

Pricing the Taper

According to the Bank for International Settlements, the total of public and private debt in the G20 Nations is 30 percent higher than it was before the Great Recession of 2008 and 2009. And when you think of a crisis as a period for deleveraging, or starting to reign in and payback debt, that hasn't been the case across the world's 20 largest and emerging market economies, and policies like ultralow interest rates and quantitative easing have only acted to encourage and exacerbate the issue.

The concern stems from the stimulus driven policies of the world's central banks that have allowed consumers to go out and make big ticket purchases at relatively low financing costs. Buying that new car or managing mortgage payments were made significantly more achievable because of how longer term interest rates were and are being suppressed. But as the Fed enters this period of altering their form of stimulus which they provide to the market by shifting away from an exhausted bond purchase program towards enhanced forward guidance on record low policy rates, the market still conceals a lot of uncertainty that becomes difficult to price in.

We like to believe in the efficiency of markets and that the price of an asset reflects all the current available information to any level of investor. And that encompasses the fact that expectations of future events are priced into the market as well. Hence the episode back in May of 2013 when Chairman Bernanke hinted at the idea of paring back bond purchases, the effect on financial markets was significant because easy money policies from the Fed provided fuel for risky assets. But now that the markets have seemed to have digested the idea of a taper from the US Federal Reserve and the realization that Quantitative Easing (QE) can come to an end, some analysts suggest that this is then realized in the price of financial assets.

But the uncertainty still remains, and unfortunately I think it's more prevalent than ever. Beyond the fact the G20 Nations are more levered than they were before the crisis, the biggest risk to 2014 is that the market has mispriced the effect of tapering QE. As we know, the monetary efforts employed by the US Fed were experimental policies that have previously never been experienced. *It's very difficult to price something into the markets that we have never seen before.*

The McKinsey Global Institute published a challenging paper back in November of last year stating the effects of ultra-low interest rates and a stimulus policy on financial markets is inconclusive. That could suggest the withdrawal of stimulus might not impact asset prices, but this paper has been refuted quite logically by many leading thinkers as it assumes that stimulus level rates had no effect on the real economy. It essentially ignores the fact that businesses were able to finance new projects and lock in record low borrowing rates (which they have), or make those investments in an easy-money environment. The markets are forward looking (and given strong annual returns, economic growth numbers are beginning to echo that), but the uncertainty questions whether the natural players in the market can pick up the slack created by the US Fed's diminished presence.

Whether this market can sustain its momentum once the US Fed no longer plays an as active role in the longer term debt markets is the unknown for 2014. Its without doubt the Fed will remain in its accommodative stance with their forward guidance and projections while maintaining a rock bottom Fed Funds Rate, but the question will be with regards to how the economy will fare one to two years down the road.

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