How Fed Tapering Will Affect Markets Worldwide

Last week, the Federal Reserve announced it would taper its monthly bond purchases to USD75 billion from USD85 billion beginning in January 2014, as job growth and other economic indicators reflected an improving economy. This is a move which incoming Fed chief Janet Yellen agrees.

In fact, as early as September 2013, the Fed was dropping clues in its Federal Open Market Committee (FOMC) minutes. One thing was clear from their statements – the tapering decision would hinge upon better economic data.

Here's three quick reasons why the Fed decided to announce its tapering decision at the end of 2013:

1) ***Economic Figures –*** Economists were forecasting December's Non-Farm Payroll (NFP) figures to come in at 180K, but the official figures were 203K, a positive surprise for the market. This brings the 4-month NFP average to 204K. The 200K mark was a crucial factor in the Fed's tapering decision.

2) ***Budget Deal –*** The US Senate has approved a bipartisan, 2-year budget agreement last week with a 64-36 vote. The figure for the federal spending for 2014 has been set as USD1.012 trillion, which is the mid-point between the Republicans proposed figure of USD967 billion and the Democrats USD1.058 trillion. It is important to note that the budget deal does not raise the debt ceiling, nor does it extend long-term unemployment insurance.

3) ***Credibility –*** In May 2013, Ben Bernanke mentioned that the tapering of assets could arrive later in the year and would consider entirely ceasing Quantitative Easing (QE) if unemployment dropped to 7%. Deciding to taper in the last month of 2013 would essentially keep his credibility intact in the record books.

An interesting point to note was the reaction of the market. Most traders and economists would think that a tapering decision has the following effects: a rise in the value of the US dollar and a drop in the equity markets. The rise in the US dollar was seen in the Forex market with the USD/JPY rising over 150 pips in a few hours, and the EUR/USD dropping over 150 pips in the same time.

However, the anticipated drop in the equity market didn't happen. In fact, the Dow Jones Industrial average climbed more than 200 points in the two hours following the tapering announcement.

Why?

The answer, lies in the 3 words called “Enhanced Forward Guidance.”

In the public conference, Bernanke said “Reflecting cumulative progress and an improved outlook for the job market, the committee decided today to modestly reduce the monthly pace at which it is adding to the longer-term securities on its balance sheet.” This result of this sentence is the USD10 billion tapering from USD85 billion to USD75 billion.

However, an equally powerful statement was that the Federal Funds interest rate will remain at virtually zero “well past the time when the rate of unemployment reaches 6.5%”, especially if projected inflation continues to run below the Fed’s 2% goal.

This is the best of all possible worlds when people in charge foretell future actions on monetary policies - hence the term “enhanced forward guidance.” The Dow Jones rocketed to a new high because the markets interpreted “enhanced forward guidance” to be a stimulus for stock prices moving higher.

In the same press conference, Bernanke mentioned that the Fed may taper its buying by about USD10 billion per meeting, which means that the QE program will effectively end in 2014. Such stunning transparency about interest rates and monthly bond purchases are a boon to Wall Street bankers and global financiers, who will find decision-making a lot easier without the guesswork.

Germany Shines in Europe

Data coming out of Germany continues to shine with the IFO business climate index rising to its strongest level since April 2012. German businesses grew more optimistic in the month of November and even though the increase was in line with expectations, it is still indicative of momentum and strength in the Eurozone's largest economy.

Some investors were worried about the decline in current assessment but the expectations component of the index rose to its strongest level since March 2011. In other words, German businesses have not been this optimistic about future opportunities in more than two and a half years. While this is great news for the country and the region as a whole, the European Central Bank (ECB) still needs to see this same pace of growth in other parts of the Eurozone.

As German Chancellor Angela Merkel recently said “Europe is not yet over the mountain on crisis."

As traders, it is important to note the stark contrast between the divergent policies of the Fed and the ECB. The Fed is starting to unwind its stimulus which gives rise to a hawkish sentiment, but the ECB remains decidedly dovish.

I expect rates to remain low in Europe for an extended period of time and this reality should make the euro less attractive compared to other currencies such as the GBP and NZD.

In summary, the unwinding of bond purchases by the Fed is definitely bullish for the US dollar. Now that the central bank has hinted that QE could end in 2014, I expect to see the first rate hike in 2015. Additionally, 10 year bond yields could rise above 3%, creating more demand for US dollars in the process.

My top takeaways:

1) Stocks will continue to trend higher in 2014 with the "enhanced forward guidance" approach by the Fed

2) USD/JPY to hit 105.50 and the EUR/USD to head towards 1.35 in the near term

Mario Singh is the Director of Training and Education at FXPRIMUS, Asia's fastest growing brokerage firm.