Taper Tantrum 2: The Fed and the Furious

Monetary support is being tapered despite significant risks. Pressure is building steadily and we think that recent resilience is going to be tested.

FOCUS ON THE FED

So far, the focus of monetary tightening has been on the US Federal Reserve (Fed). But despite a wobble in March as investors realised that the first hike of the year would be unexpectedly early, markets have been well behaved. Indeed, the funding conditions for dollar borrowers have been pretty stable even after the Fed's March hike. The trade-weighted dollar has gone sideways, equity volatility has been subdued and high yield corporate funding costs remain at very low levels.

Part of the explanation is that investors think the Fed will tighten policy very gradually. The US economy has not improved from its sluggish 2016 growth rate, and both prices and wages are failing to accelerate. So what's the rush? Futures markets are pricing in one or two more hikes this year and while the Fed may reduce the reinvestment of its stock of bonds towards the end of 2017, they are expected to do so cautiously.

ELSEWHERE, THE TIDES ARE TURNING TO TIGHTENING

While the Fed is exiting easy monetary policy on its own terms, the same cannot be said for other central banks. We think that investors should be worried about such forced tightening.

The European Central Bank (ECB) reduced its monthly bond purchases by €20bn in April, and even though President Mario Draghi insisted that such a move was not to be called tapering, the chances are that a 'true' taper will be announced in the next few months. This is not because quantitative easing (QE) has successfully accelerated prices – core inflation remains below 1% - but because the ECB will reach the limit of government bonds it can own. This limit can be changed, but to get agreement on such an extension would probably require another round of European stress. We have already seen some anxiety in peripheral government bond markets around the potential withdrawal of the biggest buyer, notably in Italy. We suspect there is more to come.

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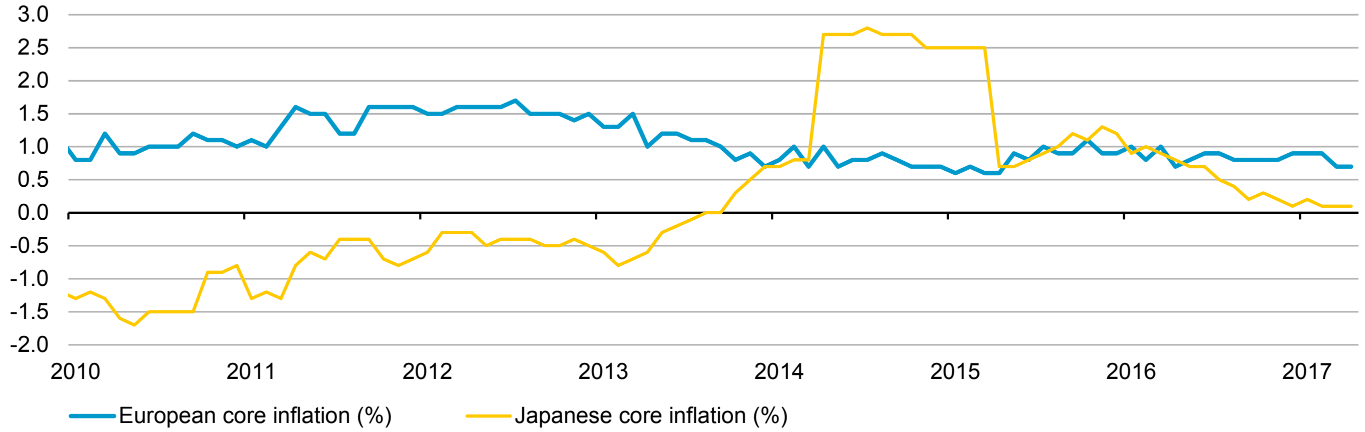
INVESTMENT MANAGEMENT

Figure 1: Inflation in Europe and Japan is still undershooting targets



Source: Bloomberg L.P.

Similarly, the Bank of Japan (BoJ) is reducing its bond purchases despite core inflation languishing around zero. The BoJ already owns over 40% of Japanese government debt, and could run out of willing sellers if it continues to buy them at the recent rate of 80 trillion Yen a year. This must have influenced its decision to switch from purchasing a set volume of debt to targeting a yield level for the 10-year government bond last September, hoping to get away with fewer purchases.

While small in comparison, the Bank of England (BoE) has now completed its gilt purchases programme, implemented following the Brexit vote, and its corporate bond buying programme is also drawing to a close.

Adding the ECB, BoJ and Fed's purchases, and making some conservative assumptions for how quickly the central banks will withdraw their support, leaves a clear downward trajectory for QE, as shown in Figure 2.

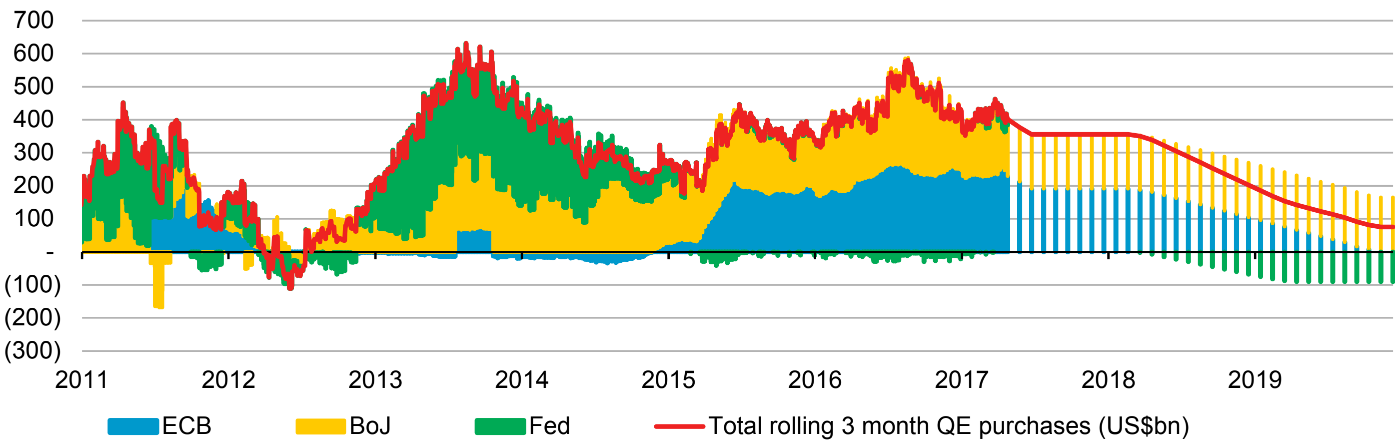
TAPER TANTRUM 2: THE FED AND THE FURIOUS

This year should see a modest reduction in global QE, but the fall could really accelerate in 2018. So when should we worry about the market impact?

Draghi's insistence that his QE cut is not a taper is probably because he fears a repeat of the 2013 US taper tantrum, when credit spreads spiked in anticipation of a reduction in the Fed's QE programme. This tantrum occurred in June 2013, a few months in advance of the expected tapering initiation in September. Indeed, the negative reaction was enough for Bernanke to delay tapering to the beginning of 2014. Again, we would expect markets to price in this global tapering well in advance of its actual occurrence, probably in the second half of 2017, but quite possibly sooner.

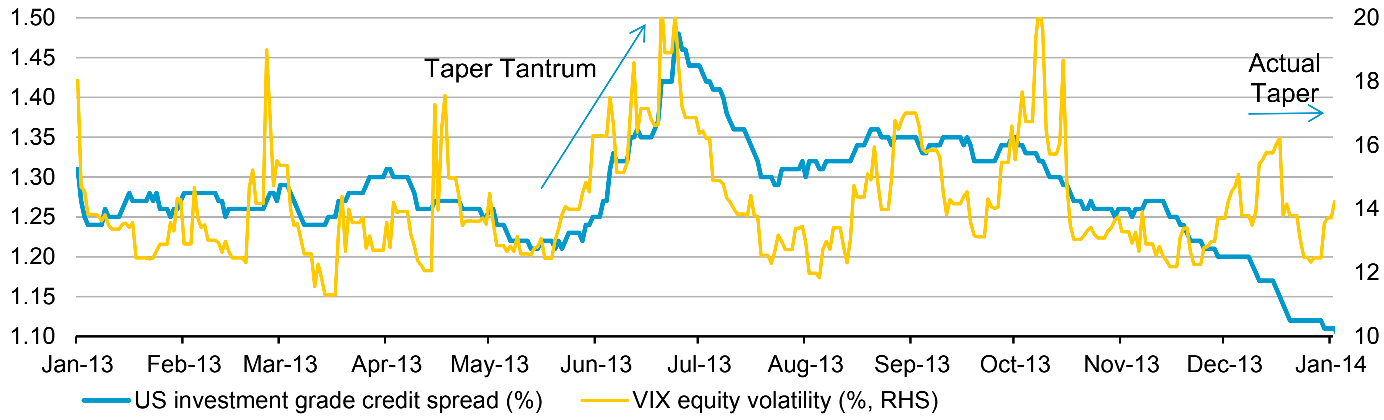
The 2013 taper tantrum involved higher government bond yields, but we suspect the reaction may be more complicated this time. Indeed, in the absence

Figure 2: QE support is being withdrawn



Source: Bloomberg L.P., LGIM assumptions

Figure 3: The tantrum was months before the taper



Source: Bloomberg L.P., Barclays Credit Indices

of accelerating growth and inflation, a withdrawal of stimulus could even lead to lower government bond yields, particularly in Japan and across core Europe. This would be exacerbated should credit and equity markets fall, leading to stronger demand for risk-free assets.

REFLATION REVIVAL?

Given this withdrawal of monetary policy support, the global reflation trade needs to quickly find its second wind. What would such a scenario entail?

In the US, Donald Trump would deliver tax cuts and deregulation, spurring business investment and stronger personal consumption from higher wages. In Europe, elections would produce pro-European candidates that solidify confidence across the periphery and embolden consumers in core countries. The de-globalisation trend would pause, with better trade boosting the Asian export powerhouses, while Chinese domestic growth would remain strong. This would all be good news for commodity prices, boosting Latin American countries.

While possible, at the start of the year we gave such a scenario just a 20% probability and we don't think the chances have improved much.

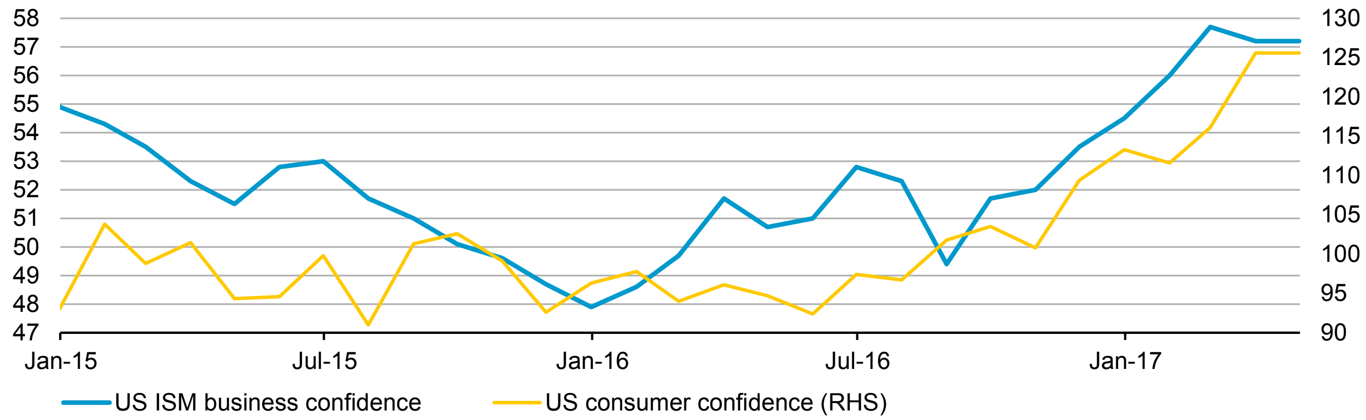
TOP TRUMP – CAUSE FOR OPTIMISM?

Business and consumer confidence has definitely surprised on the upside this year, but actual economic activity has lagged behind. At least part of this discrepancy is explained by the optimism of President Trump's supporters following his election victory compared to the reality of actually implementing policies.

Republicans have found it very difficult to repeal Obamacare, suggesting that full tax reform will also not be easy. More likely, we'll see just a modest tax cut towards the end of the year and even this should not be taken for granted. Markets have already reflected some disappointment in Trump's reflation agenda with treasury yields falling, commodities weakening and equity markets stalling. But markets have further to fall if they retrace the full post-election euphoria.

Trump's difficulty in passing domestic legislation means that businesses have not rushed out to invest. Notably, US business loan growth has hit a soft patch (although this may partly reflect commodity companies cutting their emergency borrowing).

Figure 4: Business and consumer confidence has soared following Trump's victory



Source: Bloomberg L.P.

AUTO SALES ARE RUNNING OUT OF GAS

While consumer spending continues to grow steadily, auto sales have fallen 10% since December. At the same time, the +$1trn auto loan market is gaining attention with rising delinquencies and defaults thanks to falling second hand car prices and the hangover from years of loose lending conditions. This is a toxic mix.

We suspect that rising commodity prices are at least partly to blame for such a reduction in discretionary spending. While the price of oil remains low compared to past years, it has increased substantially over the last twelve months, far more than average wage rises. So once consumers have paid more for their energy bills and filling up their cars, they have less to spend on other things.

Given low and still-falling unemployment, workers could be demanding higher wages to offset these higher prices. But because businesses are still struggling to accelerate revenue growth, we're not surprised that wage increases remain subdued.

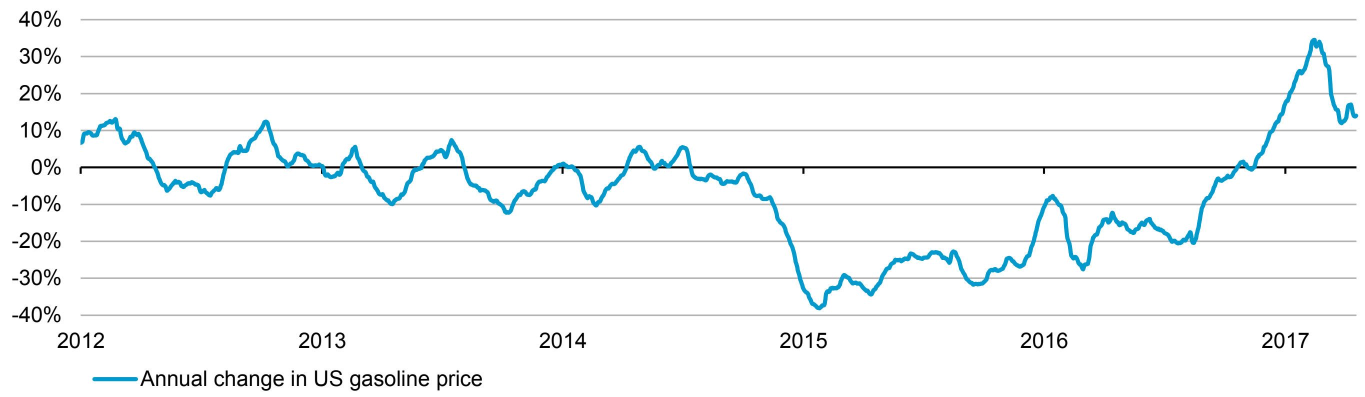
EUROPEAN UNCERTAINTY

Higher commodity prices are also having a negative impact on Europeans, but the impact is particularly hard in the UK where consumers have to spend more on imported goods due to the pound's post-referendum weakness. Brexit will continue to occupy the headlines in the coming months, given the upcoming general election. As separation negotiations finally get under way, we suspect this protracted period of uncertainty will weigh on UK business investment as well as heighten political tension in continental Europe, where their own election cycles are in full swing.

Focus is currently on the French Presidential election with Germany also due to vote later this year, followed by Italy before next spring. There may have been some postponement of business and consumer spending across all three countries which could take a further downturn in the event of a destabilising outcome.

A benign outcome could unleash pent-up demand, but we think the tapering of ECB purchases, and the implication for peripheral borrowing costs, particularly in Italy, provides a significant offset. Overall, we continue to believe that the euro is an unstable union without unconditional fiscal transfers, and that the next downturn or political crisis will pose make-or-break questions for the single currency.

Figure 5: US gasoline prices are up in 2017



Source: Bloomberg L.P.

CHINA AND COMMODITIES – ONES TO WATCH

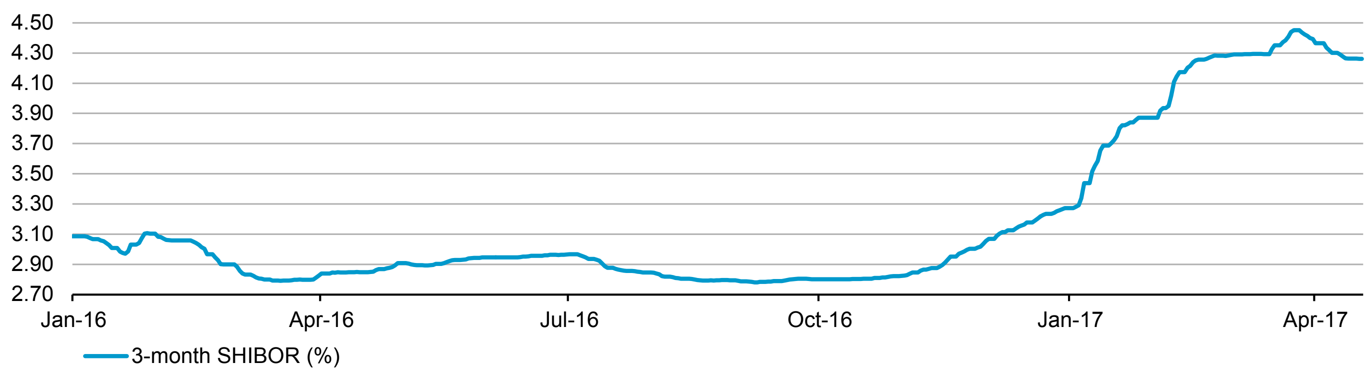
Regulators and central bankers have been trying to get to grips with the Chinese shadow banking sector for some time now, leading to sharp increases in interbank funding costs. Similarly, they have attempted to arrest the recent housing market surge, implementing various purchase restrictions across the country. So far, the impact appears to be minimal, but we'd expect them to persist in the coming months, risking a sharp slowdown at some point in 2017.

Even if policymakers manage to prevent a significant downturn, they will presumably try to avoid a reacceleration of growth, which could lead to even bigger problems in the future. This all argues against a sustained boost to global trade and commodities. With US dollar monetary policy also being gradually tightened, the outlook for emerging markets is mixed at best.

GEOPOLITICS – TENSIONS RISING IN THE EAST

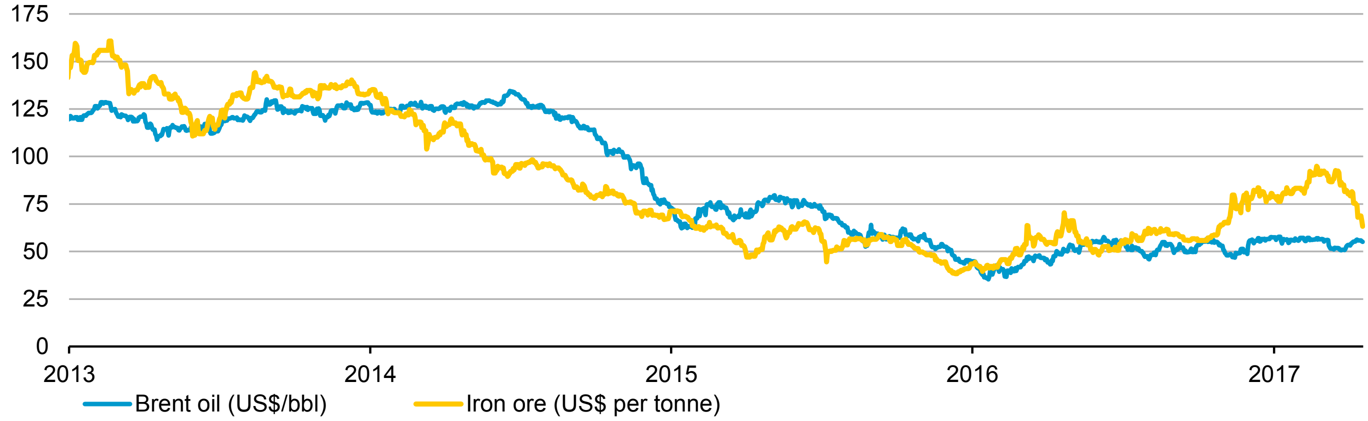
Finally, the new US President is facing a tense geopolitical environment, most notably concerning Syria and North Korea. Thwarted domestically, his willingness and ability to be aggressive with foreign policy has taken many people by surprise. Situations are of course fluid and hard to predict, but Trump's willingness to engage suggests that investors should be very sensitive to developments. In general, markets find it very difficult to factor in political risks, from domestic elections to geopolitical tension, given their binary outcomes. But in general we see very little cushion for significant tail risks.

Figure 6: Chinese interbank funding cost has increased



Source: Bloomberg L.P.

Figure 7: Commodity prices remain subdued



Source: Bloomberg L.P.

WHAT DOES THIS MEAN FOR PORTFOLIOS?

As was the case during 2016, markets are likely to be buffeted by numerous risks in the coming months. Unlike last year, major central banks are not in a position to unleash a wave of monetary support. Indeed, they are doing just the opposite. As a result, we believe that 2017 will end with wider credit spreads and lower government bond yields.

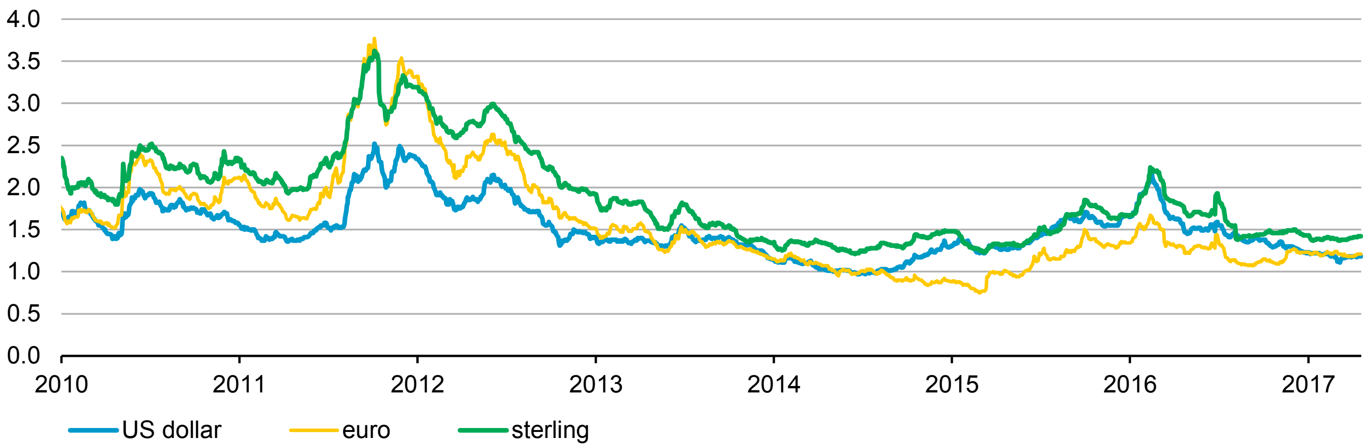
We don't know when markets will react to policy tightening, and geopolitical risk is always difficult to predict and to time accurately. But with valuations at such tight levels, running a structural underweight to credit is relatively inexpensive and allows us to take advantage of market weakness when it occurs. In terms of government bond markets, our bias remains to own duration, but here low yields are not in our favour, arguing for a more flexible approach.

We hold an underweight in European credit given political risks, with a particular focus on Italian risk given how much that bond market relies on ECB bond purchases. We are also cautiously exposed to the UK consumer, which is struggling with higher prices and Brexit uncertainty.

We have a preference for US risk, including the banking sector. There is significant uncertainty over Trump's policies, but his intentions seem to favour domestic growth and deregulation, even if there are disappointments with implementation.

Across emerging markets, we have been generally cautious, focusing on improving credits such as Argentina and Brazil. This asset class has benefitted from strong fund inflows, but we think it is also susceptible to tighter US monetary policy and lower commodity prices. To reflect this, we are long the US dollar versus emerging market currencies.

Figure 8: Investment grade corporate bond spreads remain tight (%)



Source: Bloomberg L.P., Barclays Credit Indices

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