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Hasenstab: Much Ado About Fed Tapering

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In the past few months, the global markets seem to have been fixated on the US Federal Reserve's words and actions (or lack thereof). Will the Fed wind down its longstanding quantitative easing (QE) program, and when? Will the money tap dry up, and, with it, global liquidity? In more recent days, US markets in particular have been focused on a looming government shutdown, adding a dose of uncertainty—and volatility.

Initial hints of such a winding down of the Fed's prolonged QE program triggered a market jolt in June, and participants were pricing in a September start to so-called "tapering." It was a surprise, then, when the Fed decided to push pause on any such plan at its September 18 policy meeting.

Dr. Michael Hasenstab, co-director of Franklin Templeton's International Bond Department and portfolio manager of Templeton Global Bond Fund, said the reasons for the Fed's inaction were a mystery even to him.

But Hasenstab, who also manages Templeton Global Total Return Fund and co-manages Templeton Global Balanced Fund, said it is important that investors not get too caught up in the whims of the Fed.

"The equity and bond markets had priced in the end of QE, the beginning of tapering, in September. I think the effectiveness of QE has long worn off and the Fed had a perfect opportunity to taper then. I think it was a mistake not to. Maybe one day we'll be able to figure out exactly why the Fed didn't act in September, why they missed that opportunity. But investors shouldn't get too sidetracked by that one decision.

"I think it is still very clear that tapering is going to happen. Whether it happened in September or will happen over the next couple of months, the point is that the Fed cannot continue to artificially support the bond market, buying Treasuries in perpetuity. So we should be ready for a world where that ends. I think the good news is a lot of that appears to already be getting priced in. We might have to go through a bit of a re-pricing for when it does happen, but definitely we should be ready for an environment where the Fed buys less."

Global Liquidity Pool Remains Full

Hasenstab is quick to point out that US central bank tapering does not mean draining the global liquidity pool.

"Tapering means that the Fed is no longer pumping water into the pool, but the pool is still filled with global liquidity. At the same time, Japan is only just turning on the spigot. So as the Fed turns off, Japan is turning on that pool of global liquidity. We are already seeing the impact of that in many emerging markets; Japanese banks are increasingly lending into those markets. I think that dynamic will continue and help off-set the Fed eventually beginning to taper."

Volatility = Opportunity

Hasenstab said he wasn't too concerned about the heightened volatility the bond market has experienced in the second and third quarter, although he differentiates the causes of it. In his words:

“Pretty much every year there is a period of volatility when markets panic, when correlations all go to one, and people panic and sell everything in different sectors. I think it’s not atypical to have periods of exaggerated volatility followed by a sort of normalization. I do think the Fed distorting markets through their massive QE programs has heightened that volatility. I would say, at the margin, we should expect financial markets in general to have elevated volatility. However, we shouldn’t be afraid of that. We should really use those panic periods to exploit opportunities. That’s what we did, and have always done.

“Interest rate risk is one of the areas where we are being very defensive. There was a lot of volatility in interest rates [this summer].The volatility we experienced in our portfolios had to do more with currency markets: in periods of panic, you tend to have a uniform sell-off across a lot of currencies. What we did during that period was to go in and cherry-pick the ones that we thought had good long-term fundamentals but were just being swept up in the broad panic of the market. Emerging markets really fell into that category. The talk of tapering led a lot of people to believe that all emerging market currencies were doomed.”

Hasenstab says that while it’s true a “handful” of emerging market currencies may face problems, probably more for domestic reasons, it’s important not to use a broad brushstroke when it comes to characterizing these situations.

“What happened over the last three or four months is that all emerging market currencies got washed out, but we think a few are actually in really good shape. Our job during those periods is to sit down and methodically identify where we think there was panic and not a fundamental revaluation. For example, South Korea is not the same as India; Turkey is not the same as Mexico. We think emerging markets are now increasingly split between those that are reliant on foreign capital and have made policy missteps, and those that are not reliant on foreign capital and have good policies. The cluster we are focusing on is the latter, places like Mexico and South Korea.”

Learn more about the Templeton Global Bond Fund, Templeton Global Total Return Fund and Templeton Global Balanced Fund.

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What Are the Risks?

Templeton Global Bond Fund

All investments involve risks, including possible loss of principal. Currency rates may fluctuate significantly over short periods of time, and can reduce returns. Derivatives, including currency management strategies, involve costs and can create economic leverage in the portfolio which may result in significant volatility and cause the fund to participate in losses (as well as enable gains) on an amount that exceeds the fund’s initial investment. The fund may not achieve the anticipated benefits, and may realize losses when a counterparty fails to perform as promised. Foreign securities involve special risks, including currency fluctuations and economic and political uncertainties. Investments in emerging markets involve heightened risks related to the same factors, in addition to those associated with these markets’ smaller size and lesser liquidity. Investments in lower-rated bonds include higher risk of default and loss of principal. Changes in interest rates will affect the value of the fund’s portfolio and its share price and yield. Bond prices generally move in the opposite direction of interest rates. As the prices of bonds in the fund adjust to a rise in interest rates, the fund’s share price may decline. The fund is also non-diversified, which involves the risk of greater price fluctuation than a more diversified portfolio. Changes in the financial strength of a bond issuer or in a bond’s credit rating may affect its value. These and other risk considerations are described in the Templeton Global Bond Fund’s prospectus.

Templeton Global Balanced Fund

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Templeton Global Total Return Fund

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