INVESTMENT STRATEGY
WEEKLY VIEW

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THE FED IS GEARING UP TO TAPER, BUT A TANTRUM IS UNLIKELY

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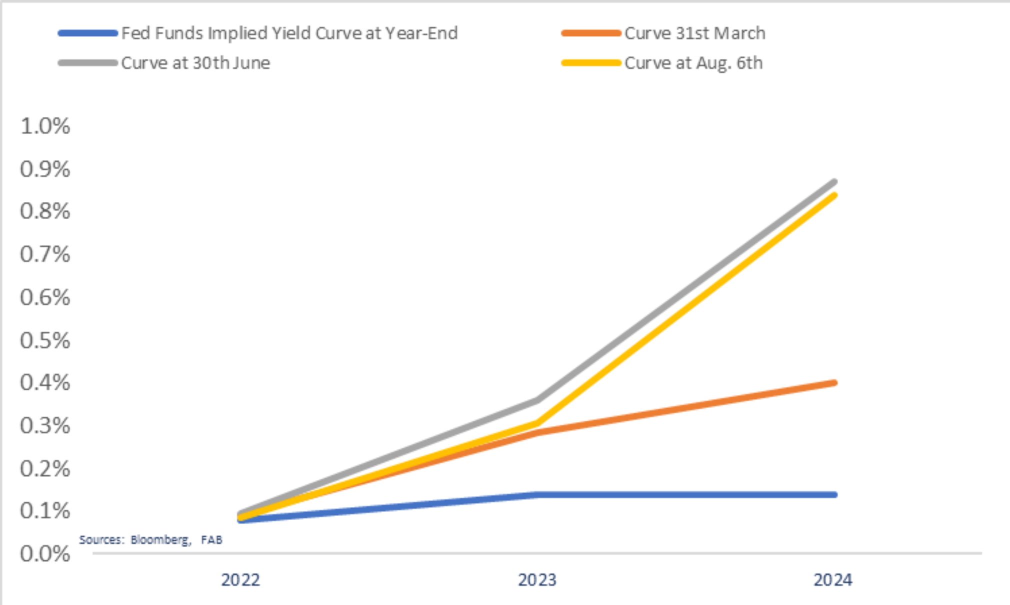
- Richard Clarida, the Federal Reserve's Vice-Chairman, said rates could rise in 2023.
- Other Fed Governors have said they expect asset purchases to start being tapered this year.
- The comments suggest a taper announcement could come in the months ahead.
- The FAB AAC is overweight in equities, IG and EM bonds. It is underweight cash and neutral in gold.



The US Federal Reserve has changed how it operates since the Global Financial Crisis. The latest shift has seen its approach to inflation control move from a preemptive stance, which changed monetary policy as soon as models began to flag higher inflation ahead, to a reactive one, by which the central bank only starts to tighten policy once it is convinced that inflation has become ingrained and sustainable.

Perhaps the biggest change occurred shortly after Ben Bernanke took over, in 2006. He was the first Fed Chairman to avoid surprising markets too much, and to focus on communicating monetary policy ahead of time. By the time he left, in 2014, it was a common joke on Wall Street that economists no longer needed to forecast the outcome of rate-setting meetings of the Federal Open Market Committee.

Nowadays, the Fed starts signaling its moves way ahead of any announcement, unless it is making emergency changes. This is why the market has started to price-in an asset purchase taper as early as this year, and the first interest rate hike in 2023.

And, in keeping with the new tradition, last week, Fed Vice-Chairman Richard Clarida said that if his outlook for inflation and unemployment is realized, then the Fed's thresholds for raising rates "will have been met by year-end 2022." Mary Daly, the Governor of the San Francisco Fed, said the very next day that she saw a high possibility of an asset-purchase taper starting as early as this year.

Perhaps more importantly, Fed Chairman Jerome Powell has already said policymakers had started discussing when to begin tapering the current US$120 billion a month of bond purchases in their last rate-setting meeting.

Fed funds markets have gone from pricing in no moves to three rate hikes by 2024

Another more arcane indicator of the nearing taper was also revealed in the last Fed meeting. The central bank said then that it would create a standing repurchase facility, to replace the temporary one instituted a couple of years ago.

The announcement addresses an issue highlighted by Fed research staff for years, who indicated that the sudden tightening of liquidity that the buyback shift caused in capital markets was part of the reason for the "Taper Tantrum" in May 2013, when interest rates shot up and stocks wavered after the Fed said it would start unwinding the bond buyback program created following the 2008 Financial Crisis. That, some analysts have suggested, could have been mitigated with a standing reverse repurchase facility, such as the one just announced.

This commitment to liquidity, even as the Fed reduces the speed at which it is expanding its balance sheet, may be part of the reason why the stock market has been shrugging-off the recent clearer indications that the central bank is really moving toward removing some of the monetary easing measures.

The market is not completely immune to the prospect of a slower-growing Fed balance sheet, though. The S&P 500 fell 0.46% last Wednesday, the day Vice-Chairman Clarida made the comments mentioned above. It rallied the next two days, though, and still closed the week at a new record of 4,436.52 on Friday, as investors continued to cheer stronger-than-expected earnings on Wall Street.

So far, 86.5% of the companies that reported their second quarter earnings beat analyst expectations, in line with what happened in the first quarter. That is a high number still, and, to put it into perspective, the average number of companies beating had been 72.2% in the five years leading to December, 2019, the last quarter before the Covid-19 crisis began. Therefore, Wall Street did have good reason to celebrate in the past few weeks as US companies continued to prove that analysts had been too bearish about recovery prospects.

There is another reason for equity markets to rally further. A steep drop since the start of June has pushed the yield of 10-year US Treasuries to just less than 1.3% as of Friday. That number had gone as low as 1.17% in July, before it rallied 13 basis points last week. Even at Friday's higher level, long-term US government bonds yield less than the 1.32% average dividend of the S&P 500. Stocks tend to gain when the S&P 500 dividend yield is higher than the 10-year US Treasury's.

The reasons for such low Treasury yields, however, may prompt some questions regarding how much the difference between dividend yields and government bond returns might influence the stock market going forward. The 10-year US Treasury was yielding nearly 1.7% as recently as May 12th. Its price has since staged a historic rally, driven partly by technical factors, such as excessive short positions in long-term bonds and related derivatives, and growing demand for them compared to relatively low supply.

Analysts have also suggested, however, that long-term Treasuries have rallied so much lately also because investors are starting to price-in the possibility that the US economy will lose momentum in the year ahead. They have also suggested that the spread of the Delta variant, which is more infectious than the original Covid-19 virus and now accounts for nine out of every 10 new cases in the US, could mean new lockdowns might still occur in advanced economies.

At least one indicator suggests that such an ominous prediction may not be so far-fetched. New York, where most US stock trading is done, has seen the number of new cases rise. While the hospitalization rate has remained low as more people get vaccinated, two-thirds of the ICU beds in the state are taken. The biggest concern here is the fact that the flu season lies ahead, and Covid-19 behaves similarly to the common flu. This means that Covid case numbers could spike in the fourth quarter, leading to renewed lockdowns in the state, something that may spook traders.

A potential rise in new cases of Covid-19 as the Northern Hemisphere starts getting colder is very likely, the key question, though, would be how governments react to it. If they take the British approach and tolerate a temporary rise in cases as long as hospital systems are not overwhelmed, any impact on markets could be short-lived.

If, however, they take the Chinese approach and start locking down cities, there could be some volatility ahead. Beijing has begun to cut internal travel, and has isolated the capital city from the most of the country as the Delta variant has caused a spike in the number of cases in China over the past month.

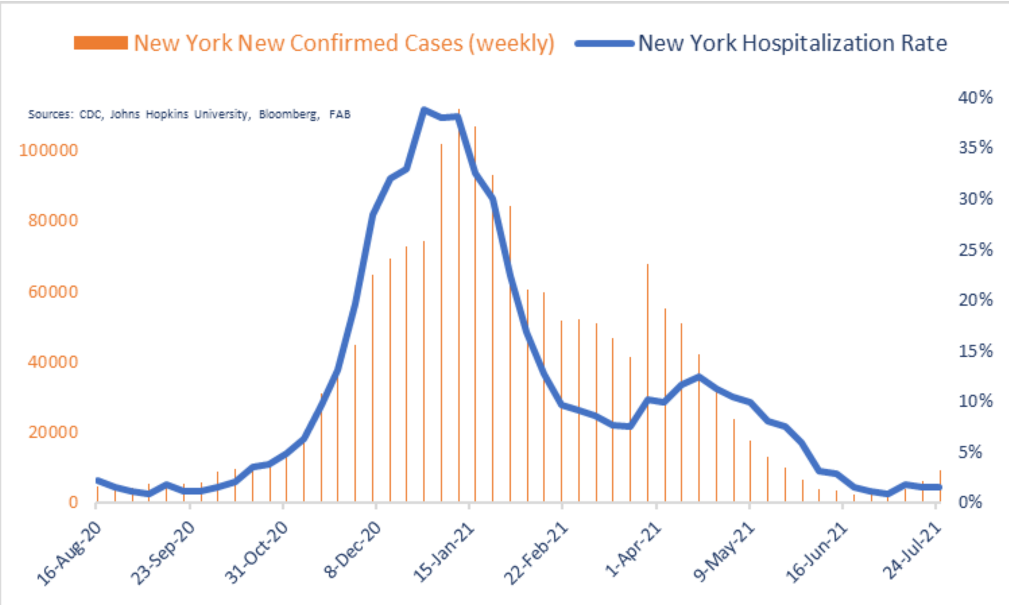
The move has ignited fears of a slowdown in the world's second-largest economy, which has already been losing momentum. Oil prices tumbled 7.4% last week, with Brent crude closing at US$70.7/barrel on Friday, just above the US$70 level, as market participants realized the world's biggest consumer of fossil fuels was restricting movement.

If coronavirus case numbers continue to rise, however, and large cities such as New York are forced to restrict movement again, like Beijing is doing, the Fed's widely-signaled asset purchase taper announcement may have to wait.

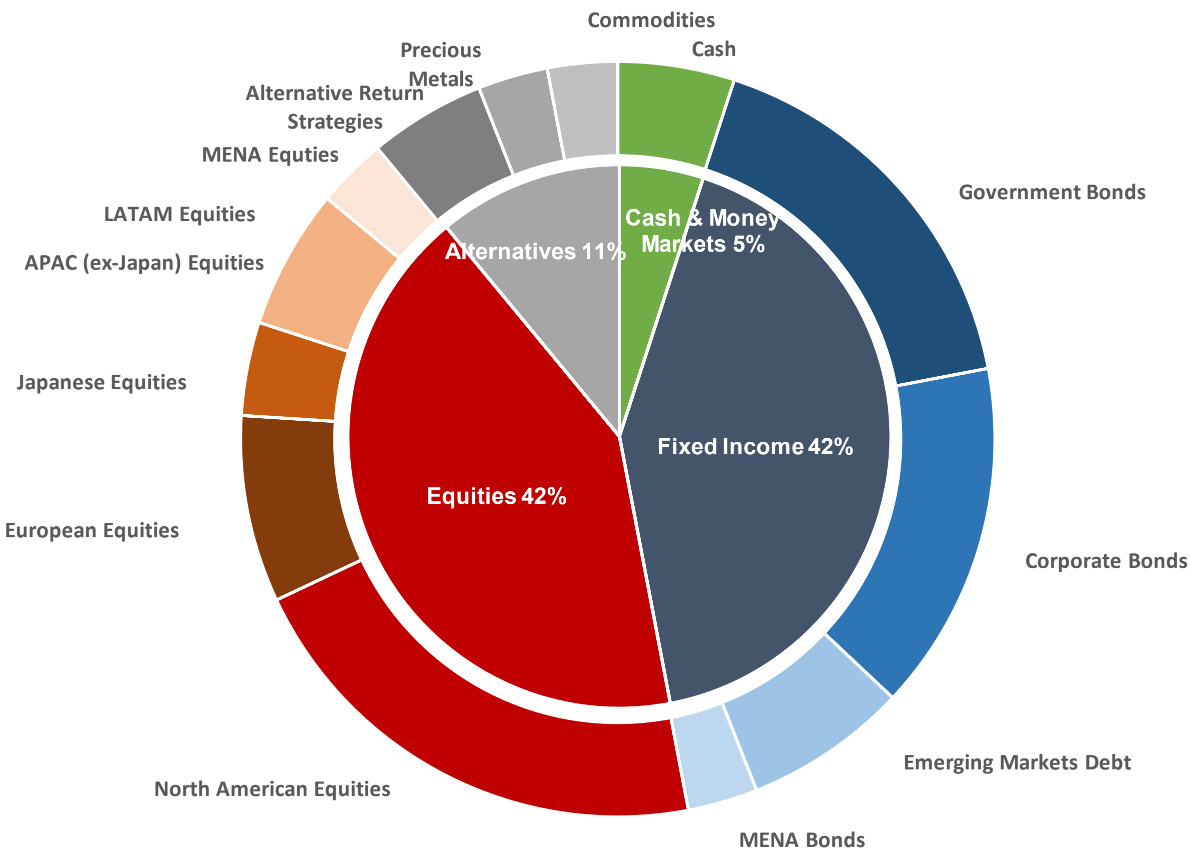
That would support stock markets at least holding on to their recent gains, and would suggest any sell-off in risk assets is limited. Hence, even if markets do wobble a bit as the Delta variant progresses, that may be more of an opportunity to increase exposure to risk assets than a reason to reduce it.

After all, central banks mostly continue to support risk assets, and are likely to quickly step in if there is any sign of another economic slowdown ahead. And if there is no lockdown, markets seem to be ready for the Fed's taper.

The Covid case count in New York has been rising and could get worse in winter



Asset Class	Positioning	Detail
Cash	Underweight	Putting cash to work in risk assets.
Fixed Income	Overweight	Keeping a slight overweight focused on EM dollar debt and on corporate investment grade bonds
Equities	Overweight	Slightly overweight in Asia ex-Japan and US markets.
Alternatives	Underweight	However, reducing the underweight in hedge funds



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