MARKETS

2014 Hot Markets: Stuck on taper

BY DANIEL P. COLLINS

When U.S. financial markets finished their temper tantrum over the Federal Reserve acknowledging that QE3 would have to end, the prospects of more rational market fundamentals emerged. But as we enter 2014, markets appear stuck on taper.

One of the frustrating elements for traders since the 2008 credit crisis slashed value is the way markets have traded and reacted to fundamental news. There were no trends, just a constant risk-on/risk-off world where opportunity gave way to fear and fear to opportunity, not so much based on the analysis of market fundamentals but on how the Federal Reserve and other central banks would manage the so-called "new normal."

Tempering the taper
New energy world

This appeared as if it may give way this summer as the Federal Reserve acknowledged that the open-ended quantitative easing (QE3) launched in 2012 would have to come to an end. The plan was to begin tapering the $85 billion in monthly fixed income purchases near the end of 2013 and get down to zero by mid-2014.

Treasuries: Is end near?

It turns out the anemic recovery of the last few years was not quite ready to fly on its own and even if it was, political dysfunction may have thrown a monkey wrench into those plans by threatening the world with a self-made economic crisis. While a series of political missteps may have delayed the onset of taper, its inevitability makes Treasuries the most interesting market going forward and adds to the possibility of two-way volatility.

"It will be an interesting market going forward in the same way it was in 2013, but I don't think it is necessarily because the bull market will end," says Andrew Wilkinson, Miller Tabak's chief economic strategist. "The market still has to come to terms with the Fed's forward guidance. The market still has to come to terms with the lack of inflation and the breakdown in correlation between commodity prices and the value of the dollar."

Treasuries overreacted to the initial taper scare in May and since have frustrated those waiting for the 30-year-plus bull trend to end. "I don't think that the Treasury bull market is over. You have to recognize that we really are living in a new normal and we have a fiscal headwind restraining the economic recovery and that there is a lack of inflationary pressure that is going to maintain a steady cap on interest rates," Wilkinson says. "It is very noticeable that the 10-year yield got down to 2.46% since the September non-taper meeting. I don't think that necessarily is because the economy weakened substantially. [It] is because the Fed has been successful reaching an increasing number of

investors with its message that even beyond finalizing its asset purchases the Fed Funds rate will not increase."

Wilkinson, who sets the range in 10-year yields between 2.75% and 3.25% in 2014, adds, "To assume that yields will rise simply because the Fed stops its purchases is extremely Pavlovian. We just lived through a period when fixed income investors have been proven badly wrong on such an assumption. Real yields are a function of economic growth and activity as well as the pace of gains in employment. We shouldn't blindly assume that yields necessarily go higher."

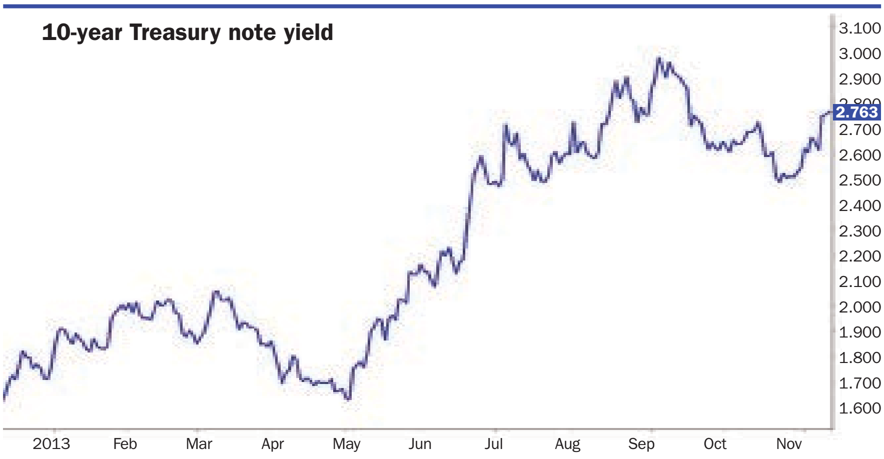
Martin McGuire, managing director at TJM Institutional Services, is more bearish.

"If we see 10-year yields move to 2.85% from [the end of October yield of] 2.62%, it suggests that a multi-month low will be in place," McGuire says. "While we might not see a new low yield at all, we should not expect to see one until after the end of the first quarter of 2014" (see "Is this the end?" right).

McGuire says the hard sell off in fixed income and equities this spring could have been an upfront insurance policy paid for future volatility. He says it could have pro-

IS THIS THE END?

McGuire believes a move in 10-year yields above 2.85% could trigger a large advance in yields.



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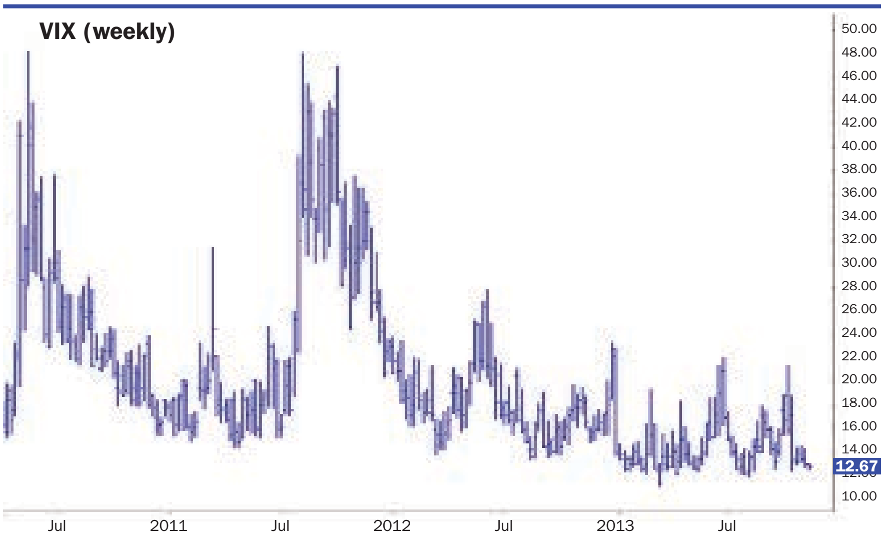
WHERE'S THE VOL?

It seems strange that in a year with so much contentiousness, when there was a government shutdown and a threat of default, the so-called fear gauge wallowed at historic lows. This likely will change in 2014.



Source: eSignal

vided for lower levels of volatility as the Fed moved toward tapering, but unfortunately the Fed's failure to pull the trigger on tapering may be a lost opportunity. "By backing away from tapering in September, the Fed is back to square one. The market is once again wondering at every economic release what will be the implications for tapering," McGuire says, adding, "I don't think the Fed intentionally misled. They got together at the meeting and they believed then and there that the risk to their credibility from misleading the market was not as great as the risk of moving too early and taking the accommodation away."

He expects 10-year yields to rise well above 3%, likely to 3.5% in 2014, and 30-year yields to move above 4% and approach 4.5%.

One of the reasons Wilkinson has been less bearish than many analysts on Treasuries is that he expects the Fed to hold onto its portfolio through expiration. "It is pretty apparent that the Fed's balance sheet is going to be left to wind down of its own accord over an extended time horizon," Wilkinson says. "So the descriptions of the bond market that many are predicting simply [are] not going to happen. The Fed will not sell bonds and force yields up. That idea is so counterintuitive that it makes no sense whatsoever."

More interesting could be movement in the yield curve. "The 5-year/30-year yield curve is going to flatten like a pancake as the Fed moves through the tapering," McGuire says. "If you believe the Fed has [the] intention to hold onto its portfolio, the policy rate will be required to do more of the heavy lifting. For any measure of economic growth (potentially inflationary), the Fed will need to raise policy rates more because it will not sell out the portfolio."

Equities continue higher?

While there is consensus that equities are dependent on the pace of tapering, there is no consensus on what that pace will be.

Alan Bush, senior research analyst at ADM Investor Services, expects the equity bull market to continue its move upward, but not based on any organic strength, just on the tailwind the Fed is providing.

"Equity indexes will continue to advance mainly because the Fed will taper later instead of sooner," Bush says, adding, "The influence that will prompt the Fed to taper QE will be when inflation starts to reemerge, which is likely to happen later rather than sooner. Until the Fed is frightened by inflation, they will not taper at all."

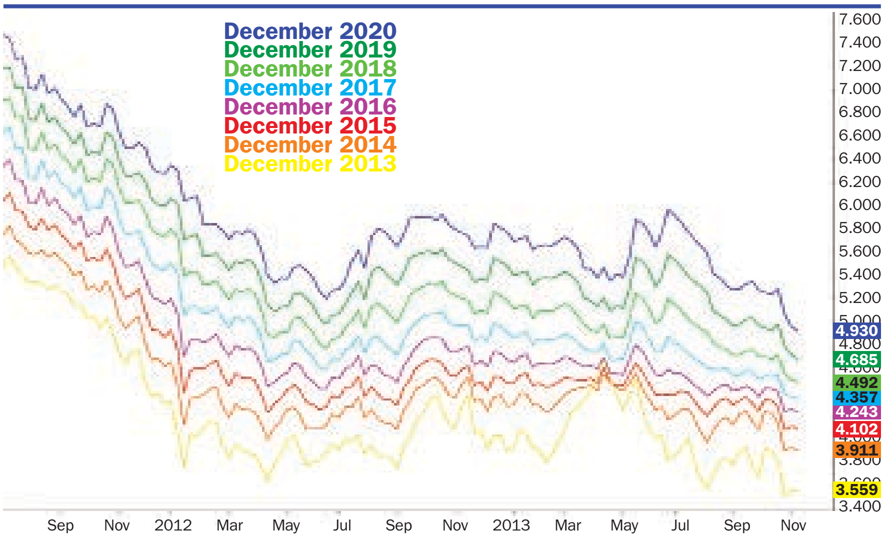
Anthony Lazzara, founder and principal of Lido Isle Advisors, is more bearish. "The market is going to have to start pricing in a more hawkish environment," he says, adding, "even if they don't taper, it will add volatility (see "Where's the vol?" above). The market is going to be more proactive in pricing in taper. It is going to be an interesting year for financials; we have had all these grinding up moves."

Bush, however, sees equities trending higher aided only by QE. "The trend is still higher. Any bad news of any type will only have a temporary downside move. When they do taper, we will see a down move; I just don't think they will taper any time soon. In fact, if they do taper, whenever their tapering announcement is, they may have to delay the next [one] for the stock indexes to recover," he says.

Bush acknowledges that equities could

HITTING THE CURVE

With increasing international demand turning natural gas into a global commodity, long-term prices may rise regardless of near-term fundamentals creating opportunities spreading the long-term price curve, which likely will steepen.



Source: eSignal

face a major downturn if he is wrong and the Fed tapers more aggressively. "I don't think they will. Whatever the consensus view is on QE in [the] coming weeks and months, I will be farther out in terms of tapering expectations."

Both Bush and Lazzara expect greater volatility in currencies, although they take opposite views on the U.S. dollar. "The currencies will be very volatile with the dollar lower," Bush says. Lazzara sees a stronger dollar with the onset of tapering.

Although Wilkinson expects tapering to come, he says equities are ready to stand on their own. "I find it very difficult to view equities negatively. They are not particularly costly. In the absence of an economic downturn, I still think the trajectory on earning is constructive. So the bull market goes on," Wilkinson says, adding, "The global economy is set to recover more strongly in 2014 and that lends itself to firming demand for commodities, whose value has been falling even as the 2013 recovery expanded."

Natural gas in demand

One of the more positive stories of 2013 was the speed at which U.S. energy production grew, which could make energies one of the more interesting sectors to watch in 2014.

"We are in a new era of lower energy prices," declares Phil Flynn, senior energy analyst at The Price Futures Group. "What is happening in the United States in terms of production is historic. It is game changing and it is changing the energy universe as we know it."

The shale gas and oil production in the United States is putting downward pressure on prices, which only may have been scratched in 2013 because of concerns over Middle East production.

"It has been a choppy ride because of Hurricane Sandy and other [geopolitical] issues. But [with] the increase in oil production and the increase in capacity from many of our refiners, we are going to see prices go down," Flynn says. He notes that there is even the chance of cooperation with Iran. "If they decide to play ball and allow inspectors in, they may come back [into] the global energy market."

Near term, he expects crude oil to test $88 a barrel, and if there is a mild winter, he believes it can test or even fall below $80.

Lazzara also believes crude will test $80. "This sell off is just getting started," Lazzara says. "There are a lot of players producing energy. Iraq's production is getting stronger."

Perhaps more interesting is the natural gas market.

"Natural gas is almost like two different markets — the long-term market and the short-term market," Flynn says. "The short-term market obviously is going to be dependent on weather. Right now natural gas is under pressure. The long-term picture for nat gas — 5-10 years — we are near a historic low."

Flynn says just as high prices cure high prices, low prices cure low prices; as the shale revolution has brought down gas prices and eventually will bring down crude oil prices, low prices are creating increased demand — particularly internationally — for natural gas. There also has been a move by big transportation firms to move, ala T. Boone Pickens, to natural gas for fuel.

"Fed Ex is changing all its short-duty trucks to natural gas. Warren Buffet is looking into running Burlington Northern [freight] on natural gas," Flynn says, noting the railroad is the biggest consumer of diesel fuel after the U.S. Navy.

Meanwhile, Europe wants an alternative to its main natural gas supplier, Russia, which likes to bully its neighbors. And Japan has increased energy needs with reductions in its nuclear energy output. "Russia is threatening the Ukraine, Japan is begging us to step it up," Flynn says. "Japan and Europe want us to export natural gas. Natural gas last winter was going for as much as $20 in China."

Becoming a natural gas exporter will require the United States to ramp up liquefied natural gas (LNG) facilities, but with price differentials where they are, it should happen quickly. "We were paying $3 or $4 over here. With that kind of discrepancy market forces won't let that continue forever," Flynn says. "If you ever get below $3 again, it is going to be a major long-term buy. Shorter term, it looks like $3.35. Over the next two years the demand for natural gas is going to explode, similar to oil prices in the late 1990s. What happened is the demand for that cheap product exploded and then before you knew it we had a major bull market."

An interesting natural play may be its long-term price curve. "The curve is relatively flat,which to me is amazing," Flynn says. "If I were a big corporation and I could lock in September 2020 natural gas, I would be jumping all over it (see "Hitting the curve," above)."

The June 2017 natural gas contract at the

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beginning of November was at $3.90, the May 2020 contract was at $4.50. Natural gas always has been a domestic market, but with the huge price discrepancies overseas that demand should push prices higher out on the curve when transportation is worked out (see "Dan Dicker: Mad about oil," October 2013). "If I were a natural-gas-dependent corporation, I would be locking in these prices for a long time," Flynn says.

He adds that the increased domestic energy production should be positive for the dollar. "It changes the dollar flows. Instead of dollars running out to other countries for importing oil, more of those dollars are going to stay home. The more dollars you have at home, probably the faster you are to remove stimulus; it should eventually make the dollar stronger," Flynn says.

Keeping an eye on beans

While commodities may be set to benefit from a general increase in demand, soybeans may be the most interesting grain market to watch. Chad Burlet, principal of commodity trading advisor Third Street Ag, says, "We can expect quite a bit of volatility in the soybean market in the next six months. The current situation is very tight and prices are high," Burlet says. This has led to record planting in South America, which could lead to a 15-million-ton premium to last year's record South American crop, according to Burlet. "With good weather the market could break $2-$3 per bushel. However, if the crop gets hurt we easily could rally by that much," he adds.

If all this analysis is making you hungry you may not want to hear that you probably will be paying more for a steak in 2014.

Alvin Hults, principal of introducing broker Tejas Trading Company, expects live cattle to hit all-time highs in the first half of 2014.

"Supply is tight due to the massive kills," Hults says.

Two years of droughts and elevated feed prices have caused feedlot operators to kill livestock prematurely, leading to a short supply of beef. While the worst drought was in the 2011 growing season, 2012 had drought condition as well and supplies of grain had been tight already.

"We didn't have any recovery in 2012. We slaughtered cattle that [weren't at full weight] due to high grain prices," Hults says, adding that live cattle could get as high as $1.50.