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Investment insight

US update: a start to tapering and some budget progress

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Brian Parker CFA
Senior Investment Consultant
MLC Investment Management

"The US economy has been growing solidly enough to warrant the Fed easing back on its QE program."

What has the Fed announced?

Overnight, the US Federal Reserve (the Fed) announced that in January 2014, it would begin to wind back, or 'taper', its monthly program of asset purchases.

Since early 2013, the Fed has been buying $85 billion of US Treasury bonds and mortgage-backed securities each month to expand its own balance sheet and inject liquidity into the financial system.

In future, the Fed's monthly asset purchases will be reduced by $10 billion to $75 billion per month. It's become increasingly clear that the US economy, while it still faces challenges, has been growing solidly enough to warrant the Fed easing back on this quantitative easing (QE) program.

In announcing the decision, the Fed reaffirmed that even when its QE program eventually ends, monetary conditions will need to remain extraordinarily loose.

In fact, the Fed's forward guidance went further than before, also noting that official interest rates will need to remain almost at zero well after the unemployment rate falls below 6.5%, and as long as inflation remains broadly under control. Their previous guidance pointed to a 6.5% unemployment rate as a possible trigger to begin raising interest rates.

Progress on the US budget?

There have also been developments on the budget front as (against most expectations) a budget deal of sorts was recently agreed. It's designed to fund the US government for the next two years, reverse some of the previous cutbacks in spending and avoid the risk of another government shutdown.

Overnight, the US Senate approved the deal that had been passed by the House of Representatives last week.

What this means is that fiscal policy is not likely to be as big a drag on US economic growth over the next year as in 2012 and 2013. Previously, the Fed had included the negative impact of fiscal policy – particularly the government shutdown and the debt ceiling debacle – on its list of reasons not to taper its QE program.

What does all this mean for share prices?

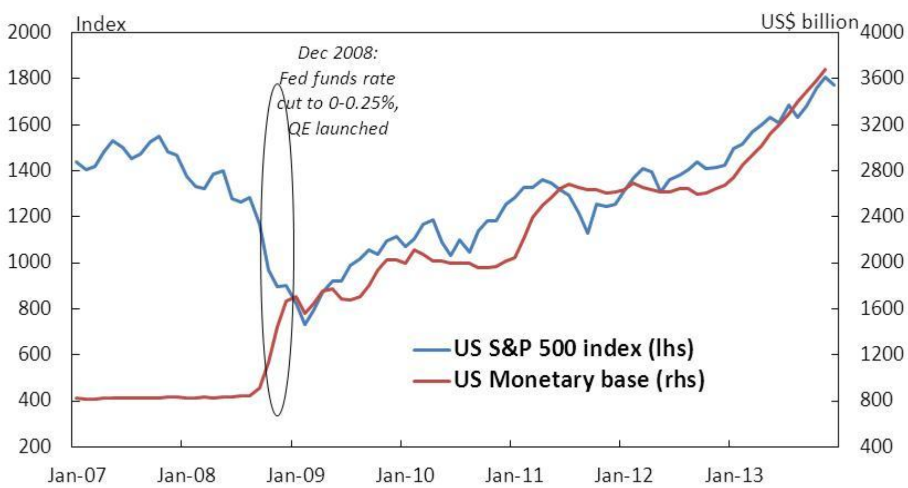
We've believed for some time that the extraordinary policy measures adopted by the world's major central banks – most notably the Fed – have provided considerable support to share prices across the world. Short-term interest rates close to zero, and historically low bond yields (helped by the Fed's bond buying) have encouraged investors seeking returns into higher risk assets such as shares.

Chart 1 shows just how important quantitative easing has been for US share prices. It shows the relationship between the monetary base – the monetary measure that the Fed increases when they engage in quantitative easing – and the level of the US share market as measured by the S&P 500 index.

While this correlation doesn't prove a cause and effect relationship, it seems likely that since early 2009, US share price gains have been fuelled at least partly by QE and hopes for more QE.

In the US (but also elsewhere) share prices seem to have run well ahead of corporate earnings, and well ahead of the likely outlook for earnings. While the successful passage of a US budget deal adds to what is clearly an improving outlook for the US economy, it's not at all clear that economic growth will be fast enough to produce the kind of earnings growth required to reinforce the gains we've seen in US share prices.

Chart 1: Quantitative easing has helped support US share prices



What's the likely impact on our dollar?

The Australian dollar fell sharply following the Fed's announcement, trading briefly at its lowest level in three years against the US dollar. Since early November 2011, the Reserve Bank of Australia has reduced official interest rates on eight occasions and at 2.5%, the cash rate is the lowest in many decades. However, Australian interest rates have still proved attractive to international investors, and our dollar has been uncomfortably high.

The gradual unwinding of QE in the US is likely to put more downward pressure on the Australian dollar, which we consider is still overvalued and vulnerable in a range of market scenarios.

Source: Datastream