IMPERIUM CAPITAL

momentum

Flash Report

21 June 2013

What does the Fed's QE tapering mean for markets?

The meeting of the Federal Reserve that took place this week will be seen to be critical in the evolution of the current market cycle: it pointed to the beginning of the end of ultra loose monetary policy in the US. Bernanke indicated that if the economy continues to make steady progress, unemployment declines further and inflation remains subdued, the Fed will begin to moderate its monthly rate of asset purchases later this year and end its purchases around the middle of 2014. The market has taken this to mean that asset purchases will begin to taper in September and the programme will end in June 2014. Investors have taken fright and markets have fallen significantly across the World, with bond yields rising sharply and those assets that have become heavily dependent on excess liquidity, such as gold and emerging markets, falling especially rapidly.

Following the Fed's more hawkish stance than anticipated we can now say with more confidence that the 32-year bull market in bonds is over. The move down in yields on 10 year US Treasuries to around 1.5% in the past year has clearly been driven by Fed action rather than economic fundamentals or valuations. We now face the prospect of a withdrawal of liquidity and the strong likelihood that short term interest rates will rise within investors' short to medium term time horizon, i.e. over the next two years(whereas since 2008 the prospect of rate hikes has been very distant). This must mean that interest rates on bonds will rise further, particularly during the period of uncertainty in coming months until the market knows the exact timing and scale of the Fed's tapering.

It also means greater volatility in markets as the Fed's tapering actions are short-term data dependent. The better the news is on the economy, the more likely it is that bond markets will fall and the more pressure will be put on risk assets. Under these circumstances the most interest rate sensitive asset classes will be hardest hit, as well as those assets which have become dependent on excess liquidity. Emerging market bonds and currencies have already sold off but further falls seem likely, especially in light of the negative news flow from key emerging market economies. Precious metals and commodities are also likely to remain under pressure as the cost of carry increases.

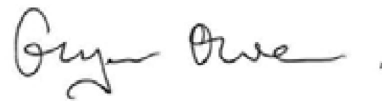
However, it is important to remember that the news that would cause the Fed to rein in ultra loose policy, namely stronger economic growth, will ultimately be good for corporate profits and equity markets. Furthermore, there is something of a backstop for equity markets in that if growth disappoints the Fed will reaccelerate asset purchases. The Fed's policy is not predetermined: tapering will not be an automatic process but will depend on economic data and the evolution of the outlook. The Fed also stressed that its policy action is akin to easing the foot off the accelerator rather than braking. It is slowing the pace of asset purchases and will not be shrinking its portfolio, and it emphasised that the tapering of QE will not have an impact on the Fed Funds rate: it continues to expect short-term interest rates to remain at current levels (i.e. effectively zero) until 2015 and any increases thereafter will be gradual. We therefore see the falls in equity markets, especially in developed markets, as a buying opportunity whereas bond markets are vulnerable to further weakness. Ten-year US Treasury yields were 4% in 2010 and could easily go back there within the next couple of years.

In our portfolios we have for some time seen no value in safe haven government bonds and have no meaningful exposure. Our fixed income exposure in multi-asset portfolios has been almost entirely in corporate debt and we have avoided particularly expensive areas such as emerging market debt, which has been fuelled primarily by liquidity flows. We have also

been anticipating an end to QE and earlier this year shortened the duration of our fixed income portfolios considerably (for example, by buying floating rate securities such as loans) so we are well protected from the interest rate rises we are now seeing in bond markets. In equities we have taken profits in the past three months following sharp rises in markets since mid 2012 and are holding higher than usual levels of cash.

We are now taking action to reduce further the duration of our bond holdings by selling high grade corporate debt, where spreads have already narrowed substantially and future performance will be heavily dependent on moves in government bond yields. We anticipate using our currently high cash levels to add to equity positions during this period of weakness, focusing most likely on developed markets. We do not envisage the favourable environment for the corporate sector changing for the foreseeable future while valuations are returning to attractive levels as markets fall.

Glyn Owen



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