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The Investment Engineers

Implications of Fed tapering

- Initial reaction positive due to the Fed's good communication
- Fed's monetary policy very accommodative well into 2015
- More value in euro fixed income than in the US

The Fed has announced the start of the reduction of its asset purchase program. What do we expect and what implications do we foresee for financial markets?

The initial reaction to the announcement has been positive. Bond prices remained more or less stable, while equities and credits rallied. This reaction is explained by two reasons. First and foremost, the start of the reduction was communicated well in advance of the actual event. Markets have been anticipating the start of tapering since the possibility was first mentioned in May and expectations and prices have been adjusted accordingly. The shock came earlier as is visible in the rise from 1.6% to 2.9% in 10-year US Treasury yields since May.

The second reason why yesterday's initial reaction was positive is the way in which tapering was announced. The Fed successfully communicated that the start of tapering should be seen separate from any intentions to lift official interest rates. This can be seen from the comments and expectations.

The gradual pace at which they intend to reduce asset purchases is a signal by itself. At USD 10bn per meeting it will take until year end 2014 to bring purchases down to zero. In the Fed's comments this is visible from a newly added sentence on the intention to keep rates unchanged "well past the time that the unemployment rate declines below 6.5%". The underlining of their 2% inflation target in interest rate decisions (currently 1.2%) shows dovish intentions as well. In their adjusted forecasts the FOMC members expect the 6.5% unemployment level to be reached around mid-2014, while they expect inflation to remain at or below 2% up until the end of 2016. The first rate hikes are expected for mid-2015 and this view has not changed in spite of the decision to start reducing asset purchases. All in all, the Fed's comments and its latest forecasts signal its intention to keep monetary policy very accommodative well into 2015. This explains the positive reaction in markets ranging from credits to equities.

What do we expect from here? First, we expect the central bank to keep signaling its "dovish" policy and only adjust this message very gradually. This should be positive news for risk markets. Second, we do think that as time progresses and the economic recovery continues as expected it will be more difficult for the Fed to keep market expectations in check. Such a scenario is visible in the UK. So while we do not expect any material change in the Fed's policy any time soon, we do see more value in euro fixed income than in the US. Lackluster growth and very low inflation in the euro area will keep the ECB leaning towards possibly increasing stimulus. All in all the Fed has managed to take the hurdle of announcing tapering without inflicting much damage to risk appetite. Well done Mr. Bernanke.

By the Robeco Rates team

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