INVESTMENT STRATEGY
WEEKLY VIEW

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TAPERING IS NOT TIGHTENING

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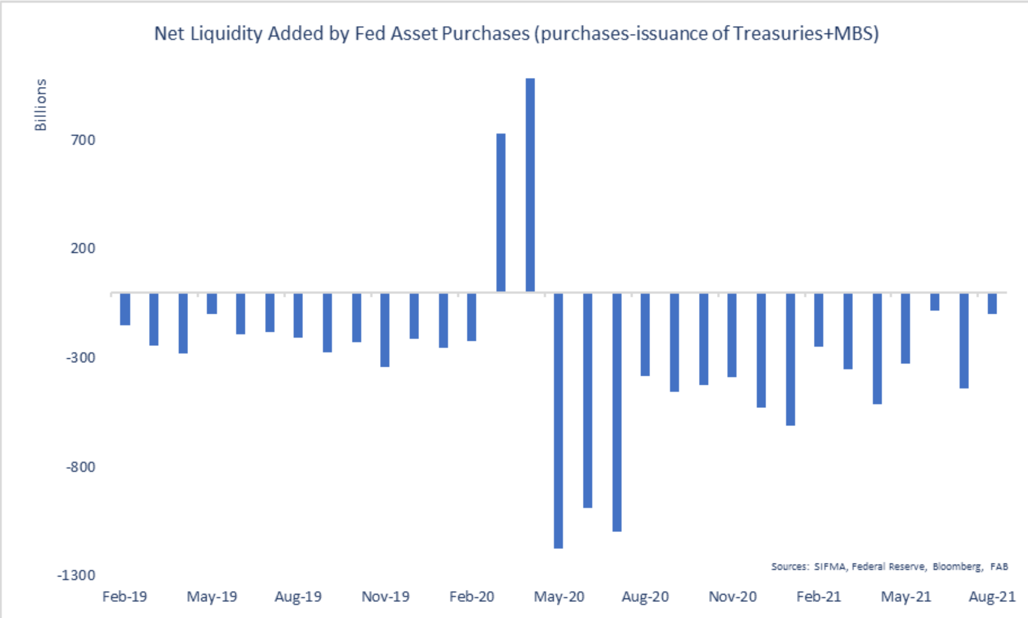
- The Federal Reserve is expected to announce that it will soon start reducing its asset purchases.
- However, Fed governors may also downgrade their growth outlook and push out the timeline for future rate hikes.
- Meanwhile, Chinese assets continue to suffer the fallout from Evergrande.
- The FAB AAC is overweight in equities, IG and EM bonds. It is underweight cash and neutral in gold.



It could be the US Federal Reserve's way of saying that the market emergency that the Covid-19 pandemic created is over. This week, the Federal Open Market Committee meets and should start commenting more clearly about when it will reduce the amount of bonds it buys every month, a move long since denoted as 'tapering' by the financial media.

Perhaps one of the things that financial commentators have not sufficiently emphasized is that tapering is not tightening. Even if the Fed announces it will buy less than US$80 billion in US Treasuries and US$40 billion in mortgage-backed securities, it will continue to buy some amount of both, and to replace the bonds that mature in its portfolio.

This is important for a few reasons. Every time the Fed buys a US Treasury bond, it prevents a portfolio manager or a bank from buying it, effectively forcing that cash to be injected elsewhere - hopefully into other loans that will prop up growth, so central bank thinking goes. Hence, even if the amount it is buying is reduced to US$80 billion a month, instead of US$120 billion, there still is US$80 billion of money that would have gone into these bonds that is going back into the economy.

The trouble is that while the Fed has been buying bonds every month, the US Treasury and issuers of mortgage-backed securities have also been busier than usual. Treasury issuance, for instance, has increased to an average of US$276 billion since the pandemic began, from about US$98 billion in the year preceding that, while mortgage-backed security issuance has increased to US$345 billion, from about US$156 billion.

The Fed's asset purchases have not made up for higher Treasury and MBS issuance

Hence in the past 12 months there has been a reduction in liquidity (if fiscal stimulus is excluded), despite the Fed's bond buying program. Still, the central bank has been under pressure, particularly regarding the purchase of mortgage-backed securities, as home prices as measured by the S&P Case-Schiller Index increased by 19.1% in the 12 months to June.

The Fed is therefore hard-pressed to justify that it needs to continue to support the mortgage market when mortgage rates are near all-time lows, while home affordability has fallen significantly. The Fed also began to buy US Treasuries to normalize financial conditions, which refer to the markets.

Bond spreads are near all-time lows in the US, and stock market indices have recently logged record after record (the S&P 500 had more than 50 new highs this year), hence it is difficult to justify financial conditions still needing support.

In conclusion, there appears little reason for the Fed to continue to buy mortgage-backed securities and US Treasuries at the same rate as recently, although there are arguments in favour of continued bond purchases albeit not so aggressively.

Starting by the fact stated above, that the US Treasury will likely still be selling a lot of bonds, a reduction of the amount the Fed buys should reduce liquidity in the market. An outright halt to the bond-buying, would, therefore, be a significant tightening, something the Fed is likely to avoid for now, given how fragile the economic recovery still is.

The fragility of that recovery has been in evidence recently, as most indicators have come in weaker than expected. The Citi Economic Surprise index for the US has been in negative territory since the end of July, indicating that more of the economic indicators for the country have come in below the median estimates of economists.

In fact, while this week's FOMC meeting could provide some clarity on when and how the central bank will taper its asset purchases, it is also likely to give investors a less-rosy outlook for the US economy. The quarterly summary of economic projections is likely to downgrade the outlook for US GDP growth this year from the 7% median forecast shown in the last summary, published in June.

The slowdown in growth has been partly due to a retrenchment of US consumers, as the number of Covid-19 cases rose to more than 1 million per week, from less than 100,000 a week, since July. While the number of new cases seem to have stabilized somewhat, hovering around 1 million cases/week for the past five weeks, the arrival of the 'flu season in the coming weeks could increase those numbers.

While that suggests a further economic slowdown in the winter months ahead, it also means that the recovery will probably last longer. After all, whether it is through vaccination or infection, the world is becoming more immune to Covid-19, and eventually the global economy should open entirely. As and when that does happen, there could be a further leg-up in growth.

As a result, while the Fed could downgrade its outlook for growth this year, it may upgrade its expected expansion for next year above the 3.3% it had previously projected, and even the 2.4% for 2024 published in the June summary. Finally, the slower expected growth this year could lead the Fed to push its time horizon for rate hikes further into the future. It would not be surprising to see their median estimate of the timing of the first hike to 2024, from 2023.

Portfolio managers will be watching the Fed's statement and economic projections more closely than ever, because of these cascading effects. If the Fed says (as its Chairman Jerome Powell suggested in the last meeting) that it will start tapering soon, but that it will leave rates near zero for longer, the market could find some support and start to reverse two consecutive weeks of losses, which have left the S&P 500 down 1.98% for September so far.

While the views of the central bank of the world's largest economy will be front-and-centre for most portfolio managers this week, the fate of the world's largest real estate developer will also demand some attention.

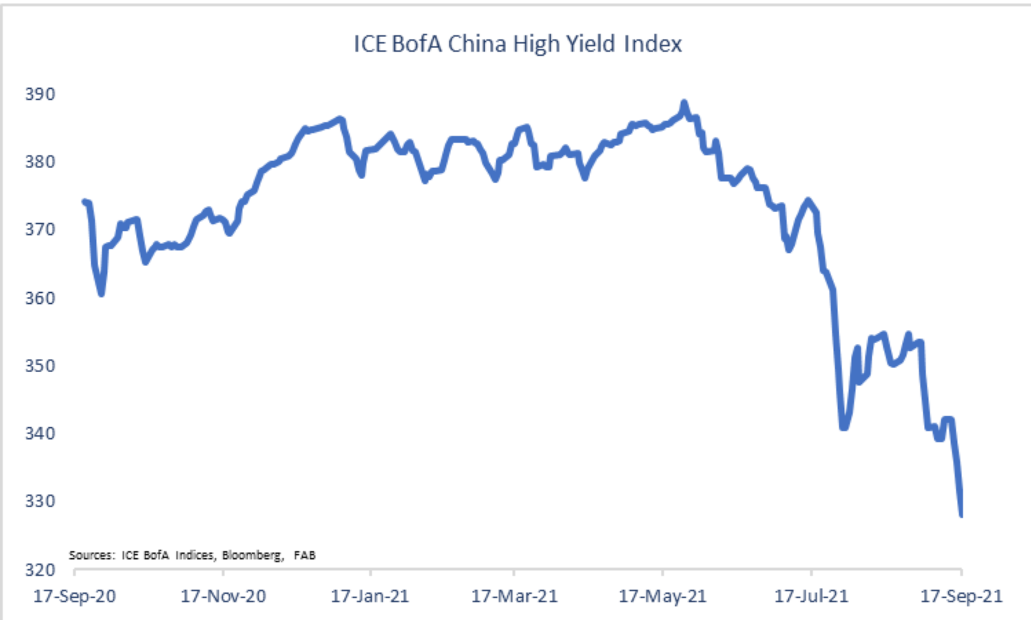
China Evergrande Group has to make an US$83.5 million interest payment on its 8.25% bond due in March. There is increasing speculation that the company will miss this payment, which is reflected in the market price of the bond, last quoted at 29.5 cents on the dollar, according to Bloomberg. With US$14 billion of dollar bonds outstanding, Evergrande is by far the biggest component of the Bloomberg China High-Yield index, accounting for nearly 12% of it if the face value of the debt is considered.

Most of the company's bonds are already trading at around 30% of face value, after it indicated it had hired financial advisers to look at its options, including restructuring. With some US$304.5 billion in liabilities, the default of an entity as huge as Evergrande could not be without consequences.

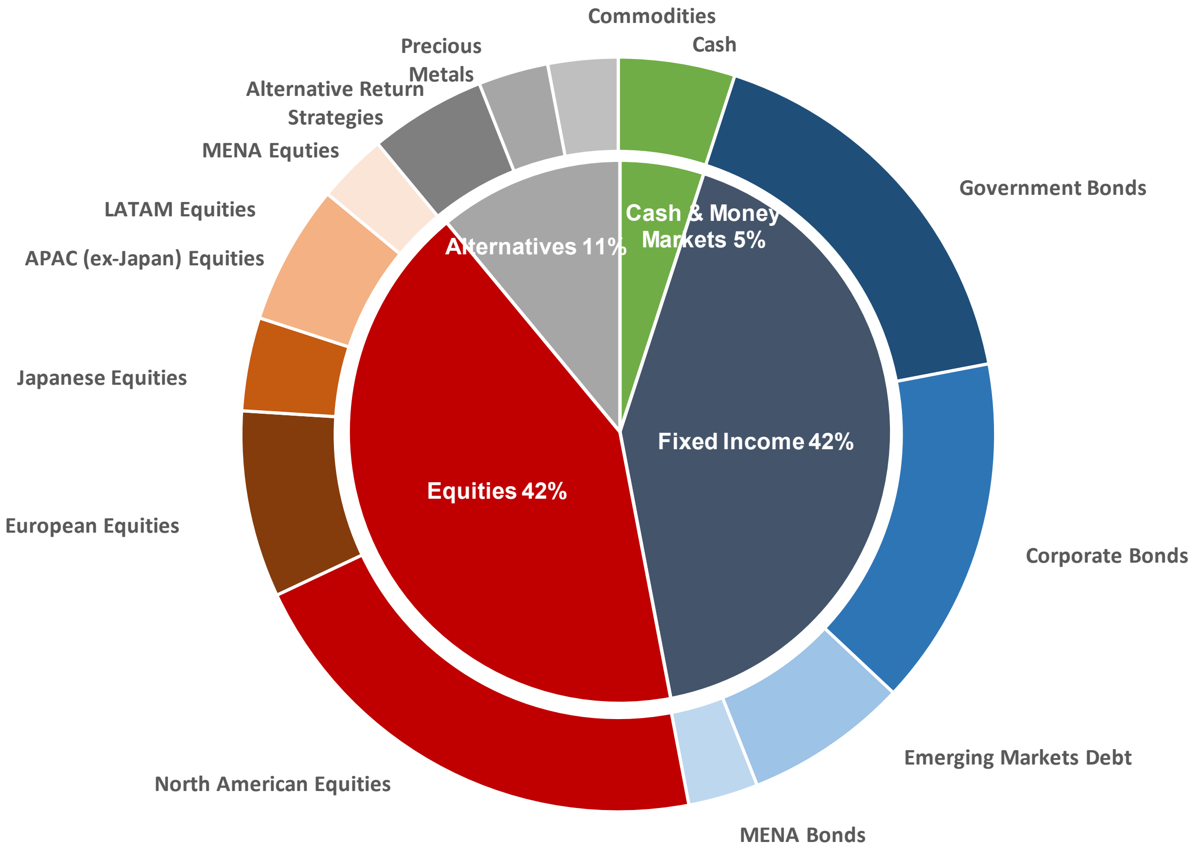
Investors have been selling bonds of property companies as a result of the debacle, pushing the ICE BofA China High-Yield index down almost 15% since the start of May, to its lowest since March, 2019, if the pandemic selloff period is excluded.

In some ways, the situation is so extreme that it is likely to prod Chinese regulators to ease domestic financial conditions. The default of Evergrande is increasing the odds of further monetary loosening by the People's Bank of China, and perhaps even increased government spending. If that is what actually transpires, investors may paradoxically pencil-in improved growth in China and the US relative to what they were assuming at the end of last week.

Excluding the pandemic selloff, Chinese junk bonds are at their lowest since 2019



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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