Into Choppier Waters

The serenity of equity markets is deceptive.

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Another month, another rise in major equity indices. Indeed, it has been very smooth sailing for stock markets for six months or so now—or at least that's how it has appeared on the surface. Underneath, the crosscurrents are changing and tensions are starting to build. What does this mean for financial markets?

In my view, the strong performance of risk assets has been underpinned by two key forces. The first—and probably most important—is the fact that the economy is still early in the "expansion" phase of the business cycle. There is currently both pent-up demand (which facilitates rapid growth) and slack resource utilization (which means central banks are happy to accommodate that growth without tightening monetary policy). In other words, the current environment is very benign for risky assets. The shift to the next stage of the business cycle will not occur overnight, but as the economies reopen fully and as pent-up demand is gradually released, the transition will likely begin. At that point, fuller resource utilization will justify a tighter monetary policy stance.

The second force driving risky assets is liquidity: Over the past 16 months, markets have surfed a liquidity wave of unseen proportions. Unlike the business cycle, liquidity can change rather rapidly—and it seems to me that we are at the cusp of an inflection point. The U.S. Treasury has been on a spending spree over the past five months, which it has financed by drawing down its historically large cash balance at the Federal Reserve (Fed). This acceleration in quantitative easing (QE) has now reached a crescendo and will, over the coming months, begin to reverse in my view. However, as investors have been paying insufficient attention to the QE surge (perhaps understandably, given the number of distractions around), its reversal will probably surprise them.

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The Fed Begins to Talk About Tapering

Another challenge to liquidity came when the Federal Open Market Committee (FOMC) indicated in its June meeting that it is time to discuss scaling back the Fed's official QE program. Of course, the Fed will not end QE overnight—it will most likely taper asset purchases

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through the whole of 2022—yet merely talking about tapering brings back the memories of the 2013 taper tantrum and can prompt some investors to take a more conservative view on the market for risk assets.

This is part of a global pattern. Over the past few months, central banks in peripheral countries have started to tighten monetary policy both by scaling back their QE and by hiking interest rates. Until now, these forces have had only a negligible impact on the financial market given that the core central banks—the European Central Bank and the Fed—have been resolutely dovish. However, a growing number of FOMC members have begun to voice concerns about the dovish posture.

These concerns reached an apex at the June Fed meeting, when several members of the FOMC indicated that they believed interest rates would be hiked over the next one to two years. My guess is that these hawkish individuals are probably not the key decision-makers in the FOMC, and in my view, they are overreacting to noisy inflation observations. I'm not saying that interest rates should remain on hold until the end of 2023—most likely, the economy will have recovered very substantially by then and rate increases will be completely appropriate. My point is simply that, when it comes to financial markets, talking about interest rate hikes has pretty much the same effect as actually tightening monetary policy—and the Fed has just dialed up the volume on the interest rate discussion.

Volatility Looms in the Autumn

So where does all this leave financial markets? I continue to think that the most important force—the business cycle stage—remains friendly to investors and that, therefore, the path of least resistance for equities is still upward. However, the change in the liquidity tide, and the discussion about when the Fed will raise interest rates and taper asset purchases, is likely to bring volatility back to the financial markets. My guess is that these forces will collide in the late summer/early autumn, and I anticipate an autumn that will be much harder for investors to navigate than the liquidity-pumped markets of the past few months.

Personally, I'm inclined to look to the currency markets, which are more jittery than equity markets, for any indications of a changing storyline.

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