Hasenstab: Fed Tapering Was Inevitable

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Michael Hasenstab, Ph.D.
Executive Vice President, Portfolio Manager
Chief Investment Officer
Templeton Global Macro

The US Federal Reserve (Fed) announced its decision to reduce its $85 billion monthly asset purchase program by $10 billion starting in January 2014. What might the eventual end of the Fed's policy of aggressive money printing mean for fixed-income investors? Michael Hasenstab, Ph.D, executive vice president, chief investment officer, Global Bonds, Franklin Templeton Fixed Income Group®, believes there's no reason for investors to panic. He outlines why he thinks that's the case, and where on the map he's spotting fixed income opportunities.

Global liquidity should continue to increase, in our view, as a number of central banks in developed markets have maintained very loose monetary policies. The Bank of Japan (BOJ) appears likely to accelerate the pace of monetary easing with further measures to amplify accommodative monetary policy in the coming months. The European Central Bank (ECB) recently cut rates a further 25 basis points to 0.25% as the eurozone slowly deleverages and several countries within the eurozone face ongoing disinflationary pressures. The ECB has indicated it could take further measures.

In the United States, the decision by the Fed to begin reducing its bond-purchasing program in January 2014 was inevitable, in our view, as it is not a realistic expectation for the Fed to print money indefinitely. We believe that the longer the program continues, the longer distortions in the market could last. Furthermore, we believe it is important to remember that the end of printing new money does not necessarily mean the end of loose monetary policy in the United States. While the Fed will eventually discontinue new purchases, and eventually even gradually raise interest rates, we believe that would still equate to fairly loose monetary policy at the global level, given the size of the Fed's outstanding balance sheet, as well as the actions of the BOJ and the ECB. The total pool of global liquidity remains abundant and is likely to continue to expand, in our view.

We believe the fear of liquidity being pulled out of emerging markets due to the Fed eventually ending its bond-purchasing program is largely overstated, as we do not believe there would be a massive contraction of liquidity out of emerging markets in response. Instead, we think the situation will likely result in less new money pouring into these markets. Many emerging markets have a surplus of savings and low indebtedness. Furthermore, many of these emerging-market countries no longer rely on foreign capital inflows as they did in previous decades due to improved fiscal accounts and a large amount of foreign reserves, which can help provide a cushion against capital outflows. When the Fed does completely end its bond purchases, we believe the interest rate differential will likely be in favor of emerging markets with high growth and inflation dynamics that should dictate higher interest rates than those in the United States. We believe the relative value potential of these countries' assets is still intact because they have not been printing money; therefore, the pace of Fed tapering is unlikely to have a fundamental impact on countries that continue to exhibit strong fundamentals.

The current low levels of interest rates and the likelihood of facing a rising-rate environment are central to our near-term outlook. We expect many emerging markets should benefit from solid fundamentals as well as ongoing capital inflows from worldwide quantitative easing. We remain encouraged about the growth prospects and low indebtedness of many emerging markets. Asia ex-Japan looks reasonably strong to us, as do select economies in Latin America and Europe. We believe credit conditions have remained favorable in these regions given their low levels of debt and relatively stronger growth rates.

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What are the Risks?

All investments involve risks, including possible loss of principal. Bond prices generally move in the opposite direction of interest rates. Thus, as prices of bonds in an investment portfolio adjust to a rise in interest rates, the value of the portfolio may decline. Special risks are associated with foreign investing, including currency fluctuations, economic instability and political developments. Investments in emerging markets, of which frontier markets are a subset, involve heightened risks related to the same factors, in addition to those associated with their relatively small size, lesser liquidity and lack of established legal, political, business and social frameworks to support securities markets. Because these frameworks are typically even less developed in frontier markets, as well as various factors including the increased potential for extreme price volatility, illiquidity, trade barriers and exchange controls, the risks associated with emerging markets are magnified in frontier markets.

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