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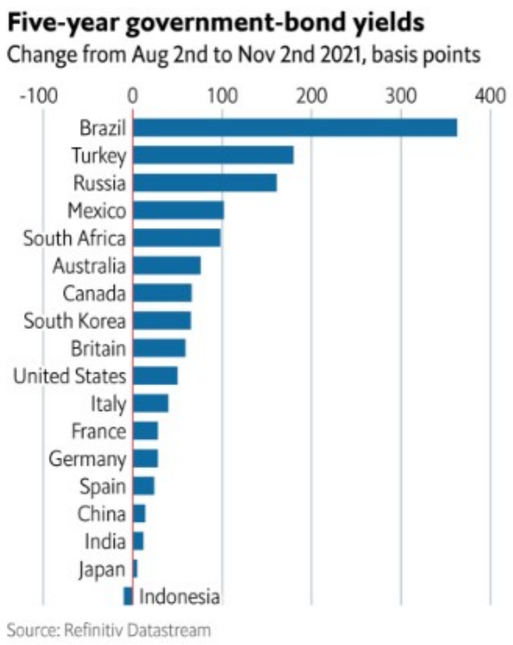
In Season Five of the political comedy “Veep”, Ben Cafferty, the hapless protagonist’s brash chief of staff tells his boss that “nobody understands the economy -literally nobody”. He was referring to voters, but recently it has seemed as if the conversion action might as well have taken place in a central bank. Last month Ben Broadbent, a deputy governor of the Bank of England, announced that the current environment was “the most challenging period for monetary policy of any I’ve seen”. This view was echoed by Jerome Powell, chairman of the Federal Reserve last week.

"I've backed into our bank account."

Bond markets can smell the unease. Central bankers’ promises that interest rates would stay low for the foreseeable future, once seen as an immutable guide to policy, have come unstuck in recent months, driving bond yields sharply up (and bond prices down). Across a panel of 35 economies, five year bond yields have risen by an average of 0.65 percentage points in the past three months (see chart). The drama has been greatest in Britain where the Bank of England surprised investors by declining to raise interest rates, while in the Euro zone Christine Lagarde, the president of the European Central Bank, is fighting a battle with investors to get them to believe her when she says that rate increases in 2022 are unlikely.



The bond market that matters most is, of course, America’s. This week the Fed announced the beginning of the end of its quantitative easing programme, carefully guiding investors to expect “tapering”. Yet America has also seen medium-term rates drift up as investors bring forward their expectations for an increase in the policy rate. And the Fed may yet be wrestling with inflation for some time. In recent months inflation has broadened out beyond just a narrow set of goods like food, fuel and clothing and is currently running at 4%, more than double the Fed’s 2% target.

In all, it is enough to bring back scary memories of the taper tantrum of 2013, when a change of course in US monetary policy caught bond market by surprise and set off a panic in emerging markets. Our view is that this time won’t be as bad, even as central banks’ grip on bond markets is a little less firm. Markets are pricing securities based on central banks bringing interest rate rises forward. Doing this requires balancing the need for a growing economy, with keeping inflation under control. This means normalizing ultra-loose monetary policy amid sky-high asset prices, heavy debt levels and above-average inflation. Godspeed to them, as this is central to our market outlook for 2022, and look for additional commentary on interest rates in subsequent Around the World posts going forward.

Thanks for reading!

Martin
1-519-546-5088

MARTIN WEILER, FINANCIAL ADVISOR
FIRST CAPITAL FINANCIAL / WORLDSOURCE FINANCIAL MANAGEMENT INC
50 CORESLAB DR. DUNDAS, ON L9H 0B2
P: 519-829-1331 F: 833-869-8042
MARTIN@FCFCORP.CA