The US Consensus – Equities vs Bonds and QE Taper

There has emerged a clear consensus about the outlook for US asset markets. While I am with the consensus for now, it is good practice to have an eye on the alternative view. With the tapering of QE, it has become established wisdom that equities will outperform bonds. Of course, there are many types of bonds; there are government bonds, municipal bonds, investment grade corporate bonds and high yield bonds. Bank debt, or loans are another debt instrument to consider in the analysis. The consensus view is the following:

1. The US economy is sufficiently strong that QE can be moderated.
2. The positive prognosis for the US economy implies the same for US corporate financial performance.
3. The Fed has announced a moderation in its large scale asset purchases from 85 billion USD a month to 75 billion USD a month, the reduction to be split equally between its agency MBS and US treasury programs.
4. The reduction in Fed purchases of US treasuries will lift yields at the mid and long end of the USD term structure.
5. The impact on bonds with any significant duration follows from the above. The relative preference for equities over bonds also follows.

The above consensus relies on some assumptions and interpretations that deserve closer inspection.

1. The US economy may be sufficiently strong that QE can be moderated. On the other hand, the Fed might be slowing LSAPs for other reasons. It could, for example, regard the size of its balance sheet as a risk to price stability. The Fed has never run a balance sheet of this size before and any pick up in demand or the velocity of money could spark of a rise in nominal output that real output might not be able to keep pace with – inflation. The Fed might have realized that interbank unsecured lending has shrunk and that lending has moved to the secured market – the repo market, and that its LSAPs are

reducing the stock of available collateral for use in repo.

2. The US economy is growing, but its long term trend rate is no longer the 4% it experienced pre 2008, and closer to 2%. The market expects growth to average 3% in 2014, but this would be above the new trend rate. Corporate earnings growth and profit margins at the same time are at a cyclical high. In the last quarter US corporate earnings saw more downward revisions and the current quarter is likely to see further moderation of earnings growth expectations. This will make current valuations, which are not cheap, harder to sustain.
3. The Fed may have tapered its notional purchases but compared with a year ago, it is buying up an increasing proportion of new issue US treasuries. US treasury issuance is shrinking by about 18% YOY and Agency MBS issuance is shrinking by about 33% YOY. A 5 billion reduction in UST and MBS purchases amounts to a 12.5% reduction. It is not trivial nor a forgone conclusion that the 10 year UST yield is on a one way ride to 4%.
4. One of the important determinants of UST yields is inflation expectations. US inflation numbers are low. The headline number is 1.2%, down from 1.8% a year ago. Core inflation, which excludes volatile and transitory items such as food and energy are at 1.7%, down from 1.9% a year ago. Considering that shelter is a large item in the CPI, and US housing and mortgage rates are rising, we should expect to see much slower inflation in the larger cash flow items (that is ex owner equivalent rent, which is not a cash flow item.) CPI ex shelter has fallen from 1.4% a year ago, to 1.0% today. Again, a 4% 10 year UST yield is not a foregone conclusion.

I am with the consensus on this one. However, whenever we have a strong consensus, we should be mindful of the alternative view and be particularly watchful for the signs that the consensus is wrong. One of the obvious indicators is price action itself. That’s why traders have a cut loss policy. At the same time we will be watching corporate profitability and economic numbers seeking signs of weakness, while remaining overweight in equities and underweight in duration.