Market Impact of Increasing discussions around Fed Withdrawal

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At a recent conference I gave a short presentation that described how we saw the US economy enjoying a “First in (to recession) and First out” position amongst world economies.

The key observations are as follows:

1. The US dealt with the credit crunch using a heavy hand which may have been beneficial in the long run. The US is cyclically ahead of the rest of the world and investors long US assets un-hedged are enjoying this restructuring dividend.
2. Every chance the US growth haven trade gets overheated – same as 1998 and removing QE punchbowl is going to require a deft hand. (to avoid a repeat of 2000).
3. Fiscal Capacity in Asia, UK, US has benefitted the US. Now, these pump priming measures have dried up- leading to unconventional CB policies.

US housing, the primary economic driver, is recovering at a healthy pace. But the billion dollar question is to what extent QE has inflated financial assets, and how far apart their pricing is away from fair value / economic reality. Excess leverage, we believe, is sure sign of overheating, so just the spectre of higher interest rates will cause leveraged assets to fall in price. The below chart illustrates that NYSE leverage is at a post 2008 peak in line with the Russell 2000 making a new high. Higher interest rates are the threat here.

Source: Bloomberg: White- NYSE Member Balances $Bn Yellow- Russell 2000 index

The Fed has pre-signalled the key economic variable that drives policy- the 6.5 % unemployment rate. A quick look at the chart below tells us they are on a collision course with actually meeting that objective.

Source: Bloomberg White- US Unemployment rate total in labour force SA %, Yellow - US continuing jobless claims

As the chart clearly illustrates, the jobs picture has steadily improved since 2009.

Much of the latest market movements have been blamed on Fed discussions regarding “tapering” QE. This volatility is to be expected- as this process could turn out to be the key market driver for the next several years.

The Fed are in an enviable position on one hand to even contemplate ending QE. But on the other hand, and this is the point, a policy error will have enormous ramifications – quite possibly another 2008.

The Fed is in fact walking the tightrope across the global markets and economies. So the importance of point 2 above becomes apparent. The US markets, namely Credit and Equities, are arguably well ahead of themselves, making the impact of a mismanaged exit even more perilous.

We have all learnt globalization is a double-edged sword.

A complicating factor for all investors amidst this upbeat story is the economic malaise in Asia and Europe that requires further fiscal and monetary easing. China is still clearly managing the slowdown, and Europe has woken up to the fact austerity isn’t working. We have discussed Japan in a previous note, and those policies add to the macro complication.

A significant mitigating factor is low US and Australian inflation rates. This should temper the markets enthusiasm to push bond rates too far. The next chart shows US and Australian CPI inflation rates YOY. The upshot of the recent 50 bp selloff in US bonds and the rise in local Bond yields and spreads is that real yields have risen which is great news for well positioned investors.

Source: Bloomberg: White- US CPI Urban Consumers YOY, Yellow- Australia CPI all groups YOY

For Australian fixed income investors, and in particular our investors, a rise in rates is a welcome development that our investment process has prepared us for.

In Australia, the subsequent upward rise in rates and credit spreads would most likely be a buying opportunity. We see the local backdrop supportive for Fixed Income and Credit, and we have been positioned for this improvement in yields.

Source: Bloomberg White- Australian Investment Grade Credit Index – Itraxx, Green- Australian 10-year bond yield

As the chart above illustrates, both Bond and Credit spreads appear to have bottomed, so the starting point for better running yields was clear in the first place. The proviso is of course your fixed income investments are short dated and not exposed too highly to rises in long term interest rates should this move be larger or more sustained than expected.

It's hard to overstate the importance of this development and also nearly impossible to estimate the impact on world markets going forward. Thus, set and forget investments are not recommended. Unattractive yields and spreads have forced investors to take equity risk and/or use leverage. So, the impacts will soon be felt, depending on the magnitude and duration of this US centric rise in rates. What can be forecast is an increase in the market volatility of interest rates, equities, credit, and currencies.

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