The View From The Outer

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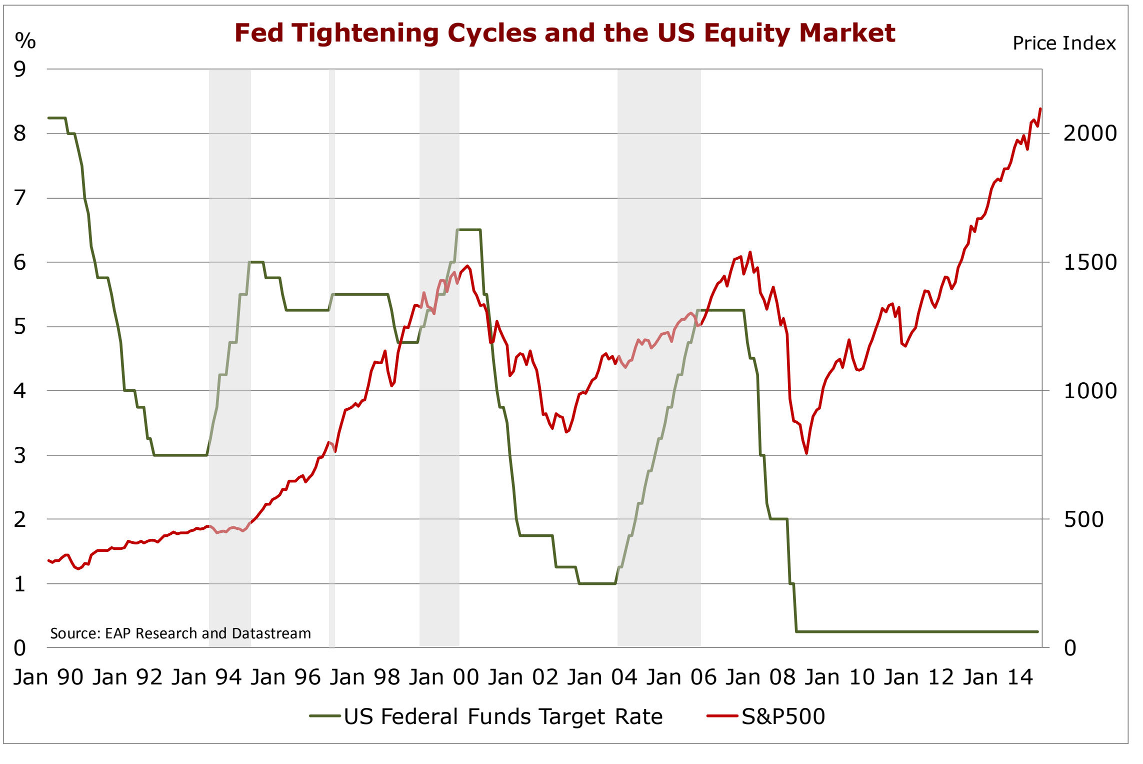
Monday 23 February, 2015

EVANS & PARTNERS

What happens when the Fed tightens?

- **Remember the so-called QE "Taper Tantrum?" In Congressional testimony on 22 May 2013, the then Fed Chairman Ben Bernanke indicated the Fed would likely start slowing – or "tapering" the pace of its bond purchases later in the year, conditional on continuing good economic news. Markets were promptly sold-off. Over the next month, the US 10 year Treasury increased by 0.5% and the S&P500 fell 5%.**
- **Beyond that, however, equity markets resumed their rally. Subsequently, the commencement of tapering was agreed to at the December 2013 FOMC; the market was seemingly unconcerned and attention focussed on other issues.**
- **In this article, we consider if there are parallels to be drawn as we assess the risks to markets once the Fed starts lifting interest rates later this year.**



The graph above shows the US Federal Reserve's Federal Funds Target Rate plotted against the US S&P500 Price Index over the last 25 years. Periods of monetary policy tightening are shaded in gray. An initial period of equity market weakness has followed the Fed starting to tighten on the four occasions shown. Whether that continued, however, was far more dependent on the prevailing macro conditions and earnings, the pricing of the equity market (forward PE Ratio) and the subsequent movement in bond yields. (See table on page 2).

A little historical background

Fed tightening (commenced)	Fed Funds Rate % (pre-tightening)	US 10 year T-Note % (pre-tightening)	US 10 year T-Note % (12 mths later)	S&P500 Fwd PE (pre-tightening)	S&P500 Index level (pre-tightening)	S&P500 Index level (12 mths later)
Feb-94	3.0%	5.8%	7.8%	15.0x	482	470
Mar-97	5.25%	6.4%	5.6%	16.6x	791	1049
Jun-99	4.75%	5.5%	6.4%	23.5x	1302	1421
Jun-04	1.0%	4.7%	4.1%	16.5x	1121	1192
(20 Feb 15)	0% - 0.25%	2.1%		17.2x	2110	

Source: Iress, Datastream

In 1994 the Fed's tightening was initially behind the curve as they sought to slow an overheating economy. By the June quarter, with annualized growth over 5%, the Fed stepped up the pace of tightening to 50 and 75 basis point increments. By November, US 10 year Treasury Notes yielded over 8% (up from 5.75% pre-tightening). Unsurprisingly, PE Ratios were sharply de-rated, despite solid profit growth, and the S&P500 index fell modestly over the twelve months post the initial tightening. (See also chart page 3.)

By contrast, any reaction to Fed tightening in 1997 and 1999 was overwhelmed by the PE re-rating of the so-called "tech boom / dotcom bubble." In the tightening commencing June 2004, ten year Treasuries were lower in yield 12 months later, the yield curve inverted in March 2006 and the S&P500 Index did not peak until October 2007.

So what does this imply for 2015/16?

The point of the above historical background being this: the market's reaction is most likely a function of what is expected or "priced-in", the pace of Fed tightening and the nature of the economic cycle that subsequently unfolds.

The lesson from the "Taper Tantrum" in 2013 being that it was unexpectedly confronting the unpalatable news of the Fed's likely timing of the initial winding back of QE that unsettled the market, not the Fed decision itself months later.

It should be of some comfort that in the current environment, the Fed seems to be going out of their way to provide guidance to the market on the factors that will drive such a decision, and determine the likely timing of the initial increase (or "lift-off") in the Fed Funds Rate. In announcing the initial increase, we expect they will caution that the pace of tightening is not pre-ordained and will be data dependent.

We suspect the Fed will be alert to the risk of the potential fragility of the recovery as policy tightens, particularly as growth will be more domestically focused as the US dollar strengthens. At the very least they are likely to be initially cautious about the pace of tightening lest confidence be unduly impacted.

Clearly we are not expecting a repeat of a 1994 scenario, where the economy suddenly overheats forcing a dramatic tightening; quite the opposite given the global growth and interest rate backdrop. Furthermore, this recovery, whilst broadening, has been far from "normal" and by the time policy tightens will already be of five years duration.

Beyond any short-term sentiment related sell off around the initial tightening, the issues that will be exercising our minds are the robustness of the US recovery as Fed Funds "lift-off" moves towards short term interest rates "normalizing" and the reaction of the longer term section of the yield curve.

The critical point here being that at 17 times forward earnings, the S&P500 appears fully priced in absolute terms; it is the extraordinarily low level of bond yields globally that is now supporting valuations.

You have to go back to 2004 to find the Forward Price-Earnings Ratio of the S&P500 consistently trading at these levels, although 10 year bond yields were obviously significantly higher at the time (4% plus) and equity markets then were notionally less attractive relative to bonds than at today's levels approaching 2%. (See chart page 3).

Too much, too soon in 2015 thus far?

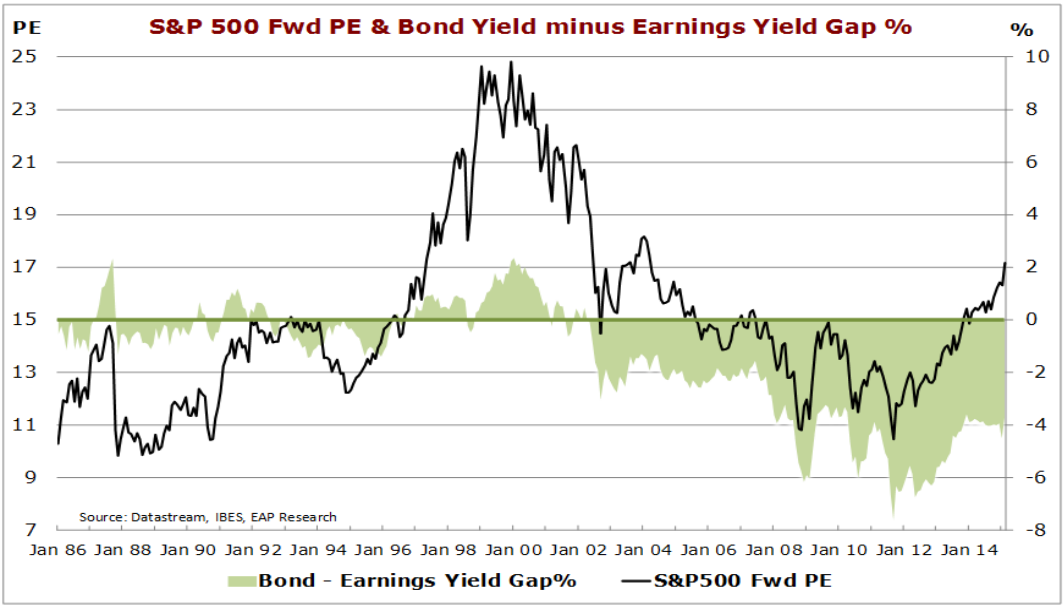
That said, we do feel the pace of the rally in global and Australian equity markets since mid-January 2015 is excessive and potentially at risk of a short-term correction. (From mid-January lows, the S&P500 is up 5.9%, the DAX is up 12.6% and the ASX200 is up 11.5%). Volatility has not gone away. The major central banks are out of synchronization on monetary policy (the Fed to tighten, while the ECB, BOJ and PBOC amongst others are easing). As expectations of the timing of policy changes fluctuate, global currency instability and the uncertain impact of a stronger US dollar and reduced US dollar liquidity are likely to see volatility re-emerge. Be ready to act upon it.

But neutral between growth assets (equities) and defensive assets, driven by low interest rates

We are reluctant to go underweight equities, however, when interest rates are so low, relative value strong (shown in the chart below by the bond yield minus equity yield gap), and the likely pace of increase in long bond yields over 2015 fairly moderate. Even though the Fed will likely be tightening later this year, the global reach for yield trade will draw foreign capital into the US bond market, attracted by the "relatively" high yields (that is, high relative to elsewhere). The impact of QE/ unconventional monetary policy in Europe and Japan will be felt globally. This is likely to constrain the increase in US 10 year bond yields (and Australia for that matter). We can accept that once the world normalizes that US Nominal GDP growth and US bond yields should settle a little above 4%. That will take time, and we assume a 2.75% US 10 year T-Note yield at end 2015 and 3.5% at end 2016.

We very much doubt equity market investors believe the current level of bond yields is sustainable any more than we do. Even at a 2.75% US 10 year bond yield (our end 2015 assumption), the US yield gap would be minus 3% (and still relatively cheap on a 30 year average basis). (See chart below).

Equity markets may have run ahead of themselves short term, but they are not as overpriced as forward PE Ratios alone would suggest, and we believe they still offer a better return profile on a 12 month view than cash or government bond yields.



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