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INSIGHTS

February 2014

Forget about Tapering… Focus on Interest Rates

Tapering begins.

Since the US Federal Reserve Board announced it was reducing its monthly purchases of US bonds (from $85bn to $75bn to $65bn per month)[1] , investor concerns have flared.

Many fret that with 8 Open Market Committee meetings slated for 2014, the door is opened to a reduction of $10bn per meeting in the monthly bond purchases. On this basis, quantitative easing would finish by year-end. Investors fear that accelerated tapering will lead to (a) a rise in US (and world) interest rates and (b) an outflow of capital from Asia.

The two are interlinked; many fear that an Asian capital outflow would trigger a round of Asian interest rate hikes. They point to recent hikes in both India and Turkey as evidence; the causality may not be so simple, we suspect.

Tapering's impact on US and global interest rates could be less than feared.

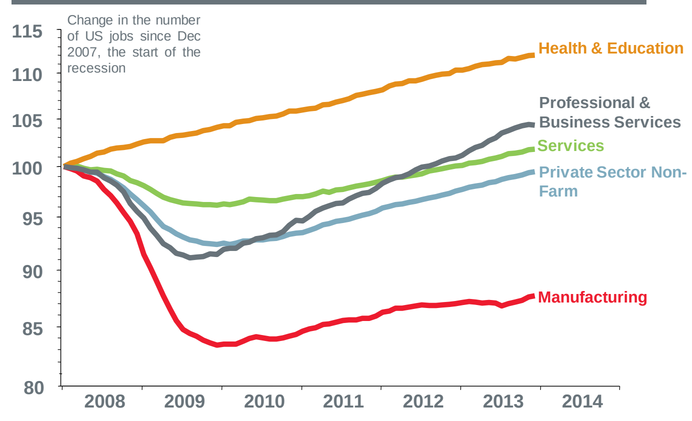
Despite recent encouraging data, other data suggests the US economy, though mending, remains weak.

The unemployment rate, for example, is falling. But if this was falling because people were finding jobs, the employment per population numbers would be rising. They are not, which implies that a growing number of people are leaving the workforce.

Jobs are being created, but not where it counts in the manufacturing sector (they are rising slowly).

A surge in new jobs could signal a more aggressive Fed rate stance. It all depends on where those jobs are being created. If they are in the manufacturing sector, a more aggressive stance seems likely. But if

US manufacturing jobs are slow to recover



Source: US Bureau of Labor from Thomson Reuters Datastream as at 3 February, 2014.

they are in the services sectors, the Fed could well be more dovish.

This caution is echoed in the "soft" US capex outlook; non-financial companies in the S&P 500 index are forecast to increase capex by only 1.2% in the year to October 2014 – a four year low[2] .

This reluctance to invest is despite the cash piles on which companies are sitting. Until the confidence evident in the PMI new orders outlook translates into firm orders, caution will likely persist. While household spending, the major driver of the US economy, could rise as a result of rising non-farm payrolls, it is worth noting that much of the reduction in the US household debt financing burden is due to falling interest rates rather than loan repayment.

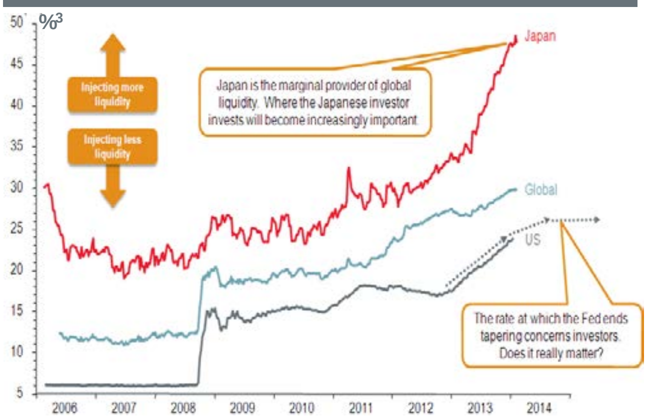
In all, it seems that the US economy is in no shape to take a significant rise in interest rates. Indeed, with inflationary pressures low, there is little incentive for the Fed to raise rates significantly.

Source: [1] As reported in the Financial Times, 30 January 2014. [2] Factset as reported in the FT, 24 January, 2014.

Tapering ≠ Rising Interest Rates

The Fed has frequently delineated between an end to quantitative easing and a rise in interest rates. We have also argued that a pool of global liquidity remains, which should restrain any upward pressure on rates.

Rising global liquidity should cap rates



Source: Eastspring Investments (Singapore) Limited from the relevant central banks and official data sources on Datastream as at 27 January 2014. [3]The assets of each central bank's balance sheet as a percentage of nominal GDP.

Bond markets too seem in better shape after the latest tapering news than last year after tapering fears first hit. Bonds then re-priced significantly (as our chart below illustrates).

Bonds globally seem to have discounted tapering

Source: Barclays Capital, HSBC, and JP Morgan from Datastream as at 27 January 2014. Unless indicated otherwise, all data are in USDs. *= Investment Grade, ** = High Yield, ***= Local Currency.

Having said this, domestic issues within some emerging bond markets, let alone a high level of foreign ownership, could result in yields moving higher with more short-term volatility.

The bottom line

Even though QE may be over by year-end, US interest rates could remain low for some time yet. The market is suggesting that rates will rise only by mid-2015. If our assessment of the US recovery is accurate, it could be longer.

The market expects the first rate hike in mid-2015

Source: Source : BoA Merrill Lynch 8 January, 2014. The series is constructed using a combination of Euro Dollar Futures, OIS and Fed Fund futures

Investment conclusion

For those who have invested in a bond fund, there seems little reason to sell *as long as* they are buying the fund for income. If they are buying for capital growth and if higher volatility is an issue, they should consider switching into a fund where volatility is commensurate with the potential return (such as a dividend income fund).

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