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Policy Pockets

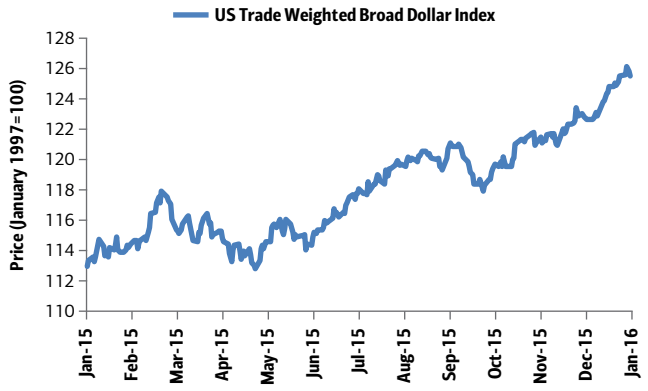
This week's statement by the Federal Open Market Committee of the Federal Reserve (Fed) looked through the past three weeks of sharp market declines and maintained the view that economic growth will continue to expand, albeit more modestly than it did before. The Fed acknowledged the recent tightening in financial conditions, the slight slowing in growth, and the fall in inflation expectations — which have nosedived in recent weeks but did not radically change its outlook for the economy. The Fed also paid heed to "global economic and financial developments" and the underlying risks to the global economy. So, is the Fed tone-deaf to the markets or looking through the noise in the markets?

The markets and the Fed seem to be in disagreement. The Fed sees its stance as highly accommodative, with or without another hike, but it has not explicitly ruled out another hike at its March meeting. Meanwhile, the markets see any subsequent hike as risking a sharp downturn. Accordingly, the markets are pricing in just one more hike before 2017, while Fed commentary thus far leaves the impression the central bank is comfortable with two to four hikes this year. The Fed is also focused a bit more on the solid aspects of the economy — jobs, consumption and housing, while the equity markets appear to see recession risks, weak profits growth, and market gauges of inflation expectations as hinting at more deflationary pressures. For the moment, the Fed is hoping to craft a truce with the markets, pausing for more information to assess its next move. We await Chair Janet Yellen's semi-annual testimony before Congress, in early February, to get a better read of the Fed's view.

While the Fed seems to be on hold for the foreseeable future, other central banks remain more committed to action. Last week, the head of the European Central Bank, Mario Draghi, waged a war of words and all but promised the markets that more accommodation was on the way in March. In addition, the weak inflation outlook in Japan and pressures from a slowing China have raised expectations that the Bank of Japan (BoJ) could introduce more policy accommodation either on Friday, when it next meets, or by late April, as our BofA Merrill Lynch Global Research Japan Economist expects. Easing by both central banks would likely snap markets back into a more relaxed mood.

China is also easing in its own way. In January, it released pressure on its slowing economy and tried to stem capital outflows by weakening its currency. We suspect the country may keep the yuan more stable through February, during the Lunar New Year, and while it hosts a key G-20 session on February 26–27. Nonetheless, it is likely that China will continue to stimulate its economy through fiscal policy in lieu of traditional monetary policy, such as reserve requirement ratios and lower short-term interest rates, which would only fuel capital outflows. China's struggle to navigate the impossible trinity of free capital flows, a semi-fixed exchange rate, and independent monetary policy will also continue.

Exhibit 1: US Dollar Strength Continues



Source: Bloomberg, Chief Investment Office

In Davos, China acknowledged it needed to hone its skills at communicating monetary and foreign exchange policies, a welcome sign from a government that has seemed to be

tone deaf to the global markets, triggering periodic waves of market volatility. The taboo idea of capital controls in China was also debated at Davos — suggested by Haruhiko Kuroda, governor of the BoJ — but appears to be an option of last-resort at this juncture.

Broadly, from a monetary policy perspective, the world remains an accommodative place that, in our opinion, will keep currencies throughout most of the world weak relative to the U.S. dollar (see Exhibit 1). So far, the dollar has strengthened roughly 12% against a broad basket of currencies since the beginning of 2015, and the U.S. will tolerate further strength — and the costs it imposes on U.S. gross domestic product growth and inflation — in order to see the rest of the world emerge from its growth slump. Many emerging and export-led economies can only recover through a weaker currency, as quantitative easing is a nonstarter without a robust, consumption-based economy. We expect the U.S. dollar to continue to strengthen in fits and starts throughout 2016, reflecting a tacit global coordination on currencies. A more coordinated fiscal response from the G-20 is a possibility if global growth metrics deteriorate over the next month.

In summary, we remain in various policy pockets as the world struggles through the economic transition (two-track economy) in China, the severe slowdown in manufacturing and trade, and the pressure on commodity producers. Policymakers will likely continue to use all of their tools, including communication, to achieve price stability in the year(s) ahead. While markets come to grips with heightened volatility and a slower growth curve, a repricing of risk and valuations should continue, even as the realization takes hold that the U.S. consumer is, indeed, balancing out the negatives from manufacturing and trade. We will maintain our high-quality, low-volatility bias in all asset classes until we get more visible signs of a bottom in oil prices, an even more relaxed Fed, and a flattening, if not an actual decline, in the dollar trend.

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