Northern Trust | Jim McDonald: Will Central Bankers Change Their Stripes?

[MUSIC PLAYING]

Fresh concerns about interest rates have returned volatility to the financial markets and some investors are questioning whether the current easy monetary policy regime is about to change. Are central bankers about to change their stripes from long-time doves new found hawks? Will central banks start pushing up interest rates?

We think the recent concern over interest rates emanated from Japan where their 30-year bond has jumped in yield by one half of a percent from its lows two months ago. The most recent European Central Bank meeting was also disappointing for the doves as ECB head Draghi didn't hint at fresh stimulus.

Meanwhile, expectations for action from the Federal Reserve have remained muted with the market not even pricing in a full hike over the next year. We think central banks only directly control short-term rates, and their influence wanes the further out the yield curve you go.

This week's Bank of Japan meeting is taking on unusual importance as they have promised a comprehensive review of their monetary policy program. While we don't know how the economy would have fared without their ultra easy monetary policy, they have so far failed to generate their targeted levels of growth or inflation. The BOJ's options range from a further dip into negative interest rates to expanding the scope and breadth of their quantitative easing programs.

So will fiscal policy be the catalyst for higher rates? The academic case for infrastructure investment is strong as the need is high and financing costs are low. However, there are fiscal and political constraints on how far this could go. With the US and European deficits already at 3% of GDP and Japan at nearly 7%, there seems to be little room for meaningful loosening of fiscal policy.

The outlook for easier fiscal policy in the US will be closely tied to the election, but the likelihood of the Republicans holding the House probably limits this potential. European policymakers have been loosening austerity measures at the margin, but a wholesale change looks unlikely. Finally, Japan may be the most likely candidate for fiscal change, but we don't see coordinated monetary and fiscal policy as likely.

What does all this mean for investors? While interest rates have risen recently, they are still in their multi decade lows. The path of least resistance for central bankers is to keep rates low, so we don't expect a change in central bankers' stripes. We are closely monitoring inflation trends, the classic risk case for higher rates, but don't see worrying signs on the horizon.

The biggest risk may be that developed world stale monetary policy framework finally gets overhauled as policymakers decide to try something new. But that will likely require a change in leading central bankers, something we don't see over our tactical horizon. Therefore, we think the most likely outcome is more of the same. Interest rates are likely to stay low and risk assets will trudge higher on a more volatile path than we've experienced in recent years.