



Volatility Looms as Support Is Withdrawn

The supportive business cycle will likely provide opportunities, however.

October 2021

The U.S. Federal Reserve (Fed) is on the verge of announcing that it will begin tapering asset purchases, following similar moves from the European Central Bank and some other, more peripheral central banks. At the same time, U.S. government tightening will soon turn fiscal policy from a tailwind into a headwind. What impact will this have on financial markets?

The business cycle remains the most useful starting point for any discussion about markets—and, by and large, the global economy remains relatively early in the “expansion” phase. At this stage, there is a “Goldilocks” combination of pent-up demand and slack resource utilization—the former serves to keep growth above potential, and the latter keeps inflation pressures at bay. This allows central banks to retain an accommodative monetary policy stance. Overall, then, the business cycle is currently very supportive for financial markets.

The withdrawal of policy support is changing the picture, however. Although peripheral central banks have been scaling back support for the past few quarters with little impact on financial markets, the road is likely to get bumpier as the Fed and other major central banks join them.



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When money is pumped into the economy via quantitative easing (QE), investors are left with excess cash that they are happy to put to work when sell-offs occur—meaning those sell-offs tend to be shallow and volatility remains low. When QE is scaled back, the growth of investors’ cash balances slows, meaning there is less money to put to work during the next sell-off. As a result, sell-offs become more persistent, and volatility increases.

It is important to remember that we have been through a period of quantitative easing by stealth: As the U.S. Treasury has ramped up spending, it has pumped money into the economy by reducing its unusually large cash balance at the Fed. In this fashion, the U.S. Treasury has substantially augmented the quantitative easing administered by the Fed. Unfortunately, just as the Fed is soon expected to announce the tapering of its asset purchases, the U.S. Treasury

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finds itself with unsatisfactorily low cash balances. Consequently, the U.S. Treasury will embark on “quantitative tightening” at the same time the Fed reduces its quantitative easing. The result? Rapidly declining support for risk markets.

The U.S. is also in the driver’s seat on fiscal tightening. While fiscal policy is set to remain relatively supportive across the eurozone for the time being, the U.S. is set to tighten significantly in 2022. As the U.S. is the world’s biggest economy, this means that, overall, fiscal policy will likely have a meaningful negative impact on global growth over the next 12 to 18 months. This would reduce support for growth-based assets such as equities. However, the fact that fiscal deficits remain large means that wealth should continue to be transferred from public to private sector balance sheets, which would continue to provide support for risk assets in general.

While this is happening, the Republicans and Democrats squabble over how to raise the debt ceiling—the legal limit on the amount of debt that the U.S. government can incur.

We are set to go through another round of brinkmanship that, most likely, will result in a last-minute agreement. Last-minute agreements, however, increase the likelihood of mistakes. Should the U.S. fail to meet its payment obligations because of an impasse over the debt ceiling, financial markets may suffer a risk scare.

Investors should also be alert for further negative surprises from Chinese data. China is going through a policy-engineered growth slowdown as authorities rebalance the economy. I believe that Chinese policymakers are deeply committed to this reorganization and that the markets have not paid enough attention to the implications this has for growth.

So, as policy support fades, investors should brace for more volatility. However, as the business cycle remains supportive and large fiscal deficits persist, any price fluctuations will likely provide favorable opportunities for investors who manage their portfolios to ensure that they can try to take advantage of pullbacks in risk.

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