

All Tapered Out at year End

Fed keeps pedal to the metal on zero interest rates. Buoyant Equity markets for 2014? "If incoming information broadly supports the Committee's expectation of ongoing improvement in labor market conditions and inflation moving back toward its longer-run objective, the Committee will likely reduce the pace of asset purchases in further measured steps at future meetings. However, asset purchases are not on a preset course, and the Committee's decisions about their pace will remain contingent on the Committee's outlook for the labor market and inflation as well as its assessment of the likely efficacy and costs of such purchases". Ben Bernanke, in final press conference as chairman of The Federal Reserve.

After months of speculation, the Federal Reserve has decided that it's finally time for the markets to spit the dummy and announced that it will reduce, or taper, the quantitative easing program which currently sees $85 billion a month being used to buy up a mix of US Treasuries and Mortgage Backed Assets (MBAs) in order to retain low interest rates.. This was an inevitable move and fully justified judging by improved news on the economy which has been broadly better than expected since September – and,

happily, much like in the UK. In the event, the news came as something of a relief to markets despite the unremitting gloom in the media predicting a market collapse akin to kicking away the crutches of an economic recovery barely able to stand on its own two feet.

In order to mitigate against this in the interests of stability, not to mention his own personal legacy before handing over the Chair to Janet Yellen, Ben Bernanke was at pains to drive home the message that tapering does not mean monetary policy tightening. And so, whilst a rise in bond yields is most likely, the Federal Reserve is determined to convince us all that they will keep the pedal to the metal by keeping interest rates at zero for, well, as long as it takes. As Bernanke put it, the Fed won't even consider using rate policy unless "all goes well". Futhermore, in case we're in any doubt that the Fed is now tracking fundamentals other than inflation, he added "the Committee believes it will be necessary to keep short-term interest rates low "well past the time" when the unemployment rate falls below 6.5%

This game is all about guidance, the technicals of the taper itself are absolutely tiny, although we note that half of the reduction is in the more toxic MBAs which is both brave and sensible in the long run, but is really just a reminder that it's a long way back; a $10 billion a month reduction to a $4 trillion balance sheet won't see a return to normality soon however fast you go.

This does not mean that QE is now consigned to the dustbin of history. Janet Yellen takes over the wheel of the Federal Reserve with a reputation for a dovish approach to the management of the economy. Her appointment, not without some controversy at the time, and not Obama's first choice, is an interesting one given her background. Where Ben Bernanke was an academic of the aftermath of the 1929 crash, Janet Yellen is a Keynesian economist whose decisions may be guided by a greater emphasis on unemployment rather than inflation. In 1995, on the Board of Governors at an FOMC meeting, she said that letting inflation rise could be a "wise and humane policy". In the here and now, perhaps Bernanke's last press conference gave some indication of how Yellen will carry on. Emphasising her endorsement of the tapering move, when asked why job growth had not been stronger in recent years, he said "People don't appreciate how tight fiscal policy has been". In any case, the Fed's measure of core inflation, which strips out food and energy, has fallen to 1.1%

So long as interest rates do stay low, rising bond yields do not necessarily create a hostile environment for equities. Indeed, following the news, the Dow Jones equity index raced up to an all time high. This is more than just a sense of relief, for it marks a welcome return to the familiar scenario of good news on the economy being good news for shares. This is the opposite of what tended to happen back in May when the Fed first announced that tapering was on the cards. Back then, only bad news was good for shares because it meant the stimulus was here to stay for longer. It was a crude and uncomfortable

environment to have to invest in.

But 2013 was a great year for those with the patience and conviction to stay overweight equities, particularly for TAM where we shifted the bias towards small and mid-caps away from income.

As we enter 2014, we do not expect equity markets to crack in the face of the tapering issue. That's not to say there won't be any setbacks. There are any number of geopolitical issues lingering on the sidelines that could spark a round of profit taking. Look out for naysayers talking about expensive equity price to earnings valuations. Yes, it is true that in the context of the 6 years since the pre-crisis summer of 2007, share P/Es are at the top of a range around 10 to 15 times earnings. But so what? If you've been around and investing since the 1980's, as we have, the more normal range is 12 to 25 times. And has no one ever heard of a re-rating?

However, even as the Federal Reserve keeps the pedal to the metal, we will be still be reliant on a good economic news to support shares. Thankfully, the UK is evidently faring better than most with GDP now revised up from 1.5% to 1.9% and inflation here in the UK remains relatively benign, although the Bank of England lost interest in that some time ago. This could be an excellent get-out for Bank of England Governor, Mark Carney, who may enjoy a period of falling unemployment and rising productivity but without the pressure to raise rates so long as inflation is constrained.

We therefore enter 2014 with a broadly positive view on equities intact, together with our now familiar negative view on Gilts. Overweight positions on equities will be quite modest, for we have exposure to excellent investments that comprehensively outperformed the main UK equity indexes in 2013 but with lower risk. But, as we continue to invest for the long term, we will be alert to any short term opportunities that arise if we believe that the risk/reward is fully justified.

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