Treasury Trends

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Bracing for increased volatility from US monetary policy: What it means for NZ and Australian businesses

Key Points

- New US Federal (Reserve) Open Market Committee Chair Kevin Warsh is altering the last two decades of monetary policy 'forward guidance' to financial markets
- Financial market pricing to become more influenced by economic data, rather than responding to what the US Federal Reserve says
- Financial market participants more likely to be 'surprised' at any given meeting, where the Fed has reached a different conclusion to the markets; increased financial market volatility between and after Fed meetings
- US interest rate markets more volatile in reaction to unexpected Fed decisions and evolving economic data. Changes to US interest rates the dominant influence over USD value and that in turn is the dominant influence over AUD/USD and NZD/USD exchange rates
- Fortunately for many NZ and Australian entities, frameworks are already in place with policies, instruments and delegated authorities to forward manage and mitigate the impact of these financial market movements on their financial performance.

Brief reminder of 'non-standard' monetary policy tools

Many origins of 'modern day' central banking, implemented through the 2010s and 2020s, stem back to former US Federal Open Market Committee (FOMC) Chair Ben Bernanke.

In a 2002 piece titled "*Deflation: Making Sure It Doesn't Happen Here*" Dr Bernanke professed in times of persistently 'low' inflation, a central bank would not be limited by a 'Zero Lower Bound' in the short-term policy interest rate.

Bernanke offered additional monetary policy tools to loosen policy when short-term interest rates were already zero, including:-

1. Quantitative Easing ("QE") purchases of long-term government debt and other securities, to push long-term interest rates lower.
2. Forward guidance including a 'commitment' to maintain short term interest rates lower for longer, to also push down interest rates across the yield curve.

These policy prescriptions were widely implemented by the Federal Reserve and other central banks during the Global Financial Crisis in 2008/9.

When the Covid-19 crisis unfolded, QE, forward guidance and other non-standard monetary policy tools were again used extensively by the US Federal Reserve and other central banks.

New Fed Chair Kevin Warsh – not such a fan of these tools

Current FOMC Chair Kevin Warsh served on the FOMC from February 2006 to April 2011, resigning in opposition to the second round of US quantitative easing in November 2010. Accordingly, the financial markets expected the merits of QE to be 're-appraised' in the Warsh era as Fed Chair.

Perhaps less anticipated is the apparent strong aversion of Warsh to 'forward guidance'. Forward guidance has been seen as assisting the financial markets to anticipate future Fed monetary policy actions, in providing market participants a clear framework around the factors impacting those decisions.

This removal of forward guidance is essentially happening under Warsh's Chairmanship. Warsh is preferring to take the raw signals from the financial markets who are weighing up the economic data themselves. The behaviour of the markets being an input to the Fed's monetary policy decisions. Rather than the Fed guiding the financial markets around their expectations and for the markets to respond accordingly, the Fed's preference is to receive an unfiltered message including adjustments in financial conditions directly from the markets, potentially as input to their own decision making.

Warsh's approach has been met with much surprise and concern, to which Warsh's retort is markets need to adapt to the altered framework.

Potential impact on increased financial market volatility

Despite reduced forward guidance, it seems unlikely the Fed will always 'endorse' financial market pricing should it differ from their own assessment. However, rather than trying to re-shape market expectations ahead of each meeting, the Fed may instead be more open to 'surprise' the market on meeting day, in deciding a different outcome to market pricing.

A potential side effect of the Fed's altered approach, whereby financial market participants independently interpret evolving economic data, is increased financial market volatility. Surprisingly 'weak' or surprisingly 'strong' data in the periods between meetings may see a larger shift in market expectations and pricing for Fed monetary policy, than typically seen over the last 15+ years.

Increased volatility between meetings may be in addition to increased volatility immediately post meeting. As without Fed guidance, it's possible that market participants who have misread the outlook, are 'corrected' by Fed statements or actions differing to previous market pricing.

Risk management implications

Fortunately for many New Zealand and Australian entities, there are instruments, policies and strategies enabling forward management of foreign exchange and interest rate market volatility and related impacts.

A review of an organisation's specific financial market risks, understanding the materiality of movements in these and the sensitivity impact on financial performance are all inputs informing the design of a treasury risk management policy.

Policy design also typically includes the allowable treasury risk management instruments such as swaps, forward exchange contracts, purchased options and collar options the entity may use. In addition, policy risk control limits determine the minimum and maximum amounts/percentages that can be hedged, the forward time frame for hedging and the delegated authorities/personnel who can transact hedges.

Combined with the entity's risk philosophy and informed analyses of future financial market scenarios, these all help determine the strategy and risk management actions undertaken.

The potential for increased market volatility may sharpen the focus of entities on the management of their own risks. While not a new phenomenon, heightened potential for unanticipated events impacting volatility may provide added incentive to proactively implement risk management strategies when opportunities are provided; least these be subsequently removed at short notice without sufficient management actions undertaken. With potentially more volatility and risks being presented, organisations might be a little more active in managing those risks.

Implications

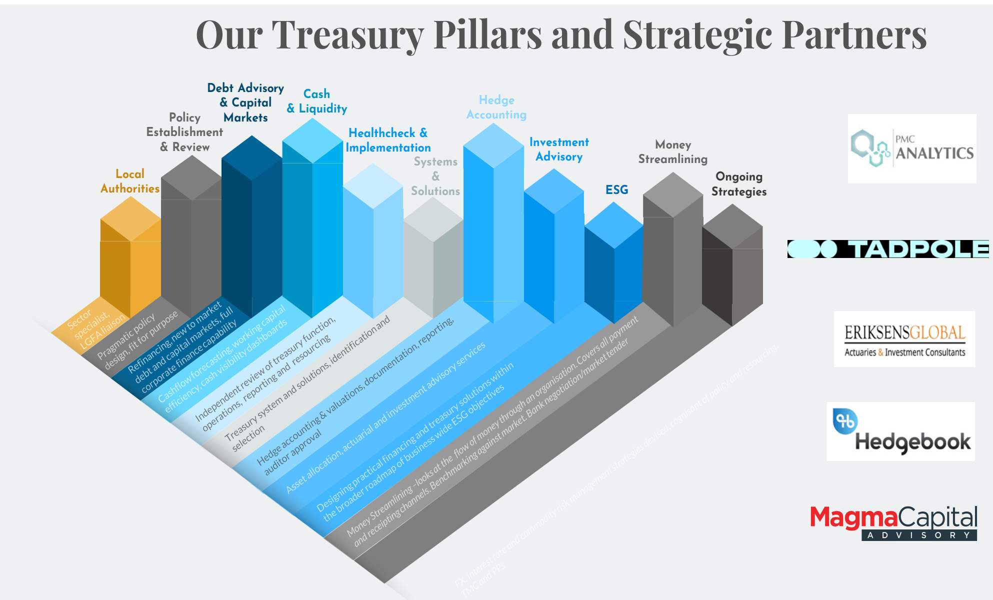
The full modus operandi of the new Warsh Fed has yet to be determined, with potentially a few months of limbo until five task forces set up by Warsh report back. On the evidence to date, there is a premise of changes coming – indeed some already appear underway.

US interest rate markets are expected to be more volatile as they react to unexpected Fed decisions and the evolving economic data. Changes to US interest rates is the dominant influence over the USD value and that in turn is the dominant influence over the AUD/USD and NZD/USD exchange rates.

The current, interim, period may be providing an opportunity for businesses to ensure the foundations are in place to deal with increased volatility and that forward management strategies are implemented – noting the ongoing nature of these strategies rather than a one-time 'set and forget' approach.

Please contact us as below if you would like to discuss policy implications or strategy considerations ahead of any potential changes to market behaviour.

WHAT WE DO



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