What will investors be facing in the coming months: the Fed's tapering and Evergrande

For our October article, we are addressing two much talked issues: the end of Quantitative Easing (QE) by the Fed, and the recent real estate problems that hit China's Evergrande.

Fed's tapering: what does Tapering mean and how will it impact markets?

Monetary policy – particularly in the US – impacts global markets. As the Fed starts to talk of its tapering timeline, we take a look at what that really means and how it could play out on US stocks, indices and global assets. Tapering is the reduction of the rate at which a central bank buys new assets. It's most commonly used when talking about the reversal of quantitative easing policies and is regarded as the first step in winding down from a period of monetary stimulus. Tapering is just another tool used by central banks to control interest rates and the perception of future rates. QE programs are put in place by central banks to stimulate economic growth. Once the desired targets have been met, a central bank will start to reduce its acquisition of assets. Central Banks have to taper their spending because continuing expansionary policies can lead to over-inflation and bubbles. For example, up until August 2021, the US government was buying $120 billion worth of assets each month in a bid to aid the recovery from the coronavirus pandemic – a program it had started in March 2020. When the US government starts to reduce the value of assets it buys, say from $120 billion to $100 billion, that would be the start of QE tapering.

What is the impact of tapering on markets?

Tapering often leads to the collective panic that follows the central bank reducing its QE program. As central banks start to buy up fewer assets, fears that liquidity would decline cause investors to fear the global market could crumble. This "panic" often plays out across bond prices. And when bond prices fall, bond yields rise. There's always the potential that shares and indices could follow, since the bond market is believed to support stocks. However, in previous tapering scenarios, this has never actually happened. We have already been exposed to tapering in the past (2013 and 2018), but this is a new breed. The panic of 2018 had its roots in the Fed's reduction of its balance sheet in conjunction with a raise in interest rates.

The Fed's tapering program 2021

In August 2021, expectations that the Federal Reserve would start to taper its buying of assets caused a taper tantrum in which commodities and global shares fell. After recovery from the Covid-19 pandemic caused stock markets across the world to rally, news that US monetary policy could start to pull back led to fears that optimism had peaked. However, the tantrum only lasted a day as markets waited to see what the next monetary policy meeting had in store. This tapering is due to end in spring 2022.

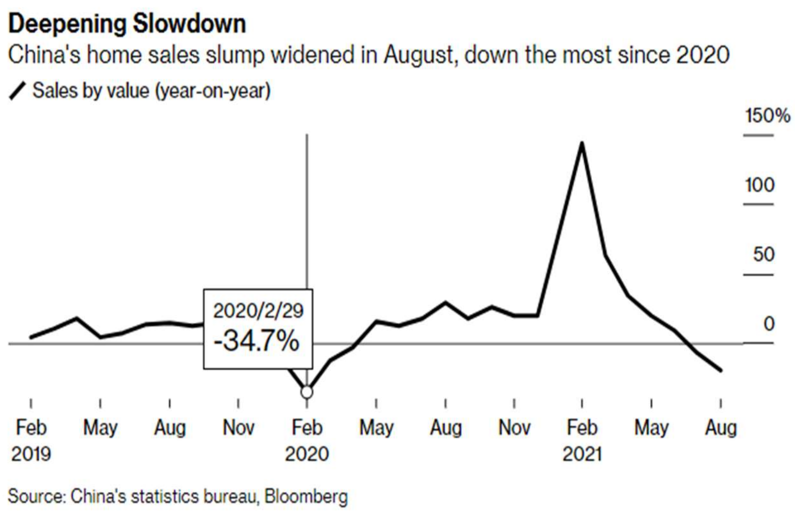
China real estate issues: Evergrande

China's residential property slowdown deepened last month, signaling that regulatory tightening and an escalating crisis at the country's most indebted developer are hurting buyer sentiment.

Home sales by value slumped 20% in August from a year earlier, the biggest drop since the onset of the coronavirus shut swathes of the economy at the start of last year, according to Bloomberg calculations based on National Bureau of Statistics data released Wednesday.

New-home prices in 70 cities, excluding state-subsidized housing, rose only 0.16% last month from July, the slowest pace this year, the data showed. Prices in the secondary market dropped for the first time since February 2020, slipping 0.02% from a month earlier.

Softness in the housing market is becoming more evident as regulators' efforts to curb the real estate sector coincide with a worsening cash crunch at China Evergrande Group. Higher mortgage rates, tighter rules for home purchases, and measures to curtail excess borrowing by developers have all weighed on the market.



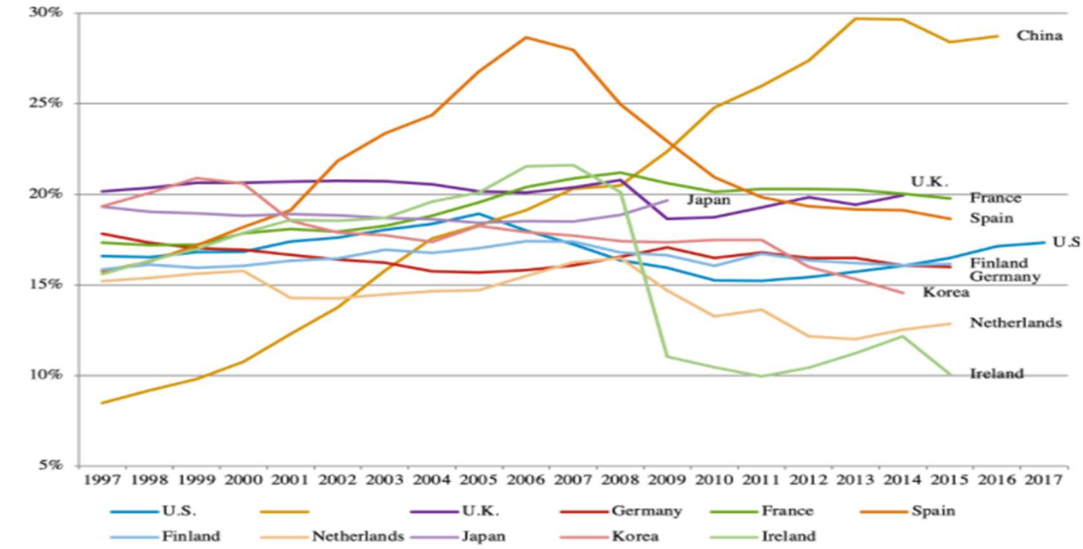
The turmoil at Evergrande is catching the regulator attention. The Chinese National Bureau of Statistics said on Wednesday that some large-sized property companies are encountering some difficulties, and that the impact on the real estate industry needs to be monitored.

Numerous sectors could be exposed to credit risks if Evergrande was to default, Fitch Ratings wrote in a note Wednesday, adding smaller banks and weaker developers would be hurt the most. Still, such a scenario wouldn't put significant pressure on housing prices nationwide, given the developer only has a 4% share in a highly fragmented market, the ratings company said.

Authorities haven't shown signs of easing up on the property industry, with Vice Premier Han Zheng saying in July that it shouldn't be used as a short-term boost for the economy.

"Tightening over the real estate sector has been unprecedented recently, and it's clearly had an impact," Song Hongwei, a research director at Tospur Real Estate Consulting Co., said before the figures were released. "More developers are resorting to price cuts to recoup cash, as it becomes harder to get proceeds from mortgages and other fundraising methods." Sometimes we feel that some agencies are somewhat detached from reality and the operators in the real markets are more down to earth as perception of the environment.

Real Estate contributes for approximately 1/3 of the overall Chinese GDP, and that for too long the central government has closed an eye giving way to increased speculations. It’s now confronting the dragon it let loose, but the balance between too much or too little intervention is extremely delicate.



Note: This figure presents the impact of real estate related activities on total GDP in China, U.S., U.K., Germany, France, Spain, Netherlands, Finland, Ireland, Japan, and Korea..
Source: Rogoff and Yang (2021).

In the event of a collapse, the Chinese economy and its financial system will suffer a huge blow along with a domino effect on several other domestic sectors. It will also have an impact on the global economy, especially financial institutions and businesses that are directly and indirectly linked to real estate and housing. One lesson to be drawn though: perhaps too big to fail is no longer a valid mantra.

Overall, it seems that all eyes are turning to China. The recent US-Australia deal concerning the sale of submarines might signal a new “cold war” scenario between the first two planetarian economies, but at the same time words of appeasement have been spoken by Biden and Ping at the recent United Nation’s General Assembly. In my humble view, so long business -and profits-will be running, I do not see that much of a crisis. In any event, it seems that China’s so far closed economy is finally catching all the potential downside of the west’s liberalism. It might be not such a bad signal after all.

And additional preoccupying piece of news is the confrontation between China and Taiwan? Could that develop in a full-blown crisis, so reminiscent of the US-Cuba missiles one of the early sixties? Most likely not as China simply wants to demonstrate that the South China Sea, along with a that “renegade province”, is its backyard and exclusive territory.

Frankly, given the geopolitical incertitude, we’d rather stay on the safe side for the months to come, meaning holding positions as we feel it’s too early to take accentuated risks.

Marcello Tedeschi, October 20, 2021