Central Banks’ Failure to Communicate Boosts Bond Yields

By Simon Kennedy and Rich Miller - Jun 17, 2013

What central banks may have the world over is a failure to communicate.

Officials are struggling to spell out their visions for monetary policy, often amid a chorus of competing views. Chairman Ben S. Bernanke is trying to manage expectations about when the Federal Reserve will slow asset purchases and raise interest rates. Bank of Japan Governor Haruhiko Kuroda’s reflation-push is backfiring by driving up bond yields. European Central Bank President Mario Draghi is dashing investors’ hopes he once kindled for extra stimulus.

The muddied messaging already is roiling financial markets, threatening to undermine the confidence of investors, households and consumers and so undoing efforts by central banks to strengthen their economies. The opacity puts policymakers under pressure to improve the communication techniques they’ve been using to restrain borrowing costs.

“The purpose of central-bank transparency was to give markets clarity and reduce volatility,” said Ed Yardeni, president and chief investment strategist at Yardeni Research Inc. in New York. “Instead it’s increasing volatility and been counterproductive. Clearly the back-up in bond yields and sell-off are disconcerting.”

Bernanke will get a chance to clarify the U.S. central bank’s stance on June 19 when he holds a press conference after the policy-setting Federal Open Market Committee completes a two-day meeting. Rather than focusing on when the Fed will start reducing its bond buying, Bernanke probably will stress the how and why of such a step, said Michael Feroli, chief U.S. economist for JPMorgan Chase & Co. in New York.

Not Tightening

Bernanke will “want to emphasize that a tapering of asset purchases is not a tightening of policy and isn’t necessarily irreversible,” said Feroli, a former researcher with the Fed board in Washington.

Bond prices have slumped since Bernanke told Congress’s Joint Economic Committee on May 22 the Fed could scale back stimulus efforts “in the next few meetings” if the employment outlook shows “sustainable” improvement. He stressed that any decision would depend on what the economic data showed and that a move to reduce the pace of purchases would be delayed if recovery falters and inflation falls further.

His remarks came in response to a question from Representative Kevin Brady, a Texas Republican and chairman of the committee.

Bond Vigilante

The dumping of debt is reminiscent of the waves of selling that took place in the 1980s, only back then investors were worried about fiscal, not monetary, policy. Yardeni coined the phrase “bond vigilante” to describe the financial institutions involved.

The yield on the 10-year Treasury note was 1.93 percent the day before the committee hearing and went on to trade at a 14-month high of 2.29 percent last week. The yield was 2.12 percent at 11:40 a.m. in London today.

The sell-off in Treasuries has triggered convulsions in capital markets elsewhere, with the more than $40 trillion of bonds in the Bank of America Merrill Lynch Global Broad Market Index falling an average of 1.1 percent since May 21 as of June 13.

“Central banks have given a sense of near total control, driving volatility and bond yields to historic lows and compressing risk premia,” said Michala Marcussen, global head of economics at Societe Generale SA in London. As the “countdown” to the end of the Fed’s quantitative-easing program advances, “volatility and higher bond yields are making a return.” She predicts the 10-year Treasury yield will rise to 5 percent by 2017.

‘Very Worried’
Alan Blinder, Fed vice chairman from 1994 to 1996, said he’s “very worried” financial markets will overreact to steps by the Fed to reduce and eventually exit from its efforts to support the economy.

“I’m afraid it’s going to be worse than 1994,” when 10-year yields jumped almost 2.5 percentage points as the Fed tightened credit, said the Princeton University professor. And capital losses will be larger because the starting point for yields is lower, he added.

Policy makers are aware of the potential pitfalls. The Fed will need to “think carefully about what combination of actions and communications” it should take to head off a market overshoot once it begins “normalizing policy,” Federal Reserve Bank of New York President William C. Dudley said on May 21.

Bernanke may be “trying to help the market build up immunity” to future Fed actions with his suggestion that the central bank could cut back on its bond buying, said Lou Crandall, chief economist at Wrightson ICAP LLC in Jersey City, New Jersey. “This is a little verbal vaccination.”

**Reverse Move**

Treasury yields will “probably even reverse some of the recent upward move” if Bernanke succeeds in getting investors to buy into the Fed’s complicated message, said Roberto Perli, a partner at Cornerstone Macro LP in Washington and a former researcher at the central bank’s Division of Monetary Affairs. The Fed has a history of making markets understand its intentions, reducing fears of a sharp policy tightening in 2004 and introducing a time frame for a rate increase in August 2011, he said.

That message has three parts, according to Perli. While the Fed probably will scale back asset purchases in the next few months, it won’t do so unless it is increasingly confident in the economic outlook. It is prepared to stop tapering, or even reverse it, if growth falters. And a slowdown in quantitative easing doesn’t mean the Fed is accelerating its plan for its first interest-rate increase since 2006.

**Near Zero**

Policy makers have held the target for their benchmark rate near zero since December 2008. They’ve promised to keep it around there as long as unemployment remains above 6.5 percent and the outlook for inflation doesn’t exceed 2.5 percent. Joblessness was 7.6 percent in May, while inflation, as measured by the personal-consumption-expenditure price index, was 0.7 percent in April.

Investors also have been confused by a “mixed message” from Fed policy makers, said Marvin Goodfriend, a professor at Carnegie Mellon University’s Tepper School of Business in Pittsburgh and a former central-bank official. “They’re divided, so the market is divided and therefore you’re getting more volatility.”

James Bullard, president of the Federal Reserve Bank of St. Louis, said on June 10 that the low level of inflation may warrant prolonging the “aggressive” use of bond buying to spur growth. Just five days earlier, Dallas Fed President Richard Fisher said the central bank should already have begun to cut back on its purchases of mortgage-backed securities, adding that he wasn’t concerned about deflation.

**Surging Yields**

In Japan, Kuroda also has faced a surge in 10-year government-bond yields to 0.815 percent on June 14, even as the Bank of Japan boosted its bond-buying to defeat 15 years of deflation. The yen also has climbed to the highest against the dollar in two months, having touched its weakest level since 2008 in May after Kuroda began easing.

Such gains conflict with Kuroda’s efforts to juice borrowing and spending by lifting inflation expectations and wages. He said May 22 that higher yields could be expected as the economy improved, after saying previously that the central bank aimed to lower market interest rates.

“Kuroda needs to be consistent with what he says,” said Masaaki Kanno, a former BOJ official and now chief Japan economist at JPMorgan Chase in Tokyo. “The market expectations were for a more market-friendly BOJ.”
The central bank last week refrained from tackling bond-market volatility, and Yoshiki Shinke, chief economist at Dai-ichi Life Research Institute in Tokyo, says investors may have looked for too much from the BOJ.

"It’s a typical pattern that investors and traders expect a central bank to implement policy measures to support markets, and their expectations are betrayed by monetary authorities," he said. "Investors were prompted to anticipate more easing measures, but the central bank unveiled nothing."

Policy makers should explain that bond yields probably will rise as inflation expectations take hold and that its purchases are designed to hold down real interest rates, said Goodfriend, who just returned from attending a BOJ conference in Tokyo.

The officials may be tuning in. “The bank should make greater efforts to promote an understanding among the public and market participants of its monetary strategy and pursue more effective communication strategies,” BOJ board member Sayuri Shirai said June 13.

‘Some Self-Correction’

At the ECB, Draghi is undertaking what Deutsche Bank AG economist Gilles Moec calls “some self-correction” in its perceived stance after remarks Draghi made on May 2 triggered an increase in stimulus bets. The central bank cut its benchmark rate to a record low of 0.5 percent, and Draghi said officials had an “open mind” about reducing the so-called deposit rate below zero.

Draghi then played down these measures on June 6, helping to push the euro to its highest against the dollar since February and yields on Spanish and Italian 10-year bonds to their highest since April.

“Communications have been a bit hard to follow lately," said Moec, co-chief European economist in London and a former Bank of France official. Investors need to “average out” Draghi’s last two press conferences to divine the ECB’s true stance, he said.

The change in tone reflects “complete disagreement” within the ECB’s 23-member Governing Council, forcing Draghi to find a consensus after actively pushing stimulus, said Marc Ostwald, a strategist at Monument Securities Ltd. in London.

Not Realistic

Hours after Draghi said in May the ECB was technically prepared for a negative deposit rate, Governing Council member Ewald Nowotny told CNBC that such a move “shouldn’t be seen as something that’s realistic in the foreseeable future.” Colleague Christian Noyer said in a May 28 interview he also doubts the merits of such a policy.

The clarifications may not be over. Laurence Boone, chief European economist at Bank of America Merrill Lynch, says ECB officials still will want to correct market interest rates to ensure they remain low.

Draghi rejects talk of splits as a “dramatization” and said the diversity shows a debate is under way with few conclusions made.

“You have different views in all central banks, and in a period of such uncertainty you obviously have a variety of opinions,” he said on June 6. “That is actually very good.”

Investor Insight

The communications challenges represent a speed bump after a period in which transparency has been hailed as key for policy. The more insight investors are given into the minds of officials, the theory goes, the more they’ll be able to interpret correctly a central bank’s plans and reinforce them in the market.

At the Fed, for example, Bernanke has begun regular press briefings, adopted an inflation goal and released the expectations of officials for the appropriate path of policy rates.

The dilemma now is that officials are in what Sylvester Eijffinger, a professor of financial economics at Tilburg University in the Netherlands, likens to what old maps would call “terra incognita” -- the Latin for “unknown land.”
In the case of the Fed, while good communications are vital for controlling markets, they’re complicated by the officials themselves not knowing when to exit, disagreeing over the right timing to do so and political pressure to hold back.

“Those factors make it very hard for the central bank to communicate,” said Eijffinger, who advises the European Parliament on monetary policy. If the Fed isn’t able to “control the process” to recovery and manage inflation and interest-rate expectations, then the U.S. could “be confronted with a kind of abrupt slowdown of growth” two or three years from now.

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