Marketexpress

Markets seem to have adapted to the concept of Fed tapering. Evidence is emerging that they have 'learned' to understand the Fed better as they have started to appreciate the difference between tapering and tightening.

Taper fears are back, but should we be scared?

Better than expected US macroeconomic data and a somewhat more hawkish perception of the Fed have increased the probability of Fed tapering on December 18. Although we still believe that tapering will not start before March 2014, it is wise to assess the broader market consequences of such a move.

Probability of tapering in December has increased

A number of better than expected US macroeconomic data, combined with a somewhat more hawkish than expected Fed statement after its last meeting on 30 October has brought back speculations in the market that Fed tapering could start rather sooner than later. The government shutdown, the lingering uncertainty about fiscal policy and a weakening trend in job growth caused markets to start pricing in a delay in tapering until March or April 2014. Yet, both the ISM Manufacturing and Non-Manufacturing indices surprisingly increased in October. The biggest surprise came from the labour market report, which showed an increase in non-farm payrolls of 204,000 while there were a net 60,000 upward revisions to the previous two months.

Although we must not be fixated too much on one month's data, the assumption of many market pundits that corporate confidence and hiring intentions would take a hit from the government shutdown and the budget discussion does not seem to materialize.

We still believe that the tapering of the Fed's asset purchases is more likely to commence somewhere in the first quarter of next year, also because the December meeting will coincide with the conclusion of US budget discussions, which given past precedence have a high probability of failure. Still, the odds of December tapering have increased. It is therefore crucially important to take the balance of risk surrounding our view into account. Moreover, we need to assess what the broader market consequences of such a policy move will be.

The easy part of the analysis is the acknowledgement on an increased probability of an earlier than expected start of tapering. With stronger labour market trends, easier financial conditions and gradually declining fiscal policy risks, we cannot exclude that we are only one strong payroll report away from the start of tapering. Again, not our base case, but no longer a negligible risk for the market outlook until year-end.

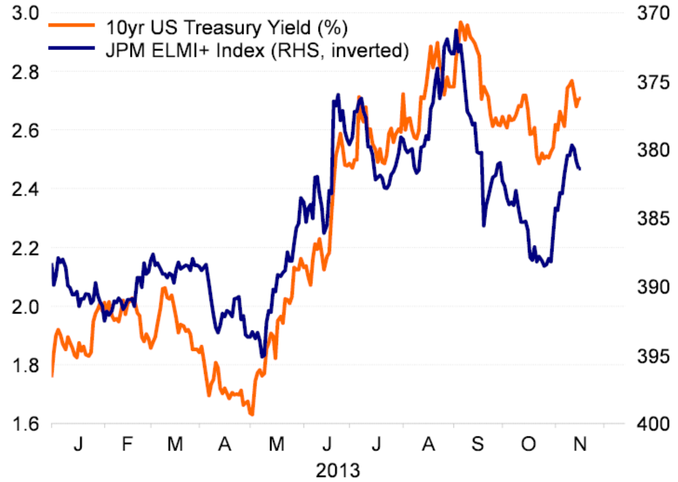
Implications of tapering now less severe

To address the possible impact on markets, whether it happens this or next year, it seems fair to point at least to factors that might make the implications for most parts of financial markets less severe than in the May-June period.

The first noteworthy difference is simply the starting position. When Fed Chairman Bernanke delivered his, by now, infamous speech in May, 10-year US Treasury yields were still trading well below 2%. Having risen around 80-90 basis points since then, it seems fair to say that the risk of a comparably sharp rise over a comparably short period of time is significantly lower than in May/June.

Another way of saying this is that the market seems to have adapted to the concept of Fed tapering. Part of that risk is now priced in and reflected in a higher term premium in the US yield curve. Furthermore, some evidence is emerging that the market has 'learned' to understand the Fed better as it has started to appreciate the difference between tapering and tightening.

EM currencies remain vulnerable to tapering (expectations)



Source: Thomson Reuters Datastream, ING IM (01/01/2013 - 15/11/2013)

The new strategic game plan of the Fed – allowing for more growth before starting to hike interest rates, anchored by forward guidance – is now better understood and reflected by much more stability in money market and short-term treasury yields than in May. If the start of tapering will no longer lead to investors expecting substantially more and earlier tightening of Fed policy (i.e. rate hikes) then it seems likely that the resulting upward pressure on long-term yields and the negative fallout on risky assets will be less than earlier this year.

Emerging market assets remain vulnerable

Most vulnerable to tapering still are emerging market (EM) assets. As we can see in the graph on the front page, EM currencies (represented by the JP Morgan ELMI+ index) have moved largely in line with the US Treasury yield since the start of the taper talk in May. After the last Fed meeting on October 30, the Treasury yield resumed its rise while EM currencies started to weaken again after an impressive rally since early September. As EM assets have attracted so much foreign capital since the Fed and other central banks introduced their unprecedented monetary policies, they remain vulnerable to capital outflows. As with the US Treasury yield, we do not expect a sharp move comparable to the May/June period, but the risk of further weakening is likely.

This is also due to more structural reasons. The EM currency correction *in real terms* has been modest so far - only 5% - after a real appreciation of 32% between 2002 and 2011. Deteriorated macroeconomic fundamentals, higher political risk, eroded competitiveness, the continuous deterioration in EM growth prospects, the risk of a hard landing in China, all in combination with the expected normalisation of US monetary policy, justify a bigger correction in our view. Although we currently have a neutral view on emerging market assets - both debt and equities - it remains our least preferred region.

We are comfortable with our risk-on stance

In the coming months, however, the possibility of 'shocks' to the system - although never to be excluded as a possibility - seems relatively small relative to recent years. This awareness keeps us convinced that we can ride the risky asset wave for now, as a broadening of the global recovery, fading austerity and a more flexible ECB point towards a gradual normalization of allocation stances of money managers that will support growth assets such as equities and equity-like segments of fixed income.

MSCI Regional Indices (EUR)		%
	8 - 15 Nov	YTD
MSCI World	0.70	21.39
MSCI Europe	0.23	18.58
MSCI Emerging Markets	0.09	-4.26
MSCI US	0.71	25.82
MSCI Japan	3.32	23.88
MSCI Developed Asia ex Japan	-0.79	6.67

MSCI Sector Indices (EUR)		%
	8 - 15 Nov	YTD
MSCI World Energy	0.64	14.39
MSCI World Materials	0.25	0.61
MSCI World Industrials	0.54	24.89
MSCI World Consumer Discretionary	1.34	32.27
MSCI World Consumer Staples	0.62	19.20
MSCI World Health Care	1.15	30.62
MSCI World Financials	0.46	22.14
MSCI World Information Technology	0.80	19.82
MSCI World Telecom Services	0.52	26.02
MSCI World Utilities	-0.02	12.57

Bond & Credit Yields		%
	15 Nov	8 Nov
10-yr Bund (Germany)	1.71	1.76
10-yr Treasury (US)	2.71	2.74
US Investment Grade Credits	3.20	3.27
Euro Investment Grade Credits	1.86	1.89
Global High Yield	6.00	6.01
EMD Hard Currency	5.84	5.83
Asian Debt Composite	5.24	5.17

FX & Commodities		
	15 Nov	8 Nov
EUR/USD	1.346	1.343
Crude Oil (WTI Spot, USD)	93.80	94.56
DJ UBS Commodity index	248.05	248.14

Economic Releases (18 - 22 Nov)		
	Date	Consensus
US Advance Retail Sales (Oct, m-o-m)	20 Nov	0.1%
US CPI / Core CPI (Oct, y-o-y)	20 Nov	1.1%/1.7%
US Existing Home Sales (Oct, SAAR m-o-m)	20 Nov	-1.7%
Eurozone Flash PMI Composite (Nov)	21 Nov	52.5
China HSBC Flash PMI Manufacturing (Nov)	21 Nov	50.7
Germany IFO Business Climate (Nov)	22 Nov	107.5

Sources: Thomson Datastream, Bloomberg. YTD data until 15 Nov 2013