UBS

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Asset management

Bearing the market

Economist Insights

When the Fed raised rates in December, who would have expected equity markets to enter virtual freefall? After all, the hike was no surprise. So, are there other forces behind the equity bear market that has prevailed since last summer? Might it be that the increase in real rates since the Fed tapering, combined with fears about global growth and the plummeting oil price have been the real drivers of financial markets?

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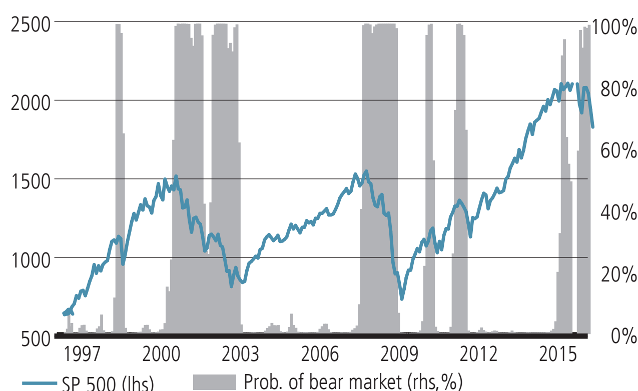
Never has monetary policy looked so powerful. One month the Federal Reserve hikes rates by just 25 basis points in order to tighten financial conditions slightly, and the next month equity markets are in freefall. The MSCI world index has fallen by almost 11% year-to-date. Monetary policy is meant to take a lot longer to have much impact, and never to have that much impact. Especially when it has been so well signalled in advance. The Fed must feel as if it lit a small firecracker but got an explosion like a bomb.

But is this really the result of Fed tightening? Periodically the equity market gets into a self-perpetuating negative mood, returning nothing or looking for excuses to break lower. The equity market actually entered such a bear market last summer and has pretty much been in one ever since (chart 1). The imminent start of the rate hiking cycle may have contributed, but a combination of weakness in China and other emerging markets, plus the sharp fall in oil prices with an inventory correction in the US were probably more important.

Chart 1: Here be bears

SP 500 and probability of being in an equity bear market (i.e. negative returns and high volatility)



Source: Bloomberg Finance LP

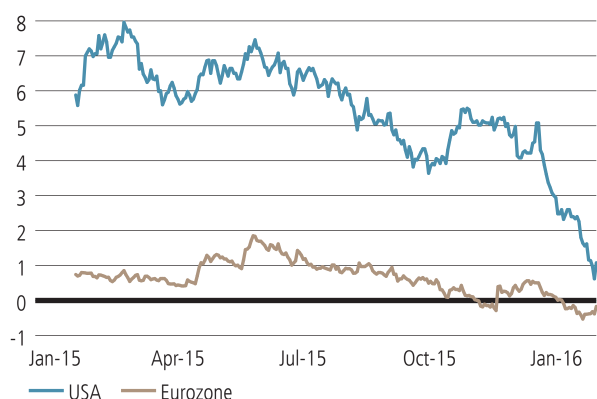
In this environment of fear, the market was looking for some reassurance from Fed Chair Janet Yellen during her semi-annual testimony to Congress. While she did sound some dovish notes, it is always a good idea to apply the counterfactual test. What else could she have said? For example, if she had not mentioned the market turmoil the market would have interpreted this as extremely hawkish, signalling that the Fed did not care about the messages from the market. What she did say was the bare minimum, effectively saying that as long as things did not worsen the Fed would continue hiking this year.

The market is having none of it. Even if the market believes that the Fed wants to hike, it does not believe that circumstances will be strong enough to allow for further tightening. Back in November, the market did not believe the Fed would be as hawkish as the FOMC projections suggested (see *Splendid Isolation*, 2 November 2015), but nonetheless they were pricing 5 hikes by the end of 2017 (chart 2). Since the bear market in bonds really took hold in January that expectation has been slashed and now it doesn't even fully price in any rate hikes at all this year or next.

In the Eurozone the market is looking for further rate cuts, pushing deeper into negative territory. But unlike the US this expectation most likely reflects the announcement made by Draghi at the January meeting rather than a correction in expectations led by market fears. What was the 'great divergence' between the Fed and ECB is now starting to feel more like a great convergence. Despite this narrowing of the differential, the ECB continues to look a lot looser than the Fed - quantitative easing (QE) is still ongoing in Europe and the program is likely to become much bigger.

Chart 2: Punting on a 'put'

Number of 25 basis point rate hikes priced into the market by end 2017

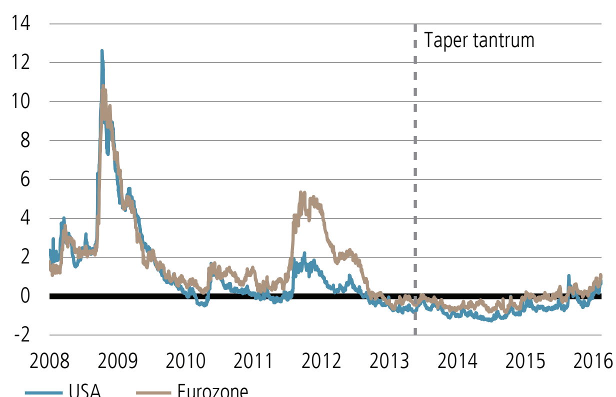


Source: Bloomberg Finance LP. Note: USA is based on Fed Funds futures, Eurozone is based on EONIA.

This is clear when we look at measures of financial conditions. Financial conditions have gradually become tighter in the US (chart 3), yet in the Eurozone they remain very loose. But to be fair, it is not as if financial conditions are all that tight in the US, at least according to most measures. Conditions were tighter in 2011 and 2012 during the Eurozone sovereign crisis, for example.

Chart 3: Not really tight?

Bloomberg financial conditions indices (higher is tighter)



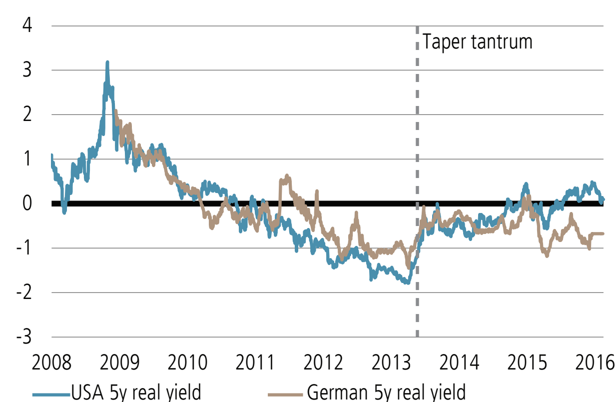
Source: Bloomberg Finance LP

The recent turmoil appears to have happened too quickly and too suddenly to be blamed on the first rate hike in December. After all, it's not as if the rate hike came as a surprise. And given the lag in its transmission to the economy it has not had enough time to have an impact yet (for as much as 25 bp can have). The bigger surprise over the last year or two has been inflation, brought down by sudden drops in energy prices. Financial conditions indices are effectively nominal, since they only use nominal variables. So it makes more sense to look at real interest rates (which take into account inflation) to figure out what has happened to underlying financial conditions.

A quick look at the yield on the 5-year inflation-linked US Treasury bond (TIPS) shows that real yields have been rising for some time (chart 4). The real turn in the monetary cycle came when then-Chair Ben Bernanke announced that the Federal Reserve would start to taper their QE programme. The resultant dislocation of the markets from a world of continual easing to one of eventual tightening was dubbed the 'taper tantrum'.

Chart 4: Really tight?

Real yield on 5 year inflation linked government bonds



Source: Bloomberg Finance LP

Before the taper tantrum, 5y real yields were almost -2%. In practice what that means is that you could borrow money today and would have to give up less purchasing power to pay it back five years from now than you gain by borrowing it today. The taper tantrum cut this benefit in half, but since then 5y real yields have risen steadily and are now positive. This is not much in the way of purchasing power to give up, but markedly different from the 'free' money of earlier years.

It could well be that the market stresses now are simply the lagged impact of this underlying real tightening; the timing is just unfortunate enough to make it look like the direct result of the first rate hike. Or it could be a combination of factors: asset pricing that was predicated on lower real yields are bound to end up stretched but perhaps not break. But combine those real yields with concerns about global growth and the valuations can end up breaking.

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