

Bad news is good. Bad news is bad. Which one holds is arbitrary.

In recent times equity and credit markets have reacted to bad news with optimism, reasoning that weaker economic data would encourage the central banks to cut rates which would in turn boost the economy and support higher asset valuations. This is a perverse logic but one that supports trillions of dollars in investments. This year, the US Federal Reserve, the ECB, and the Peoples Bank of China have accommodated investors' calls for easier monetary policy. Economic data have indicated a general weakening of growth, so providing justification for the central banks' acquiescence. This is the bad news is good news scenario, and it relies on investor acceptance of the logic above.

An equally valid argument is that slowing economic growth would impact companies' earnings growth leading to weaker equity and credit markets. The market has not followed this script. It may do so in future. This is the bad news is bad news scenario. Both the bad news is good and the bad news is bad scenarios are valid. Why would investors accept one and not the other is fairly arbitrary and depends a lot on sentiment.

The switch can be triggered by a catalyst or it can happen for no reason at all. One potential catalyst is higher interest rates. Given that central banks are in full accommodation mode, this is unlikely. Longer term rates may start to climb if fiscal support is accelerated which would lead to steepening term structures unless QE bond buying is restarted in earnest. This would leave central bank balance sheets permanently inflated with rates close to or below zero, and the economy decelerating.

Then we shall see how bad the news can be to make it good.