

What to watch this week: The FOMC and Evergrande

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Markets are watching two critical issues this week. One has been on the calendar a long time — the Federal Open Market Committee (FOMC) meeting — and investors will be looking for any indications about the Federal Reserve's plans for tapering. The second issue has been brewing in the background but is dominating today's headlines — Chinese real estate developer China Evergrande. Evergrande's debt issues triggered a sell-off in the Hang Seng Index that is reverberating through global markets.

Is the FOMC going to announce tapering?

Years ago, I made the mistake of not warning one of my kids that he would be receiving an inoculation at his annual physical examination. I honestly didn't think it was a big deal, but the lack of notification on my part set off a hellacious chain of events that involved yelling, crying, kicking and even an impromptu game of 'hide and seek' under the pediatrician's examination table. Rest assured I never ever made that mistake again. (I also may or may not have toyed with the idea of wearing a disguise at future visits.) The important takeaway from this story is that I made sure that I communicated well in advance any possible jabs or other potential sources of pain.

That's a lot like the FOMC. The Taper Tantrum that was unwittingly set off in May 2013 by then-Federal Reserve Chair Ben Bernanke has been burned into the minds of all current FOMC members, especially Fed Chair Jay Powell, just as the tantrum in the pediatrician's office has been burned into my mind. Powell's behavior — especially his emphasis on warning markets well in advance of tapering — has been informed by that negative experience. And so the Fed has over-communicated that tapering is coming and that it will most likely be announced this fall.

And so we find ourselves a mere hours away from the next FOMC meeting Sept. 21 and 22, waiting with baited breath like the audience at the Oscars, as speeches drone on while we just want the envelope ripped open and the winner announced. Some are anticipating the Fed's tapering announcement will come this week while an increasing number of Fed watchers believe it won't be announced until later this fall. I am a betting woman, and my belief is that tapering will be announced this week and will likely commence soon thereafter. Here's why:

1. Quantitative easing (QE) has had a bigger impact on markets than it has had on the economy. In fact, a number of FOMC members have shared the view that they don't believe QE has had a significant impact on the economy.

That means the bar is much lower for the Fed to start tapering than for the Fed to start rate hikes, which would have a bigger impact on the economy.

2. As I mentioned in previous blogs, Powell made it a point in his Jackson Hole speech to decouple tapering from rate hikes. That gives the Fed more freedom to begin tapering without worrying that it is sending the message that rate hikes will follow soon after tapering begins.
3. Despite the onslaught of the Delta variant, the US economy is doing well. Not all recent economic data has been terrific, but the preponderance of the data indicates an economy that is on solid footing and is improving.

What about the 'dot plot'?

However, I must provide the caveat that the "dot plot" may quickly overshadow any talk of tapering. That's because it's likely that this iteration of the dot plot could be a bit more hawkish than the last one, and that could unnerve markets. The practical implications would be a "risk off" environment, with short-term volatility for risk assets, short-term strength for the US dollar, and a short-term flight to those assets perceived to be safe havens.

But let me stress that the dot plot is a very new concept — if you've been in this business as long as I have. It was introduced in order to provide more transparency, but I believe markets have ascribed far more importance to it than they should. The dot plot is merely a policy prescription provided by each individual member of the FOMC. This is each member's best guesstimate of what they would advocate for in terms of rates in the future given the current state of the US economy.

But that's not the way the Fed actually works. Thank goodness the Fed doesn't vote today on rate hikes for one or two years in the future; that would be like driving with a blindfold on. Instead, the Fed is continuously reviewing data and updating its view on the US economy. So guesstimates about what an individual Fed member would do in 2023 is rather irrelevant, since they haven't seen the data for 2022 yet. We're not in some science fiction movie like "The Minority Report" where three clairvoyants can tell us what the future holds and Tom Cruise can arrest future criminals. In other words, take the dot plot with more than one grain of salt.

Markets react to Evergrande's debt problems

Finally, I also would like to say a few words about the sell-off in Chinese stocks that has extended to other markets. The trigger for the sell-off is one company, China Evergrande, a real estate developer with a heavy debt load which has been in the news for weeks. Evergrande is struggling to pay its lenders and investors as well as its business partners, such as suppliers. Evergrande has been trying to raise cash by selling property but warned in a letter on Aug. 24 that it needs help from Chinese policymakers in order to remain viable. Because of Evergrande's size, it has the potential to impact many companies and the overall economy in China, which is why its difficulties have reverberated through Chinese markets, dragging down stocks and bonds.

Evergrande has approximately \$300 billion in liabilities¹ and more than \$80 billion in interest coming due later this week² – which is why market fears have intensified. The question is whether Chinese policymakers will deem the company "too big to fail" and give it a bail out, as it has done on occasion for other companies in the past, or whether Evergrande will need to pursue a different option.

We believe a bail out seems less likely at this juncture given the government's focus on reform. The other two options are a restructuring or a liquidation. We think the more likely scenario is a restructuring, and that Evergrande bonds could actually experience a bounce if that were to occur, which could extend to a broader bounceback for Chinese bonds in general. However, we will want to follow the situation closely. There is the potential that markets remain volatile in coming weeks; there is even the potential for the situation to get worse if there is a liquidation given the potential for some contagion.

As I write this, I am seeing a lot of “red” across my screen. I believe that because global markets are already jittery given a variety of factors, especially the FOMC meeting later this week, they have reacted very negatively to the news about Evergrande. But as with any crisis, I must underscore my view that it shouldn’t cause us to divert from long-term asset allocations; that’s why investment policy statements can be so valuable and help keep emotions out of portfolio decisions. I leave you with one pearl of wisdom from author CJ Redwine: “Losing your head in a crisis is a good way to become the crisis.” In fact, using your head in a crisis could mean finding opportunities, especially in the collateral damage created by a crisis-driven sell-off.

With contributions from Global Market Strategist David Chao

Notes

¹Bloomberg L.P., “China Tells Banks Evergrande Won’t Pay Interest Next Week,” Sept. 15, 2021

²Fortune, “Can Evergrande pay back its bonds? We’ll find out this week,” Sept. 20, 2021

Important information

This does not constitute a recommendation of any investment strategy or product for a particular investor. Investors should consult a financial professional before making any investment decisions. Companies and investments mentioned are for illustrative purposes only and are not buy/sell recommendations.

All investing involves risk, including the risk of loss.

Tapering is the gradual winding down of central bank activities that aimed to reverse poor economic conditions.

Investments in companies located or operating in Greater China are subject to the following risks: nationalization, expropriation, or confiscation of property, difficulty in obtaining and/or enforcing judgments, alteration or discontinuation of economic reforms, military conflicts, and China’s dependency on the economies of other Asian countries, many of which are developing countries.

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