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The Bigger Picture

A weekly snapshot of the markets

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Implications of unexpected moves by central banks

Bank of Canada latest central bank to surprise markets after unexpected rate cut

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In the realm of unexpected moves or "surprises" from central banks, there are nasty shocks and pleasant surprises. The Swiss National Bank's (SNB) bombshell decision on January 15 to abandon its cap on the Swiss franc (CHF) at 1.20 to the euro – which led the currency to soar as much as 40% against the euro – is an unequivocal example of a nasty shock. While the effects of the shock inflicted by the CHF cap removal are still reverberating in global financial markets, it has already caused trading losses estimated at hundreds of millions for some large banks, and the near-bankruptcy of retail forex brokerage FXCM. It has also triggered a huge spike in mortgage liabilities for thousands of hapless European homeowners who were lured by record low interest rates on the Swiss franc, but paid little heed to the implicit risk of borrowing in a currency that was being artificially suppressed by its central bank.

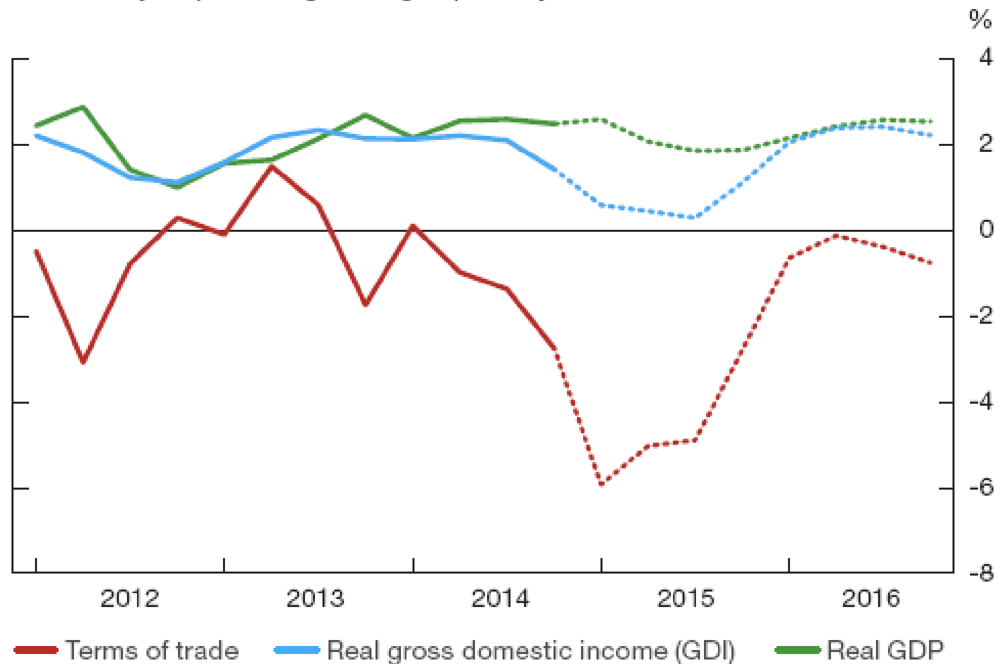
On the other side of the coin, an unexpected rate cut is generally viewed as a pleasant surprise, at least judging by initial market reaction, although the euphoria tends to fade as the reasons for such policy action become apparent. The Bank of Canada (BoC) last week became the latest central bank to deliver a surprise rate cut, after similar moves by the central banks of Turkey, Denmark, Peru and India earlier this year.

The Bank of Canada's January 21 announcement that it was lowering the overnight rate by 25 basis points to 0.75% led to a 252-point surge in the TSX Composite, while the Canadian dollar slumped almost 2% for its biggest one-day decline in more than three years. The Bank said that its rate decision was "in response to the recent sharp drop in oil prices, which will be negative for growth and underlying inflation in Canada" (Figure 1).

The Bank said that real GDP growth in Canada would slow to about 1.5% in the first half of 2015, while the economy would gradually strengthen in the second half of the year as the negative impact of lower oil prices will be mitigated by a stronger U.S. economy, a weaker Canadian dollar, and the Bank's monetary policy response (i.e. lower interest rates). Overall, the Bank forecasts real GDP

growth of 2.1% in 2015 and 2.4% in 2016, compared with its October projection for growth of about 2.5% in 2015 and 2.0% by the end of 2016.

Figure 1: Impact of the oil price slide on the Canadian economy



The Bank of Canada's surprise move was a key topic of debate even in a week where there was no shortage on market-moving news. A day before the BoC decision, the IMF made the steepest cut to its outlook for global growth in three years, trimming its growth estimate by 0.3-percentage point from its October forecast to 3.5% for 2015 and 3.7% for 2016. On Thursday, ECB President Mario Draghi unveiled Europe's version of quantitative easing, by pledging to buy government bonds worth 60 billion euros per month until at least the end of September 2016 in a 1.1-trillion euro program.

Bottom-Line:

2015 is shaping up to be a year of unprecedented currency volatility, and our concern is that this could inevitably spill over into equity markets. In this context, Federal Reserve chair Janet Yellen's warning in November that "normalization (of monetary policy) could lead to some heightened financial volatility" could well prove to be the understatement of the year. Here are some implications of the recent unexpected central bank moves:

1. **Monetary policy will continue to diverge** between the U.S. and most other nations, given their differing economic outlooks. The U.S. was the only nation to have its growth forecast increased by the IMF in last week's update, to 3.6% in 2015 (up from 3.1% in October) and 3.3% in 2016 (from 3.0%). Most economists expect the Federal Reserve to raise the federal funds rate in mid-year, even as most major nations are taking steps to stimulate their economies.

2. **The dollar may continue to power ahead**: The Canadian dollar is trading at its lowest level against the USD in almost six years as it tests support at 80 U.S. cents. The euro is trading at its lowest level against the greenback in more than a decade; while it has absorbed overnight news of the election of the anti-austerity Syriza party in Greece with equanimity, Draghi's QE program may soon see the euro test support at the 1.10 level. Monetary policy divergence virtually assures that the USD will continue to power ahead.

3. **U.S. equities remain the preferred alternative, but are getting to be a "crowded trade"**: U.S. stocks may have more upside from current elevated levels in the absence of more compelling investment alternatives, but this is at risk of becoming a crowded trade. In our view, the market environment currently is somewhat similar to the situation in the late 1990s, when U.S. equities were the "go-to" asset class after the Asian currency crisis of 1997 and Russian debt crisis of 1998. The dot-com and technology frenzy of that period culminated in the S&P 500 almost doubling in the three-year period from 1997 to 1999. Note that the S&P 500 has surged 64% over the past three years (2012 to 2014).

4. **Market volatility may rise**: In our view, the days of steady gains and becalmed markets that characterized the upward move from Q4 of 2011 ended in September 2014. We believe market volatility will rise significantly in 2015, not least because central banks' actions have become much less predictable as they pursue their mantra of growth at any cost.

For some ideas on suitable stocks to own in this environment, look for our "Top RRSP/TFSA Stock Ideas" report to be released later this week.

Market Snapshot

At close today

S&P TSX	14797.83	+18.48	Commodities			Yields (%)	Can.	US
TSX Venture	674.39	-3.79	Canadian $ (US cents)	80.15	-0.33	90 Day T-Bill	0.58	0.01
DJIA	17678.70	+6.10	Gold (Spot)-US$	1281.38	-12.72	2-Year Bond	0.51	0.51
S&P 500	2057.09	+5.27	Oil (WTI-Feb.)	45.09	-0.50	10-Yr.Bond	1.46	1.82
NASDAQ	4771.76	+13.88	CRB Index	216.05	-0.56	30-Yr. Bond	2.02	2.40

Thought for the Day

"You miss 100 percent of the shots you never take." – Wayne Gretzky

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Hold: Expected total returns of 0% to 10% over the next 6 – 12 months.
Reduce: Expected total returns of up to -10% over the next 6 – 12 months.
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