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CENTRAL BANK SEASON

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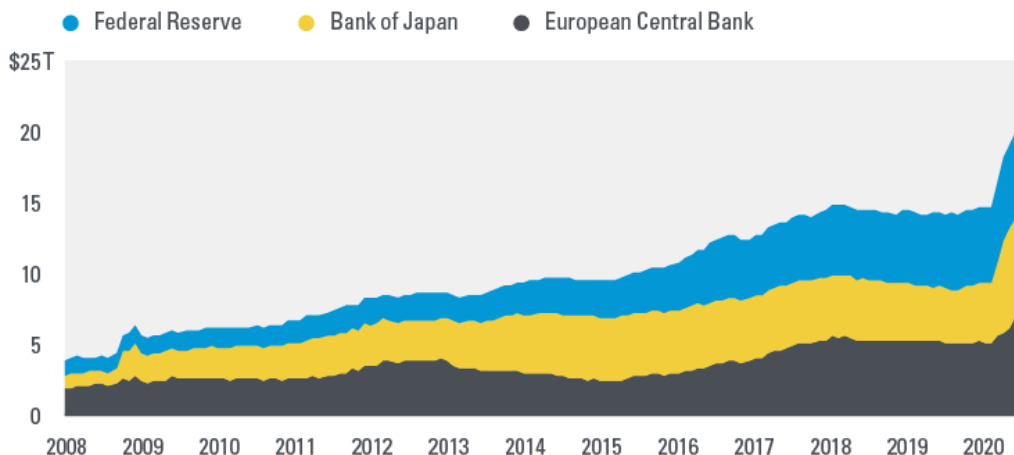
When seasons change, the major central banks meet. The Federal Reserve, European Central Bank, and Bank of Japan all met in September to discuss their outlooks on the economy and monetary policy going forward. Key observations from the central bank meetings include maintaining policy while keeping an eye on COVID-19.

FEDERAL RESERVE

Expectations for major changes at the Federal Reserve (Fed) September meeting were low. The Fed had completed its framework review at the annual central bank symposium at Jackson Hole, Wyoming, in late August and announced its shift toward [flexible average inflation targeting](#) then. While no major policy decisions were made at the September meeting, the Fed did alter the language of its guidance to align with the change in inflation targeting, allowing for potentially higher inflation before it would consider raising rates. The Fed “dot plot,” a graphical projection of when Fed members expect to see higher rates, revealed that voting members expect rates to remain at the zero-bound until at least 2023. The Fed also continues to express concern for downside risks to the economy.

Although the Fed has reiterated that negative policy rates seen in Europe and Japan are not under consideration, adjustments to the policy rate are only one mechanism for further easing of financial conditions. The Fed also can provide additional support through adjustments to its asset purchase programs or changes to other available liquidity facilities. However, the current stance may leave the Fed vulnerable to being blindsided by a better-than-expected recovery, which may have longer-term implications on inflationary forces.

1 MAJOR CENTRAL BANK ASSETS STILL CLIMBING



Source: LPL Research, Bloomberg 09/14/20

EUROPEAN CENTRAL BANK

The European Central Bank (ECB) chose to leave its policy rate unchanged and also chose not to revise its primary COVID-19 relief package, the Pandemic Emergency Purchase Programme (PEPP). The decision to stay put was largely expected by market participants, as growth in the Eurozone has been better than projected. The ECB noted that downside risks prevail, as concerns over rising COVID-19 cases in Eurozone countries have tapered the sharp rebound earlier in the summer—particularly in the services sector—while also keeping a lid on consumer confidence.

Further, one of the primary macro themes since the outbreak of COVID-19 has been the weakness in the US dollar. The dollar weakened considerably against the euro, a primary focus of the ECB at its September meeting. While ECB President Christine Lagarde emphasized that the bank does not have an exchange-rate target, she did note how the appreciation of the euro could put downward pressure on inflation expectations and potentially trigger additional policy accommodation if inflation expectations decline. Relative to the Fed, the ECB has not grown its balance sheet to the same degree during the current crisis and may leverage this mechanism to limit the effects of the appreciating euro [Figure 1].

BANK OF JAPAN

The Bank of Japan (BOJ) wrapped up its monetary policy meeting by retaining its current policy stance to keep its key interest rate at -0.1% and left the yield target and asset purchases unchanged, widely in line with market expectations. Following the resignation of Japanese Prime Minister Shinzo Abe, BOJ President Haruhiko Kuroda vowed to coordinate closely with the government of new Prime Minister Yoshihide Suga.

Similar to the Fed and ECB, the BOJ has seen economic conditions develop better than expected, but it has continued to note the downside risks presented by the ongoing pandemic. While economic conditions have picked up, the BOJ reiterated its support for fiscal expansion through the absorption of new Japanese Government Bonds, putting quantitative easing and yield curve control at the center of its monetary easing.

WHAT THIS MEANS FOR RATES

Monetary policy decisions that were previously considered unconventional following the 2008 financial crisis have become widely adopted. Following the massive deflationary shock that characterized the initial months of the pandemic, central banks have clearly shifted their focus toward boosting inflation and maintaining accommodative guidance.

While vocal critics of the new monetary policy regime warn that potential hyperinflation is likely, we stop short of calling for runaway inflation. However, positioning around normalizing inflation may still be beneficial, as inflation expectations have returned to pre-COVID-19 levels. We believe the benefits of exposure to the longest debt maturities with greater interest-rate sensitivity likely have been realized, and we see modestly higher long-term rates over the rest of 2020 and beyond as economic activity continues to recover. We reiterate our base case for the 10-year Treasury yield to end the year between 1 and 1.5%, and our bear case is for 0–0.5%.

Treasury valuations remain unattractive and corporate spreads have contracted to levels that make their incremental value less appealing. We continue to favor Mortgage-Backed Securities (MBS) as a high-quality option with relatively lower interest-rate sensitivity compared with similar quality asset classes.



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All index data from FactSet.

Please read the full [Midyear Outlook 2020: The Trail to Recovery](#) publication for additional description and disclosure.

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