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Econotes is a research publication available free on request. It is not a solicitation for business. It is devised and written by Dr. Andrew F. Freris based on 46 years of market experience which included senior positions with GT Capital, Salomon Brothers, Bank of America and BNP Paribas as well senior academic posts with universities in London and Hong Kong

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US FED TAPERING AND ITS EXPECTED IMPACT ON EMK AND ASIAN EQUITIES

Summary

- The most commonly expressed fear over of the actual shrinking of the Fed's balance sheet, and not just tapering, is that it will cause a huge withdrawal of funds from global markets and from EMK/ Asia in particular.
- For this concern to be based on facts, it has to be proved that the various QE initiatives of the Fed since 2009 caused a large flow of capital from the US to global markets, and Asia in particular. Unfortunately there is just no direct evidence for this. Hence the end of Fed injections will cause yields to rise and could impact equities, but it will not necessarily cause a "repatriation" of capital back to the US.

Investment Conclusions

- There is no clear evidence that funds created by the Fed flowed to Asian equity markets, or indeed in any other non-US market. This claim in no way denies the impact of lower/higher UST (US Treasuries) yields on global rates and, hence, on equities
- It would now follow that once the Fed shrinks its balance sheet the impact on equity markets will depend on the initial impact of higher UST yields and not on fund "repatriation"
- The impact of this on Asian equities will be highly differentiated, as Asian yields have very varied links with USD rates

Fed pumps, but here does the money go ?

Essential to our argument is a clear understanding of how the Fed injects money in the US financial markets.

The Fed buys from banks "second hand" bonds only, and does not participate in auctions, especially for UST, where it is expressly forbidden to buy "freshly issued" government bonds thereby funding directly the fiscal deficit of the US government. The Fed's operations in the secondary markets cover UST and Mortgage Backed Securities (MBS) issued by banks and other financial institutions.

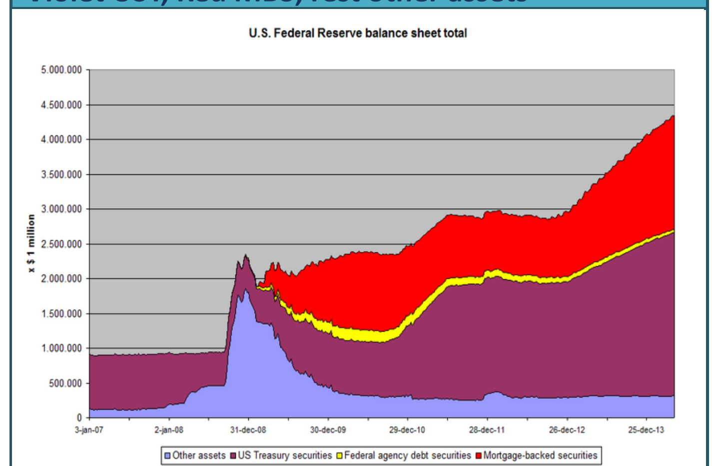
By standing willing to buy any amount of bonds offered in these secondary markets, the Fed effectively guarantees the prices of these bonds, keeping them high and thus yields very low. The participating banks and other financial institutions are willing to buy these new bonds knowing that there is little or no downside plus guaranteed liquidity when they want to sell. With Fed funds targeted at 0.25%, but currently at 0.09% it is clear that carry trades are also guaranteed to be profitable, borrowing cheaply at the short end and lending expensively in the longer end. Currently 2Y UST yield are at 0.45% and for 10Y at 2.60%

The Fed started in 2009 with a balance sheet of about USD 2.6 tr and in June 2014 had increased via QE1 to 3 to USD 4.30 tr consisting of USD 2.4 tr of UST and USD 1.64tr of MBS, the rest of USD 264 bl being other loans, an overall increase since 2009 of USD 1.7 tr. (Chart 1)

Question: What happened to that USD 1.7 tr ?

The banks which sold these securities to the Fed were primarily US institutions which shifted from long term assets, UST and MBS, to extremely short term deposits with the US Fed, USD 2.7 tr (6/2014)

Chart 1: US Fed sumary balance sheet, 2007-2013 Violet UST, Red MBS, rest other assets



Source: Wikipedia

Did this money to go equities or non-UST bonds ?

It is virtually impossible to trace on a micro level what happened to the increase in the reserves of US banks which reflected the rise in assets of the Fed. For these banks to have channeled money to EMK/Asian equities they would have had to do it by shifting out of Fed funds to EMK shares. This could have been done indirectly by lending/investing to/with other entities. Both cases are highly unlikely as these banks would have needed to do a very risky portfolio shift from very safe and liquid assets (deposits with the Fed) to EMK shares or bonds directly or, worse, indirectly via loans/investments to/with intermediating investors such as hedge funds. What did happen, however, is that the additional liquidity created pushed USD rates and yields at historic lows, made funding via the USD exceptionally cheap (and safe in the medium term as the Fed guaranteed low rates for a long time).ALL THIS LED TO A PORTFOLIO ADJUSTMENT AWAY FROM SAFE TO LESS SAFE ASSETS INCLUDING EMK SHARES. This, interest rates-led portfolio shift has been misinterpreted as a "wall of US money flooding EMK markets", disregarding the fact that a main beneficiary in terms of performance was the S&P 500, while the Nikkei 225 was driven by totally different considerations, namely the BoJ policies. It can be expected that, symmetrically, once USD yields rise, equity markets may suffer. However the degree that these markets will be affected will depend on their sensitivity to movements in USD yields.

FACTBOX : The evidence from Asian forex reserves

If Fed-generated funds had come into Asian markets the impact would have been registered not only in equities but also in forex rates. A proxy for this can be the movements of forex reserves, as most Asian economies maintain a degree of control over their forex rates. China's reserves moved at the start of 2009 from USD 1.9 tr to currently at USD 3.9 tr, a rise of USD 2.0 tr, well in excess of the rise in the Fed balance sheet of USD 1.7 tr.But then China has also registered a current account surplus throughout this period and, currently, is the single biggest holder of UST at USD 1.2 tr. Clearly here there was a wall of money coming from Asia to the US!

Chart 2: Gvt 2Y bonds,2009=100-2014,Red US,Blue India,Green Brazil,Violet Indonesia,Yellow HK

Source: Bloomberg

Bringing it all home

In terms of pure rates impact, as Chart 2 shows, Asian markets vary significantly in their responses to USD yield movements since 2007, with the extreme case being the USD-pegged Hong Kong, which will clearly "suffer" most once USD yields rise.

Since 2007 the movements of Brazilian, Indian and Indonesian 2Y government bond yields did not correspond closely, or even at all, to UST movements (or absence of) **.**

Although absence of evidence of impact on Asian equities via Fed-fund generated flows does not prove evidence of absence of these flows, it does lead to a preliminary conclusion.

Any impact on Asian markets (but,note, NOT on the Japanese markets which took off in 2012 and then collapsed in 2014 independently of the Fed QE gyrations) may well have been a combination of interest rate effects and of portfolio shifts. The Chinese market (partially closed) since 2009 has been the worst performing market in Asia, Fed flows or no flows.

Once the Fed starts to shrink rather than just taper its balance sheet, Asian equity markets will perform in a differentiated manner as they have done so far, a conviction strengthened by the absence of consistent links in UST yields and those of benchmark Asian and indeed Latam bond yields (Brazil).