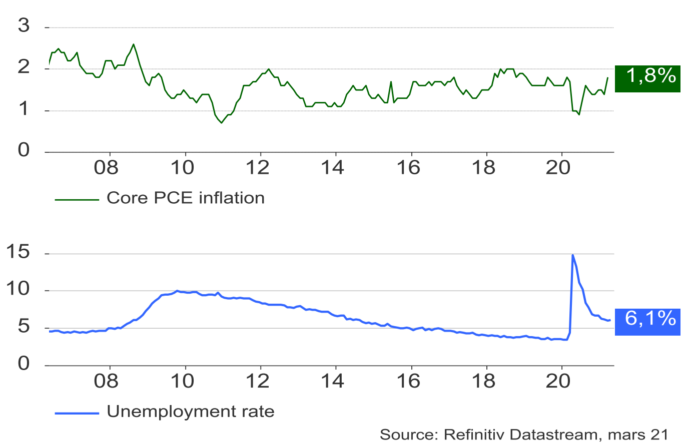
Source: BNP Paribas Wealth Management

USA

The US Federal Reserve (the "Fed") also resumed its QE in March 2020 in the wake of the pandemic. The current rhythm is at least USD 80 billion in government bonds and USD 40 billion in MBS (Mortgage Backed Securities).

According to Fed Chairman Powell, there are two prerequisites for stopping monetary support: 1) inflation must reach the target of 2% on average over a defined period and durably remain at that level; and 2) the economy must reach a maximum level of employment for all categories of the population (including women, ethnic minorities, low skilled workers, etc.). The Fed will begin tapering once substantial progress has been made on both fronts.

FED MANDATE: INFLATION AND EMPLOYMENT



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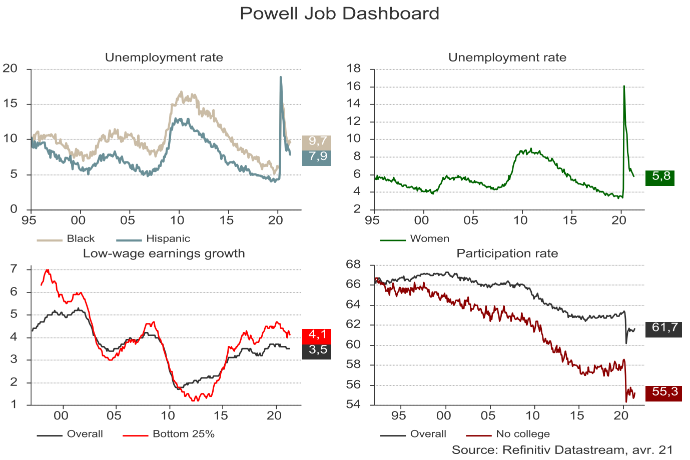
JOB MARKET INDICATORS



Source: BNP Paribas Wealth Management

However, some regional Fed chairmen are impatient and indeed concerned that the Fed is creating excesses and imbalances in the financial markets. How is QE justified when inflation expectations are at their highest since 2008, the equity and bond markets are close to their all-time highs and the real estate market is soaring?

The Fed is likely to wait a little longer in view of the last disappointing employment report. We expect the tapering debate to heat up again in June and an announcement to be made in September after several strong jobs reports and when 70% of the American population is vaccinated.

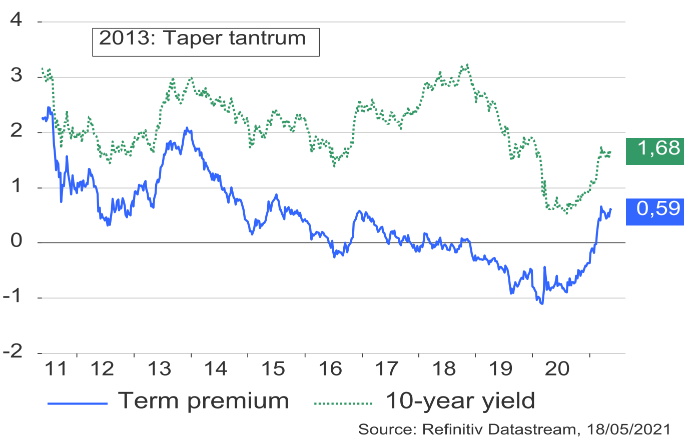
Tapering will be very slow and will likely begin with the MBS in view of the frothy housing market, especially as the Fed already holds nearly one-third of the MBS market. Reinvestment of matured bonds will continue for several years to come.

Once tapering is over, the Fed should raise its key rates when its inflation and maximum employment targets are met, probably around Q3 2023. The eurodollar futures market anticipates a tightening of key interest rates as of December 2022.

Should we fear tapering?

The experience of 2013 has left its mark. The 10-year US Treasury yield tightened sharply and quickly, by around 1.30% in the space of 4 months. At the time, the former Fed Chairman surprised the markets by making hints about tapering in front of the Senate even though economic data were still disappointing. A month later, these data started to surprise to the upside. At the same time, there was speculation that Larry Summers, an advocate of a hawkish monetary policy, could be the next Fed president.

THE US RATE AND TERM PREMIUM HAVE RISEN SINCE MID-2020



Source: BNP Paribas Wealth Management

The circumstances are a little different today and the Fed has learnt from this experience. The 10-year US Treasury rate has already tightened and the term premium (i.e. the additional yield that investors demand to buy long-dated bonds rather than renew short-dated bonds) has also risen. The next Fed Chairman will take office in February 2022. Joe Biden may decide to renew Powell's mandate or appoint another candidate. In the latter case, the obvious choice would be Lael Brainard, the current governor and a Democrat. In either case, both are resolutely dovish (advocates of an accommodative monetary policy) and should not surprise the markets.

Iceland: the first developed country to raise its policy rate

The central bank of Iceland decided to raise its policy rate on 19 May in the context of higher-than-expected inflation, the depreciation of the Icelandic krona as well as rising labour and real estate costs.

Norway: perhaps the second?

The Norwegian economy barely contracted during the Covid-19 crisis relative to other developed countries. This was thanks to its sovereign wealth fund and the support of its central bank. Moreover, the central bank cut its key rate to zero in 2020, but has never done any QE due to technical constraints: the size of the Norwegian government bond market is relatively small, the market is quite illiquid and the share of government bonds held by foreign investors is significant. The central bank hinted at hiking rates in the second half of this year.

Emerging Markets

Some 20 emerging market central banks launched QE in March 2020 during the pandemic, and the amounts were smaller than in developed countries. The central bank of the Philippines was the most ambitious in terms of QE size, followed by Hungary, Croatia, Chile, Poland and Indonesia.

Colombia, Croatia, Romania, South Africa and Turkey recently stopped their asset purchases. Only the central banks of Poland, Hungary, India and Indonesia remain very active in their asset purchases.

Several central banks have had to raise their key rates in the face of higher-than-expected inflation and rising bond yields in developed countries. This is the case, for example, of Brazil, Turkey and Russia.

Since the beginning of the year, there have been 16 decisions to raise key interest rates versus 4 decisions to cut them, in stark contrast to 2020 (9 hikes and 207 cuts).

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