Investment Strategy Update

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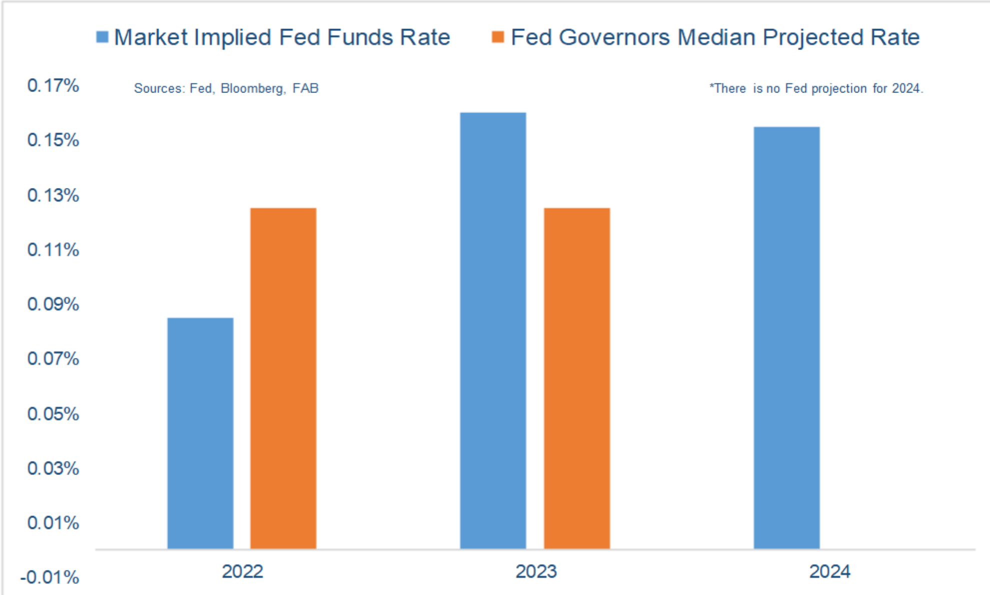
When it comes to the Fed, look at who is talking



♦ Some Federal Reserve governors have suggested recently that they could consider reducing asset purchases this year.

♦ The statements are helping to stabilize long-term bonds as investors reassess inflation expectations.

♦ The Fed governors' own forecasts, however, suggest any significant shift in monetary easing is still well away.

♦ The FAB AAC has a neutral position in equities, and is slightly overweight in IG and EM bonds, and gold.

Just as the market is starting to price in the possibility that inflation will return, Federal Reserve officials have started to talk about reducing their asset purchase program, or quantitative easing.

Recently, regional Fed presidents including Patrick Harker, Robert Kaplan, Raphael Bostic and Charles Evans all have suggested they are willing to consider reducing the speed of the money -printing machine later this year, if the US economy is showing a strong recovery.

As often is the case with the Fed, investors need to pay attention to the detail. Willingness to start discussing is different from doing it.

The so-called tapering of quantitative easing is probably far away, and some of the Fed governors remember what happened in 2013, when then Chairman Ben Bernanke signaled that the Fed would reduce asset purchases. Investors also need to pay close attention to who is saying what, as some governors carry more weight than others.

Richard Clarida, the Vice-Chairman, for instance, dismissed the idea that tapering bond purchases is even on the agenda anytime soon. Jerome Powell, the Chairman, is speaking today and is likely to put forth the same message.

There could be other reasons why these governors are pointing at a tapering of asset purchases, though. Such a move would entail higher interest rates, which would have an impact on asset prices. Maybe they are trying to send a message that markets should not get carried away.

There is also a curiosity about the four governors who have expressed such willingness to start entertaining a taper this year: two will stop voting in the FOMC, the rate-setting committee, and two are being added. Charles Evans replaces Loretta Mester as a voter starting in the next meeting, 26-27 January, while Raphael Bostic replaces Robert Kaplan. Patrick Harker, the other hawkish voice these days, is also leaving the FOMC this year.

The Fed and futures markets are both forecasting near-zero rates for a few more years

Perhaps even more importantly, Charles Evans is generally seen as a dovish figure, and is likely to err on the side of monetary looseness. He was one of the key figures at the St. Louis Fed, together with James Bullard, to question whether the Philips curve is still applicable. This refers to a long held economic assumption that a low unemployment rate leads to inflation.

The Fed has a dual mandate of low unemployment and low inflation. Its target unemployment rate is 4%, whereas it aims for 2% inflation. Unemployment is currently at 6.7% and it is on a path to tick up, instead of down. The US will see inflation data today, but economists are still forecasting it will come short of 2%. No matter what they say, Fed officials know that low rates will be around for a while.

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