Some will say central banks have supported financial markets since the credit crisis and some will say they have manipulated them, but few could deny the effect their loose monetary policy has had on asset prices.

That era of quantitative easing and ultra-low interest rates may, however, be coming to an end. The Federal Reserve is already well into a hiking cycle. The European Central Bank is continuing its asset purchasing programme. The Bank of Japan has switched its focus from interest rates to controlling its yield curve. And the UK’s Prime Minister Theresa May has complained of ‘bad side effects’ from the Bank of England’s accommodative stance and insisted that ‘change has got to come’.

It was only a few years ago, in 2013, that investors panicked at the mere thought of the US tightening monetary policy in what became known as the ‘taper tantrum’. So why do markets appear relatively calm at the present juncture?

One reason is the expectation that monetary stimulus is being replaced by fiscal stimulus around the world. The US is discussing a package of tax cuts and infrastructure investment that could be worth over $1 trillion. In Europe, Spain and Italy are running larger-than-permitted budget deficits while Germany has committed to tax cuts after its election later this year.

Yet the transition from a monetary to a fiscal regime is unlikely to be straightforward and could prompt higher volatility.

‘A key risk to watch is a possible overshoot of the US dollar versus the main emerging-market currencies,’ noted Yerlan Syzdykov, head of emerging markets – bond and high yield, at Pioneer Investments. Such a scenario could well arise from higher US interest rates due to stronger US economy. ‘This will impact US dollar-denominated external debt, either sovereign or corporate, and in this vein we see Latin America as the most fragile area, together with Turkey, Hungary, the Philippines, Malaysia and Indonesia,’ said Syzdykov.

Cosimo Marasciulo, head of fixed income, Europe, at Pioneer Investments, believes investors should consider positioning to help guard against volatility resulting from the regime change. For example, using event-driven strategies to aim to hedge geopolitical risk and keeping duration exposure low.

‘We believe maintaining a short duration bias throughout 2017 could prove useful,’ Marasciulo confirmed. ‘But in an effort to help protect against sudden, sharp bond-market rallies, or if a duration position is too extended, we suggest investors look into a new potential way to produce alpha – macro hedging.’

In addition, equity investors should seek to be well placed to benefit from any fiscal stimulus, but caution may nevertheless still be advisable. ‘We believe that companies that demonstrate sustainable earnings are more likely to grow in any
sort of an economic environment’, said Andrew Acheson, portfolio manager and leader of the US growth team at Pioneer Investments. ‘If we do not end up having the hopes of fiscal stimulus fulfilled, we believe that those companies with pricing power should continue to do well’.

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