Risk Assets Take Fed Taper Announcement in Stride

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The US Federal Reserve (Fed) delivered an early holiday surprise to some market participants, announcing at its December 18 policy meeting it would start slowing its asset purchase program known as quantitative easing in January. For some thoughts on what this may mean for the markets in the new year, we turned just after the announcement to Roger Bayston, Senior Vice President and Director, Franklin Templeton Fixed Income Group®. He believes the markets should be able to take the Fed's tapering in 2014 in stride, although investors should prepare for the proposition of higher Treasury yields.

On December 18, the Fed announced it has decided to cut its monthly asset purchases from US$85 billion to US$75 billion in January, with the reduction in purchases split evenly between mortgage-backed securities and Treasuries. After some short-lived volatility following the announcement, "risk" assets seemed to take the Fed decision in stride, consistent with the view we have long held that the impact of Fed "tapering" on US financial markets was not likely to be exaggerated. Indeed, equity indexes such as the S&P 500 ended December 18 markedly higher, and early-day declines in US government bonds soon leveled off. Two- and 10-year yields rose a relatively modest amount each over the day, bringing the US 10-year Treasury yield up to 2.89% at the close of trading on December 18 (up from 2.71% a month before and 1.60% at the beginning of May).[1]

Global equity indexes generally held or extended their gains the following day, December 19, and bond markets seemed to settle down. Not only had the markets already largely priced in the Fed's move, in our view, but they seemed steadied by the Fed's commitment to keep interest rates low for some considerable time to come and the central bank's confidence that the US economy appeared firmly on the path to a progressive improvement in economic growth. These weren't the only factors for the positive market response to the Fed's actions: There was also the welcome end to the uncertainty and endless speculation about just when tapering may begin, stretched out since the middle of 2013. Such speculation, we think, contributed to periodic falls in certain markets, most notably emerging-market bonds, equities and currencies.

We believe Treasury yields, after a measured rise during 2013, are likely to rise further in 2014. This rise should simply be seen as a normalization that mirrors optimism about the ongoing, rather unspectacular recovery of the US economy and the unlikelihood that short-term interest rates will go up anytime soon. Volatility gauges have not recently suggested to us any breakout in long-term bond yields. Ultimately, long bond yields should reflect expectations of long-term economic growth and inflation. While we believe there are indications that economic growth might be picking up, inflation measures remain subdued, potentially capping long-term rates even as the Fed unwinds its asset purchases.

We note that the Fed has left open the possibility of increasing its monthly bond purchases again if the economy does not improve in the way it expects. The Fed is not on a preset course. In particular, the US central bank intends to monitor the inflation rate, which remains persistently below its 2% target, posing a threat to economic performance. However, we believe the likelihood at this stage is that the Fed will continue to reduce the pace of its monthly asset purchases in measured steps, finally wrapping them up at the end of 2014 if the economy is on a robust and sustainable recovery path by then. An end to Fed asset buying would signal the US economy had finally repaired much of the damage caused by the 2007-2008 financial crisis. At the same time, we think the Fed's forward guidance on low rates, combined with strengthening growth, low inflation and the congressional deal on US government spending, could continue to drive investors toward "risk" assets.

What are the Risks?

All investments involve risks, including possible loss of principal. Generally, those offering the potential for higher returns are accompanied by a higher degree of risk. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions. 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.

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1. Source: US Department of the Treasury.

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