momentum

For immediate release

Did the taper tantrum teach us anything?

James Klempster, Portfolio Manager, Momentum GIM asks: did the taper tantrum teach us anything?

“Thus far, October has been a decent month for equity markets. This is likely due to three factors. Firstly, markets fell precipitously in the past two and a half months and as a result they were probably overdue a bounce of sorts. Secondly, the Federal Reserve (Fed) postponed its interest rate decision last month and thirdly, and relatedly, recent data out of the US and other developed markets has been weak, if anything deflationary, giving the markets hope that interest rate policy will remain unusually accommodative and that central bank liquidity, in all its various guises, will be around for the foreseeable future.

“We occupy a strange world at the moment where bad news for the economy is interpreted as good for markets. From a purely qualitative perspective there seems to be a pretty strong relationship between these factors: market participants believe loose monetary conditions to be beneficial to equity markets. It is easy to see where they are coming from; despite the extraordinary levels of monetary stimulus put to work in the past decade, the recovery from the financial crisis has been uninspiring. But it has been reasonably solid and perhaps we all need to start becoming accustomed to that being good enough. In a ‘normal’ environment good economic news should, in the round, provide a positive environment for businesses and consumers to operate, but we know that each positive data print is unlikely to positively influence the markets as directly as good news is negatively impacting the markets today. A positive economic environment is helpful but it is not the same as an investment case and valuations and corporate prospects should override a macro story.

“Today, however, market participants continue to conflate bad economic news with continued liquidity and as a consequence a better outlook for markets. The Fed has tried managing expectations through their regular communications, but the unexpected delay in hiking rates still caused some confusion. Perhaps it would be better if they simply grasped the nettle and made the first interest rate hike a *fait accompli* and therefore moving the debate forward from when interest rates will rise. Putting aside economic pros and cons of such a move for a moment, recent history remind us that markets reacted far more maturely to the advent of QE tapering than they did in anticipation to it. There is reason to believe that the same will happen with respect to interest rate policy. The first hike will be small and further hikes will be data dependent and so the anticipated riskiness of such a move is arguably overblown now. As I have noted before, the Fed will be reluctant to ‘do a Trichet’ and if anything the recent slew of weak data does increase the risk of that, but still, it is surely only a matter of time until the market is jolted into a more ‘normal’ mind-set where good economic news is good for markets and we can once more focus on rewarding companies purely on their prospects rather than whether they will be buoyed, regardless of merit, by more liquidity.

“We have allowed ourselves to believe in the efficacy of central bankers while they acquiesced with what we collectively wanted; namely flooding markets with liquidity. Perhaps now we must show the same faith in them as they embark on rate rises. Whether we think it is exactly the right time or not, the fact is that when the Federal Reserve raises rates the committee will, on average, believe that the time is right and we should cut them some slack in the immediate aftermath.”

Ends

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