Central banks vs. central nervous systems

Global financial markets have been jolted to start the New Year, with both equities and bonds declining notably in the early days of 2022.

Certainly, we can attribute some blame for this weak performance to the impact of a renewed uptick in COVID-19 infections and resultant restrictions on activity on the near-term growth outlook and investor sentiment, but a bigger driver of the downswing is the uncertainty surrounding central banks' response to the multi-decade high inflation readings registered worldwide.

While a little inflation can be a good thing (around 2% per year has been adopted as the target by most major monetary authorities worldwide), sustained rapid increases in prices can destroy demand and upend an economy; when inflation pressures bubble up, policy action through higher interest rates can be expected to follow to raise the cost of capital and temper demand — and the stronger the inflationary impulse, the bigger the response that may be warranted.

Which brings us to the crux of the anxiety in the marketplace right now: that borrowing costs are going higher is a certainty at this point; however, *when and how high* remains unknown, creating uncertainty for a key piece of the puzzle for global financial markets.

Moreover, the concerns are not about the impact of an imminent 25 basis point (one-quarter of one percent) increase in policy interest rates by the likes of the Bank of Canada and the US Federal Reserve (Fed), but implications of the expected cumulative 200 basis points' worth of hikes over the next two years (150 basis points of which are currently being priced-in by year-end in Canada).

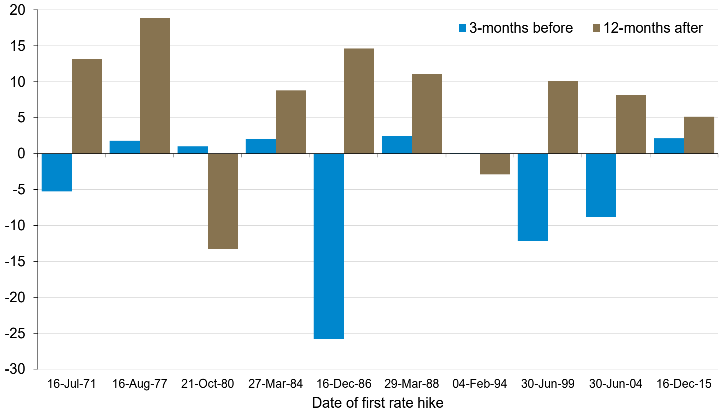
This really serves to highlight a key reason why *the stock market is not the economy* despite some protestations — the economy is the here and now, while markets have the luxury of dreamily living in the future.

So, while it may be the case that the increases in short-term interest rates (referred to as *tightening*) in the coming months will likely have only negligible impacts on current economic activity, markets are balancing concerns about the uncertainty of the path further down the road, when the cumulative policy tightening efforts of central banks ultimately push costs of borrowing to punitive levels that stifle credit expansion and choke off growth, as they have historically always done.

As such, the prospect of a tightening cycle is, understandably, being met with trepidation for the future. From a here and now perspective, however, it would stand to reason that if there is a need to slow the economy, things are going quite well, which would instead suggest that the base case for stocks is at worst neutral and probably bullish.

Indeed, while the lead up to policy change has historically been negative for markets — for example the MSCI World Index has historically declined by an average and median of 4% in the three-months leading up to the first forays into policy tightening; once the ball is rolling and there is more clarity on the road ahead, markets tend to perform well, as reflected by the MSCI World Index, which has been up one year after the first hike in eight of 10 occasions and by an average (and median) of 7%.

MSCI World Index performance around first Fed rate hike
(percent)



Source: Bloomberg, Guardian Capital

The central nervous system takes all the information from one's body and balances and organizes activity across the whole organism. This is very much the same role that central banks have in bringing order to the economy, while markets are anticipating what that equilibrium will look like.