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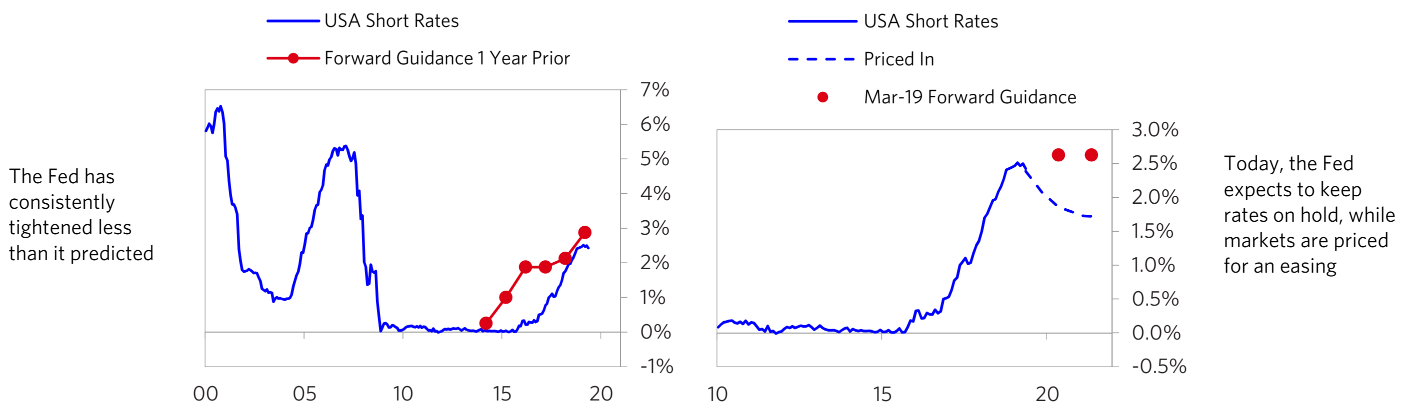
Why We Don't Believe Central Bank Guidance

Over the last decade, all major central banks have been providing explicit guidance on how they expect the economy and monetary policy to evolve. Running monetary policy is challenging enough; predicting what policy will be appropriate in the future is even more difficult. Still, looking back at that guidance in recent years, it's been meaningfully off even when economic conditions didn't surprise by much. As investors, our job is to come up with our own independent views on what is likely to occur (both in terms of economic outcomes and how central banks would react to them) and then compare them with the market pricing. Within that context, central bankers' guidance isn't something we consider strongly.

It's notable how widely the Fed's rate projections have diverged from the market pricing over the last couple of months, and this raises the question of how indicative forward guidance is. Markets are now discounting that the Fed will ease ~50bps over the next year, while the Fed is expecting moderate growth and a gradual rise in inflation and sees the risks as symmetric. At this point, not easing would constitute a tightening relative to what is discounted. This is one way markets give real-time feedback to central banks. To provide some perspective on why we don't put too much weight on what central banks say, today's *Observations* walks through the guidance and track record of the major developed world central banks over the last 10 years. The charts below illustrate the gap between what the Fed is planning to do with rates and what the market pricing suggests, as well as how wrong the Fed projections have been since they began issuing them in 2012.



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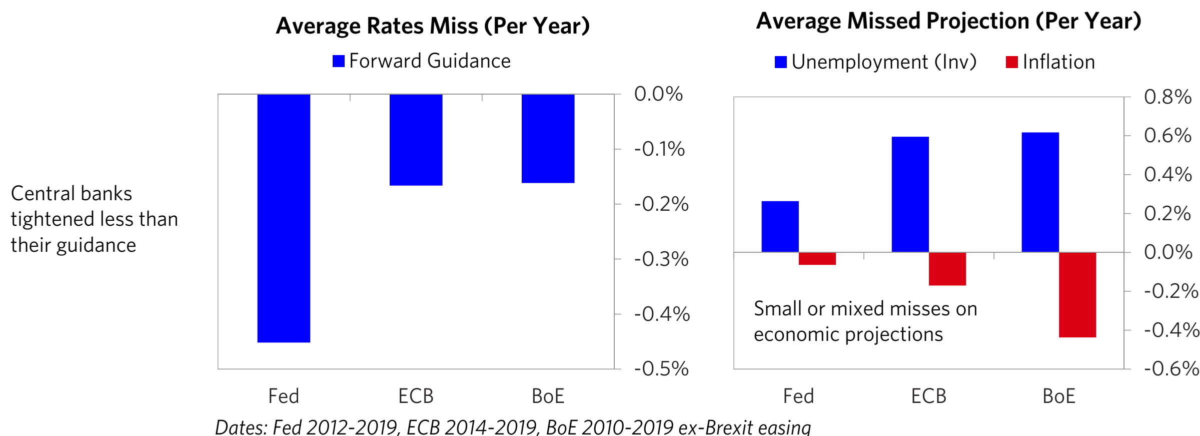
The Fed isn't the only central bank whose guidance has been off; so was guidance from the BoE and ECB, the other main central banks that offer detailed forward guidance. All three central banks shifted toward easing pretty meaningfully, even though conditions came in only a bit different from what they'd projected (e.g., growth was only a bit stronger each year as unemployment fell more than they expected, and inflation was only a bit lower). Notably, it seems that the major central banks began to put more weight on the downside misses in inflation the more persistent they became. This seems sensible to us in a world where cyclical conditions constitute only one of the drivers of inflation and developed world economies haven't created the late-cycle excesses that occurred in prior cycles. The ECB was the clearest example of this dynamic: growth and unemployment came in meaningfully stronger than the ECB expected, inflation surprised to the downside by a bit, and the ECB gave more weight to its missed inflation projections and eased relative to what they said they would do. This difference in how central banks may weigh conflicting economic pressures—combined with the fact that they consider other factors besides growth/inflation/unemployment—underscores the difficulty in using central bank guidance. The charts below show how conditions came in relative to what the major central banks projected, as well as how rates came in.



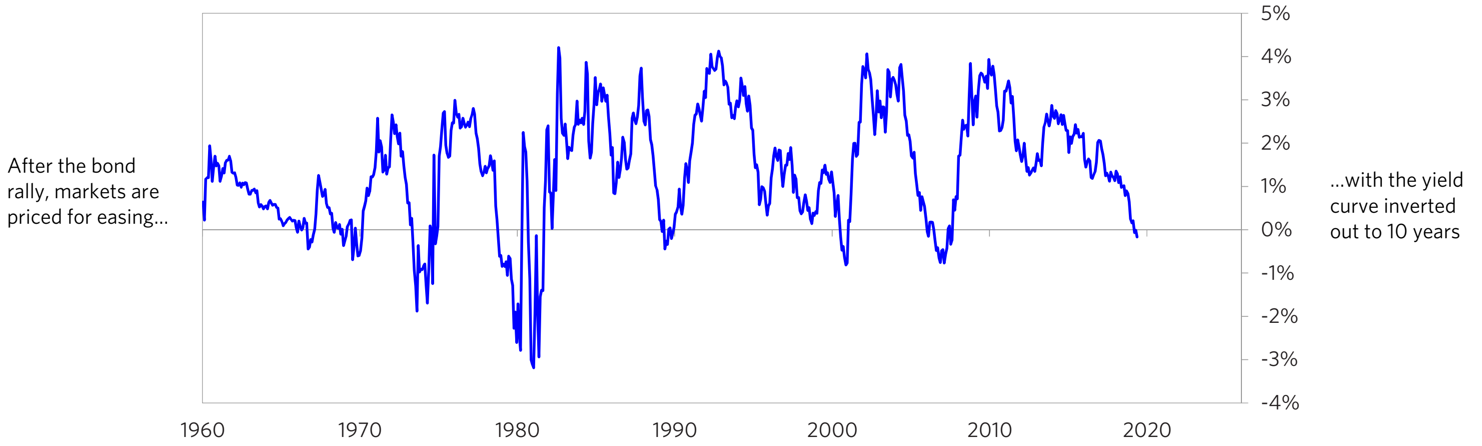
Dates: Fed 2012-2019, ECB 2014-2019, BoE 2010-2019 ex-Brexit easing

It's Notable How Widely the Fed's Rate Projections Have Diverged from Market Pricing in Recent Months

Late last year, the Fed lagged the markets in signaling the likely end of the tightening cycle. Now markets are pricing in ~50bps of easing while the Fed's language has been largely neutral (saying they are as likely to ease as to tighten). For example, Powell suggested that he saw rates as balanced in his May press conference:

> "Incoming data since our last meeting in March have been broadly in line with our expectations. Economic growth and job creation have both been a bit stronger than we anticipated, while inflation has been somewhat weaker. Overall, the economy continues on a healthy path, and the Committee believes that the current stance of policy is appropriate." —Jerome Powell, May 1, 2019

The market pricing became more dovish after the Fed meeting when US/China tensions flared up, but it had been pointing to easing and diverging from the Fed's guidance for some time. As we look at conditions today, we think the pricing is more sensible than the Fed's projections, although on the margin the degree of easing looks a bit overdone. The chart below illustrates the degree of easing priced in, with the yield curve inverted out to 10 years.



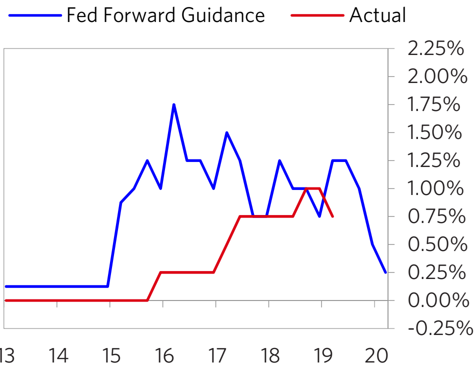
Below, we go into more detail on how the major central banks conducted policy relative to their projections in order to illustrate why their guidance wasn't all that helpful. Note: we don't include Japan in this survey because they've pretty clearly needed to keep rates low and have conducted monetary policy primarily through other levers.

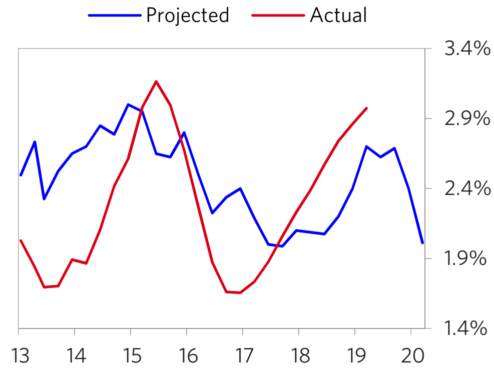
Appendix

Federal Reserve (2012-2019)

The Fed started issuing guidance in 2012, predicating a path of rate hikes on its expectations for how economic conditions would unfold. They faced growth and inflation that were a touch below their expectations, but that was combined with stronger job growth than they expected. Despite the roughly neutral way things played out relative to their expectations, the Fed on average tightened by 50bps per year less than they said they would. This suggests that policy makers weren't able to predict their response to the conditions their projections were based on.

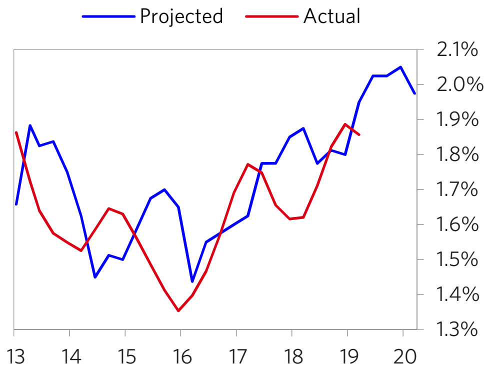
The Fed tightened significantly slower than it said it would

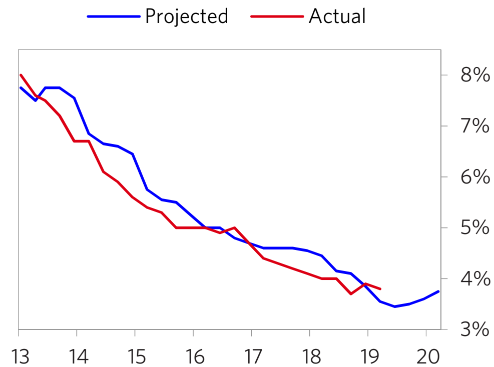




The Fed got growth about right...

...but slightly and persistently missed on inflation...

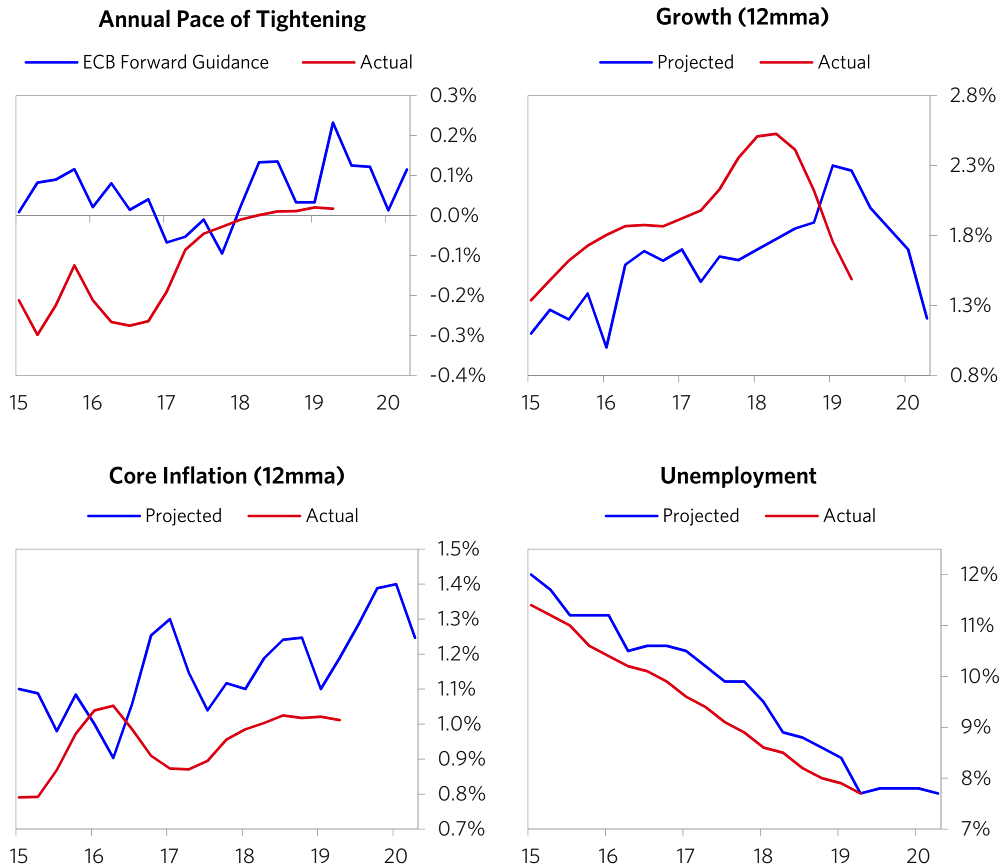




...and underestimated employment gains

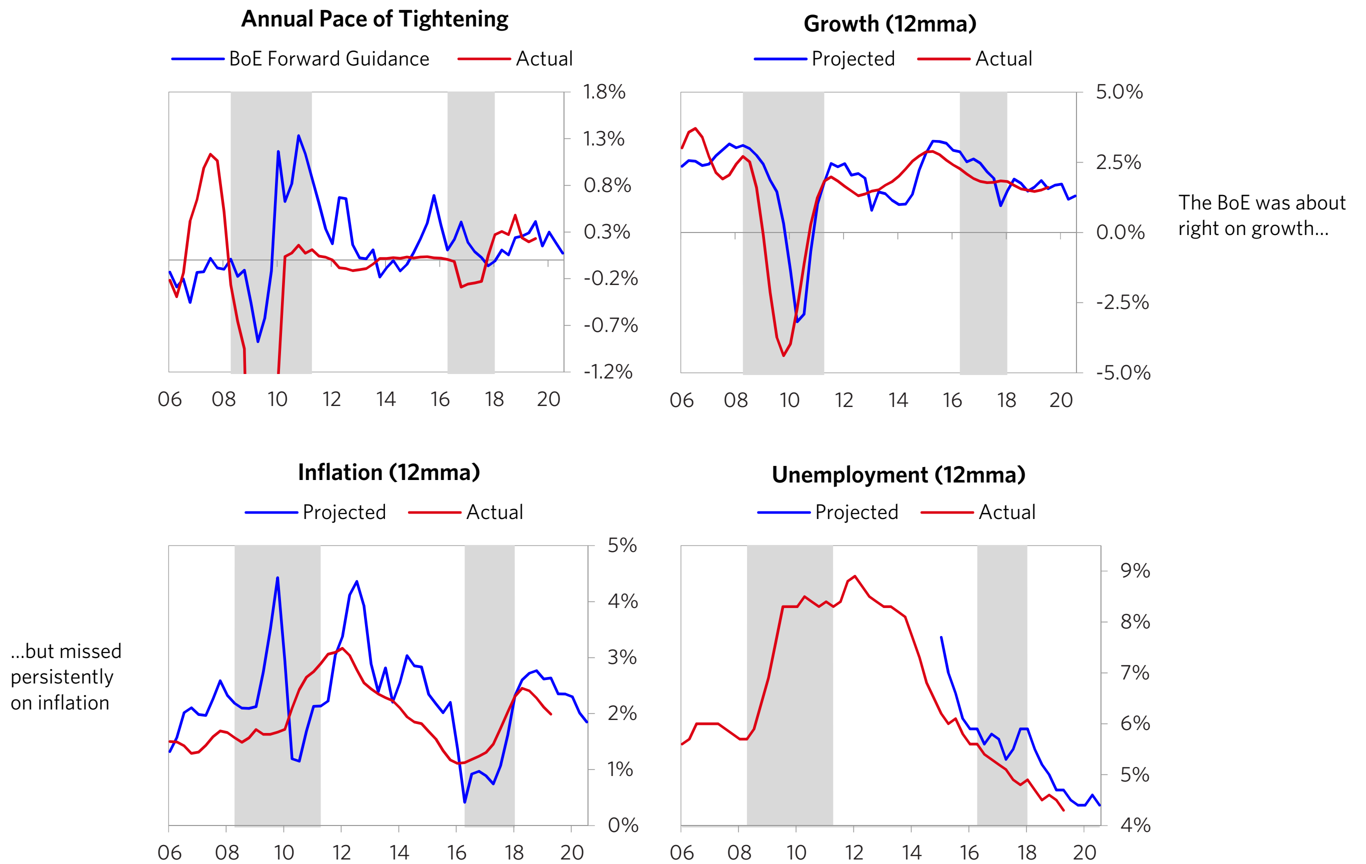
European Central Bank (2014-2019)

The ECB was around 20bps easier than projected on average, despite significantly stronger growth than they expected. They seem to have prioritized the weaker-than-expected inflation, which was also well below target. While no miss was that large, over the course of the last five years it has become obvious that extremely easy monetary policy may not be enough to lift inflation above the 1% that Euroland has generated in recent years. If inflation had come in as the ECB has projected since 2015, price levels would be 0.8% higher than they are today, a significant difference in accumulated inflation from target. That, combined with pockets of depressed economies, has ultimately led the ECB to remain easier than they thought they would be. At this point, the ECB is doing more than just guidance. They have said that rates will not be raised until at least the end of 2019 as part of their suite of easing actions, which also includes the TLTRO program. In other words, this signaling is less a guess at what they will do and more an integral part of their policy.



Bank of England (2010-2019)

The Bank of England has been providing economic and rate projections longer than other major central banks, with its earliest projections preceding the financial crisis. In order to make these projections like for like, we excluded the systemic financial shock of 2008 and the one-off, Brexit-motivated easing when evaluating the BoE's forward guidance, so we've calculated its hit rate excluding these periods. The BoE looks a bit better at predicting conditions than the other central banks, and its misses in predicting rates have been smaller. Still, even here forward guidance doesn't look that helpful in predicting their behavior.



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