

Are central banks losing their magic touch?

When markets worry about central banks, they are really fretting about two distinct things. On the one hand, there is the real economy. On the other hand, and usually of much more immediate interest is the question of how central-bank moves will impact financial markets.

For much of the period since equity markets bottomed out in 2009, those two questions have been intertwined. Not so long ago, the prices of risky assets, such as equities, seemed like a one-way bet. Bad economic news, such as lackluster U.S. job creation, led markets to expect further monetary stimulus and boosted financial assets. Meanwhile, good economic news also boosted prices of risky assets. Solid job figures, for example, suggested that the economy was healing nicely, but, given the depth of the slump, financial markets rightly expected it would still take a long time for interest rates to return to more normal levels.

This cozy era came to a close in 2015, and probably ended for good with the first U.S. Federal Reserve Board (Fed) interest-rate hike last December. Major equity markets began this new age with their worst start of the year since the 1930s, amidst growing concerns that central banks have lost their magic touch. In recent months, financial markets have increasingly seen central banks less as saviors and more as part of the problem.

What next? Of course, the range of the federal funds rate at 0.25 to 0.50% remains extraordinarily low by historic standards. What has changed, however, is the balance of risk from a market perspective. Strong U.S. economic figures are now a mixed blessing, while weak figures really are bad news. The pain caused by weakness in U.S. manufacturing, for example, is tangible enough, but the potential gain from more Fed action for now looks distant.

The stakes are particularly high for the European Central Bank (ECB) and the Bank of Japan (BOJ), amidst growing concerns that they are running out of options.

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