Taking the foot off the gas

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In May, the Federal Reserve signalled its intent to taper unconventional policy easing.

Advance Economist Andrew Dowie explores the reasons behind this decision and outlines what it means for investors.

The decision to recommence Quantitative Easing (QE3) in November 2012 was in response to mounting fears over the negative impact from an imminent fiscal tightening – the infamous fiscal cliff - which began with the 1 January payroll tax hike and then was set to intensify as the cut backs to the public purse known as the sequester gained momentum. The decision to launch QE3 without an expiry date was an indication as to just how concerned the US central bank was over the looming deflationary threat posed by the fiscal cliff.

QE is embraced by central banks to increase the money supply in order to fend off deflation and stimulate growth when the short term interest rate it controls cannot go any lower. However, other notable side effects are not just the associated decrease in bond yields / increase in bond prices but a subsequent "reach for yield" as investors are encouraged by the central bank into buying riskier assets in an environment of declining yields / returns.

Reaching for yield

Such a "reaching for yield" in the context of the American economy saw record tightening of both investment and sub-investment grade (junk) yield spreads and it was a mounting concern as to the potential danger posed by such bubble activity which led to this acknowledgement in the minutes to the 30 April – 1 May FOMC. At this meeting, concern was expressed that conditions in certain US financial assets were becoming too risky, pointing to the elevated issuance of bonds by lower-credit-quality firms or of bonds with fewer restrictions on collateral and payment terms (so called covenant-lite bonds).

One participant cautioned that the emergence of financial imbalances could prove difficult for regulators to identify and address, and that it would be appropriate to adjust monetary policy to help guard against risks to financial stability.

Such bubbles were also found internationally with the reach for yield leading to "risk-on" trades which saw emerging market currencies, bonds and equities sought most actively and which helped to propel the Australian dollar to parity plus against the US dollar.

Slowing the pace of easing

On 22 May, Federal Reserve Chairman Bernanke reiterated that the American economy remained hampered by both elevated unemployment and also government spending cuts and that reducing stimulus too abruptly could lead to a relapse of the economic recovery. However, Bernanke also added, "If we see continued improvement, and we have confidence that this is going to be sustained, in the next few meetings we could take a step down in our pace of purchases." Nonetheless the bond market decided that both the escalating risk posed by buoyant conditions in certain US and global financial assets and the associated risks to financial stability of the open ended nature of QE3 had ultimately coloured the central bank's thinking.

So, it seemed to the bond market that the Fed had essentially signalled its intent and the Fed's resolve was perhaps affirmed with the release of new economic projections revealed at the June FOMC.

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These adjustments to the economic outlook saw the unemployment rate now falling to between 6.5% and 6.8% in 2014 compared to between 6.7% and 7% in March. Furthermore, although the Federal Reserve sees inflation picking up somewhat in 2015, this will be to lower levels than envisaged as recently as the March FOMC.

Another discernible addition to the June FOMC statement was a note to the effect that "...downside risks to the outlook for the economy and the labour market have diminished since the fall ." However, along with this admission Chairman Bernanke stressed two additional factors. Firstly, that the gradual withdrawal or "tapering" of Quantitative Easing would not amount to a tightening of monetary policy, since it is essentially only a slowing in the pace of easing". Secondly, Bernanke emphasised that the opportunity to taper QE was conditional upon how well the economy was performing.

So, with the caveat that the economy does both improve as anticipated by the Federal Reserve and that the recent swoon in inflation proves to be a lingering after-effect of the GFC then what the Financial Times recently termed "the greatest experiment in the history of central banking" may be nearing its final chapter. Nonetheless, as the Federal Reserve chairman has repeatedly stressed – the bank is essentially poised on the balls of its feet – and as such is entirely flexible in its reaction. However, if part of the Fed's forward guidance initiative had been to stymie "...conditions in certain US financial markets (that) were becoming too buoyant" – then they definitely succeeded.

What does this mean for investors?

Undoubtedly, the immediate and on-going effect of the Federal Reserve's tapering intent has been for markets to differentiate investment themes on the basis of fundamental analysis rather than the QE induced risk-on risk-off type of behaviour seen previously. Indeed, the post 22 May environment has seen the US dollar strengthening on good news while risky assets are sold, the opposite of its earlier risk-on behaviour. This behavioural change is most visible in financial asset market volatility and in particular currencies such as the Australian dollar and the Brazilian real.

Furthermore, this new and evolving environment will not only be typified by increasing volatility and turbulence as economic and geo-political factors play themselves out but also with increased investor and consumer uncertainty. Indeed, how will emerging market policy makers react to increasing turbulence? Will they raise interest rates in order to counter both an inflationary threat and capital outflows – or will they reduce interest rates in order to stimulate growth and thus risk both elevated inflation and the likelihood of foreign investors repatriating their funds?

Finally, and with specific regards to the normalising of interest rates which is essentially the reason for the Federal Reserve's tapering resolve, it will take skilled and flexible investors to be able to discern where the evolving balance lies between risk and reward in a world of normalising interest rates.

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