

QE Tapering. A Significant Risk

The risk that faces the Fed today is that it will not be able to taper of its asset purchase program. All indicators point to a sustainable, albeit weak recovery. It is only reasonable that if this were true, the Fed would at some stage be well advised to reduce its balance sheet, if nothing else so that it would have the means to address the next crisis whenever that might be. By maintaining its current policy the Fed would have few other policy tools to deal with another recession or financial crisis. QE tapering is therefore a good thing and the markets appear to have come to that conclusion. Attention needs to turn now to economic fundamentals. A slowdown from here would not allow the Fed latitude to moderate its asset purchases. A climbdown by the Fed on QE tapering might come to be construed as a sign of weakness.

It is useful to consider the possibilities. A climb down from QE tapering would be negative for US risky assets if coupled with a slowdown in earnings growth, an re-emergence of financial crisis in Europe or a stronger deceleration in China. If markets are driven by both a slowdown and a postponement of QE, one would expect fixed income to rally or at least outperform. Duration would outperform and credit would underperform. Thus Treasuries would outperform investment grade, which would in turn outperform high yield. Floating rate senior loans would underperform. There would likely be a knock on effect to international and emerging markets equities and possibly their corporate bonds. The USD will generally be weakened, unless Europe or China were also sources of weakness in which case the USD might actually strengthen.

If QE tapering proceeds as planned in September, the impact on US risk assets is likely to be muted. The Fed has prepared the

market for this eventuality and its execution will have been priced in. Equities will likely continue to rise, and will outperform high yield, which in turn will outperform investment grade. Floating rate non agency MBS will outperform agency MBS. Credit will generally improve even as duration underperforms. The relative exposure to credit and duration in each debt instrument will drive their performance. What if the Fed tapers but earnings slow down? This is an unlikely combination but an interesting one. It would indicate an improving labour market and economy but not generally an improvement for corporate America. How could this combination arise? The US might exhibit this phenomenon if the world is adjusting towards a less globalized, more trade protectionist, more insular state. There are reasons why this might occur which we will not discuss here. However, this might result in an internal rebalancing of the US economy towards a less export driven, more domestically driven, self sufficient economy. The predominance of global companies in the stock market, coupled with weak emerging market and European economies might result in slowing earnings growth while domestic US output continues to improve. If this held true then the asset allocation will need to be more specific. In a sense this scenario might be the most difficult to navigate since both credit and duration would underperform together.