

Forward guidance - frankly garbage

There's nothing dramatic in the Covid-19 virus news, just a slow steady worsening, but maybe the market's concern is the absence of anything new to boost the economy



Federal Reserve

Source: Shutterstock

Ex-post rationalisation

This morning, Asian markets are expected to open a little softer following US equity weakness overnight. Newswires are putting the weakness in the US down to a couple of things:

1. Comments from the Fed's Raphael Bostic that the renewed spike in Covid-19 cases may threaten the pace of economic recovery and;
2. Further evidence that case numbers continue to rise in the Southern belt states as well as death figures, where, not so much nationally but in some of the most affected states, the 7-day moving average of daily deaths from Covid-19 have begun to creep higher.

I wonder though, whether this is the usual case of financial journalists observing the market action, and then looking for an appropriate donkey to pin the market's tail on?

There is another suspect for the market's weakness, but let me get there in a roundabout fashion, because another Fed member, Loretta Mester also remarked that the impact of the upsurge in virus cases was causing activity in her district (Cleveland Fed) to level off, and pointed to the need

for more fiscal support.

But when a Fed member says, "Things aren't good, can we have some more fiscal support please?", that should tell you something about the availability of monetary options, and this is where we get the clinching remarks.

Richard Clarida, Vice Chair of the Fed, said yesterday that should they (the Fed) need to provide more stimulus, the Fed had plenty of available tools, but then listed first in his arsenal (as well as buying more assets) "forward guidance".

Here's the thing, around the world, many central bankers have asserted that forward guidance is a tool in their arsenal. Let me tell you something. 99% of the time, it isn't. And that's because financial markets aren't stupid.

In fact, financial markets usually point to Fed cuts, or hikes, long before the Fed itself realizes it needs to make them, as was the case back in late 2018 when it saw through the Fed's projection that rates would keep rising through 2019. Forward guidance then, in terms of the dot plot and other associated remarks, was simply forward garbage.

The idea of forward guidance is that by telling markets that rates will remain very low (and then comes the tricky part) until such-and-such a condition has been achieved (sensible) or such-and-such a date had been reached (not credible), additional stimulus can be achieved by helping longer term bond yields to decline (normally the Fed only has traction at the front end of the yield curve).

But whether contingency-based or time-based guidance, there is only any market benefit to such announcements if the market was not already (as is usual) way ahead of the central bank in question. There are times (infrequently) when markets do get things wrong, and when a helpful word here or there can provide a useful nudge to get them back on the right track. But as a general option to be used to provide additional stimulus, it usually doesn't have any firepower whatsoever.

The Implied rates in the US from the OIS curve are currently flat at about zero to slightly negative right out to 2022, so unless the Fed really is going to engage in substantially negative interest rates before then (and it doesn't sound as if they are), then they have nothing to tell us.

Indeed, you can also lay quite a lot of blame of increased volatility at the feet of misplaced forward guidance, for example, the bond market taper tantrum in 2013 as the Fed had to backtrack on some of the claims it had previously made for policy as the economy recovered. This led to a step up in rate expectations, which wouldn't have been necessary if the Fed had not meddled in the first place by making exaggerated claims.

In short, when the Fed tells you, "Don't worry, forward guidance is here to help". It is actually time to be worried. But don't get too alarmed. By this time tomorrow, equities will probably have forgotten all this and found another reason to rally.

HKD worries

Another story is doing the rounds today, that I feel obliged to mention, but which has the ring of market "propaganda" to it. The reported story concerns the US allegedly considering ways to undermine the Hong Kong dollar by making it harder for Hong Kong's financial institutions to access US dollars during liquidity squeezes.

The HKMA has a USD swap agreement with the US Fed, but HK FX reserves have always been enough to defend the peg in times of stress, so this is theoretical support mainly, not practical day-to-day support.

Importantly, this idea seems to be being circulated at a fairly low level in the US administration, and does not yet seem to be being seriously considered within the White House as far as we understand.

So although this seems like a non-story, it may get some more airplay over the coming days, so it's worth keeping an eye on.

Day ahead - nothing

In neither the G-7, nor Asia, does there appear to be anything on the calendar today that looks worth a comment, though I am conscious that it is on just such occasions, that geopolitics or market gyrations fill the void, so be careful out there.

Author

Robert Carnell

Regional Head of Research, Asia-Pacific

robert.carnell@asia.ing.com

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. ("ING") solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies)*. The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit <http://www.ing.com>.