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Oops I did it again

After preparing the markets for the eventual exit from easy monetary policy over the past 5+ months, the US Federal Reserve (the Fed) did an about face in October and decided against ‘tapering’ in the short-term. In deciding against the tapering plan he had so strongly hinted at over the prior months, Chairman Bernanke could have just sung Britney Spears ‘Oops!…I Did It Again’ to market participants. He played with their hearts, got lost in the game, he’s not that innocent.

But like the guy who escaped Britney’s love, it was also a good thing for financial markets. The easy flow of money now continues as equity markets approach new highs and bond yields return toward 5 month lows. And like Britney stepping out of the car door, financial markets look very exposed to the hard glare of further tapering talk volatility.

Creating additional near-term risks will again be the US political brinkmanship game, which looks set to return in early 2014. Expect to see the debt ceiling fight, default risk, and fiscal tightening prospects quickly reappear. As bond managers with a naturally pessimistic assessment of the rationality of many US policymakers, we foresee considerable gridlock risks and economic damage in the first quarter of 2014.

Not that there hasn’t been risk over the past 6 months! 10 year US Treasury yields almost doubled from a low of 1.60% in May to nearly 3% in September. With the postponement of tapering, 10 year treasury yields dropped 0.50%, back to around 2.50% before recently rising as a result of the stronger than expected October payrolls number.

Australian bond market volatility mirrored that of the US. However, government bond yields have steadily risen since the last rate cut by the Reserve Bank of Australia (RBA) – with yields on 10 year notes reaching 4.26%, up from their lows of 3.20% in May. This, despite a slowing domestic economy. The transition from mining investment to manufacturing/export sectors will take time and require an even lower AUD. The economy is still functioning at below trend in terms of jobs and sentiment. However, the housing market has improved, the labour market isn’t doing too poorly, and we’ve seen a boost in consumer and business confidence following the elections. While equity markets reached new record levels, we do not believe current levels reflect strong growth and earnings potential, but rather cost cutting and downward wage pressures which will put more pressure on the labour market and non-mining domestic growth. The downward pressure on wages has kept disposable income levels extremely low.

While the last RBA rate cut was delivered in August, we expect another 0.25% cut from the RBA if the A$ continues to stubbornly hover around the 0.94 mark. But given the steepness of the Australian yield curve and increasing implications for eventual rate hikes, we see a dis-connect between recent economic data and market rate forecasts.

Asia slowing

The remainder of Asia will also face growth challenges in 2014. The World Bank recently cut its 2013 growth forecast for developing Asia to 7.1% from 7.8% – led by China moderation. They also cut their high growth forecast for China, from 8.3% to 7.5%. It cut forecasts for Indonesia, Malaysia and Thailand, but raised forecast for Philippines to 7.0% in 2013 and 6.3% in 2014.

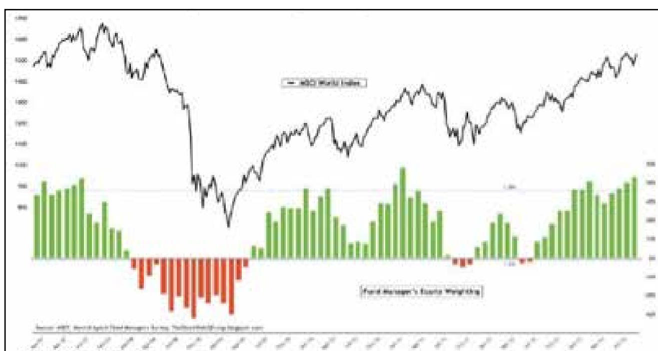
‘While the pace of growth is slowing, the region will still contribute 40% of global growth and one-third of global trade this year - higher than any other region in the

world. In China, growth is moderating as the country rebalances to pursue a more sustainable growth path. In 2013, it is expected to meet the official indicative growth target of 7.5%,' the World Bank said.

So what now?

In the short-run, financial markets will continue to be led by Fed tapering talk. Expect volatility. But with little prospects for tapering in 2013, risk markets should remain well supported. On the equity front, the US S&P is already up 24% YTD, approaching another new record. Most global equity markets are also in positive territory. With the postponement of tapering, investors will continue to flock toward risk assets and continue to overweight stocks at the expense of bonds – as seen in the below chart.

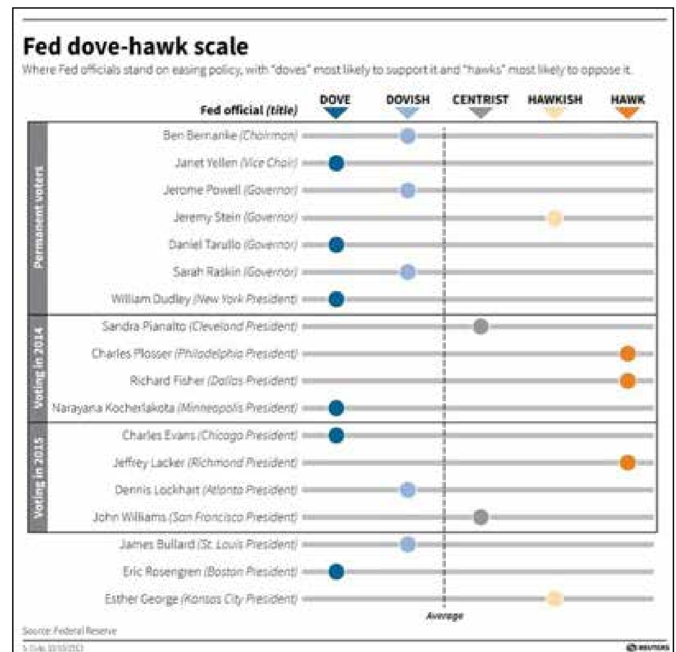
Global fund managers are extremely overweight stocks relative to bonds and commodities



Source: Short Side of Long

But the markets are awaiting further clarity – trying to understand the prospects for, and impact of, another US government shutdown and the resulting Fed policy response. We view the continuing risk-seeking trend as a blindness to future global risks. The Fed has always stated the beginning of the eventual tapering programme would be data dependent, and while we believe significant economic risks remain, we expect significant volatility. We still believe tapering prospects will come later rather than sooner, but risks remain in Fed surprise, having been stung by miscommunication. The Fed could unexpectedly act to repair its forward guidance.

However, immediate tapering risks remain small and the future voting composition will determine when the Fed will taper. It appears to us that the balance of power at the FOMC remains in the realm of the doves:



What else do we know?

- Much of the economic data between now and the end of the year will be discounted, particularly in the US, where data quality will remain suspect;
- Recent global economic data has generally disappointed;
- Notwithstanding the latest payroll number, employment growth in the US has generally slowed;
- The US Fed tapering is likely postponed until at least the end of the first quarter of 2014;
- Most global central banks will remain on hold – possibly lowering rates even further;
- Carry is King at least for now – risk assets should continue to do well in the near term.

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Portfolio implications

The only major change to our strategy has been the reduction of our cash holdings from 25% to 15%. Other allocations are unchanged. We still prefer assets in Australia/Asia – floating vs. fixed. We prefer exposures to financial sectors in Australia/U.S. (continue to avoid Europe). We continue to allocate to Asset backed securities in Australia.

We at Kapstream think the immediate future, next couple of months that market volatility will be subdued until Jan/Feb 2014 – before uncertainty starts to pick up!

In the longer run – returns in fixed income will become more difficult – expect higher volatility in all asset classes.

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