INVESTMENT NOTE

July 2013

Fed hawks, feral hogs, wild turkeys….and cold turkey.

"I don't want to go from Wild Turkey to cold turkey overnight"
Narayana Kocherlakota, hawk, President of Minneapolis Fed

"We haven't forgotten what happened to the Bank of England. I don't think anyone can break the Fed… but I do believe that big money does organize itself somewhat like feral hogs. If they detect a weakness or a bad scent, they'll go after it." - Big Fed hawk, Richard Fisher, Dallas Federal Reserve

This nice little menagerie of metaphors comes in the wake of Ben Bernanke's, now infamous, speech hinting at an earlier than expected tapering of quantitative easing, a reference to the punch bowl of cheap money provided by QE. One gets the distinct impression that the Fed is shocked at the initial market reaction hearing nothing but a call to cold turkey austerity, although some federal hawks thought the punch bowl should've been removed long before the party really got underway. But it somewhat undermines the new and improved transparent communication with the Fed that we investors are supposedly enjoying. A lack of mutual understanding has seemingly shaken both sides out of their complacency.

Bernanke's original and subsequent statements have been scrutinised to QE death while the markets have been busily unwinding carry trades in the face of a strengthening US dollar and generally retreating from risk assets globally. At one point, the FTSE 100 Index had fallen from a post-Lehman high of 6,875 to not much more than 6,023. Given the consensus view that winding up of QE is ultimately inevitable, it does seem a little harsh. Having said that, one might reasonably ask how the market had gone up so much, so fast, in the first place. Perhaps if it was a technical sell-off looking for an excuse, the Fed speech fitted the headlines nicely. Indeed, many have suggested that the simultaneous breaking news of an emerging Chinese credit crunch was of greater concern, threatening to knock a few points off Chinese growth forecasts.

The new consensus appears to be that the Federal Reserve has signalled a change in direction from which it will not budge. Like an indicator light on an oil tanker, the actual change has yet to happen and, despite rising yields from a falling bond market, there is no suggestion that interest base rates are set to rise. Indeed, the short dated end of the bond market has already backed off from this notion. Our own view is that the prospect of the death of QE has been greatly exaggerated and the scale and speed of the sell off is overdone, as often happens at such inflection points. Markets have now regained some composure. The UK Gilt 10-year yield has eased back from over 2.5% and is now 2.41% and the FTSE 100 is back to the 6,300 level.

In the meantime, the market has been told by the Fed advice to keep an eye on the unemployment figures. If, as seems likely, good news on the economy ultimately filters through to an improvement on the jobs front, the Fed will hope that good news on the economy equals good news for markets. This seems a tad optimistic but gives some idea of where the Fed is trying to get to. Reaction to macroeconomic news will depend on whether the market believes that the economy is ready to come out of rehab and go it alone without support.

There is cause for hope in this regard. Global equities gained on the most recent manufacturing data out of the US which showing a positive first half to the year, and UK manufacturing is enjoying its strongest growth in 2 years. With France recovering back towards growth and Japanese levels of corporate confidence on the rebound, the global picture doesn't look too bad. Absent a renewed crisis of confidence in the eurozone, one wonders if there are enough animal spirits to see the feral hogs charging in the opposite direction.

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