Trade Booster

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‘Tapering’ drives rotation into US equities and Europe mid-caps

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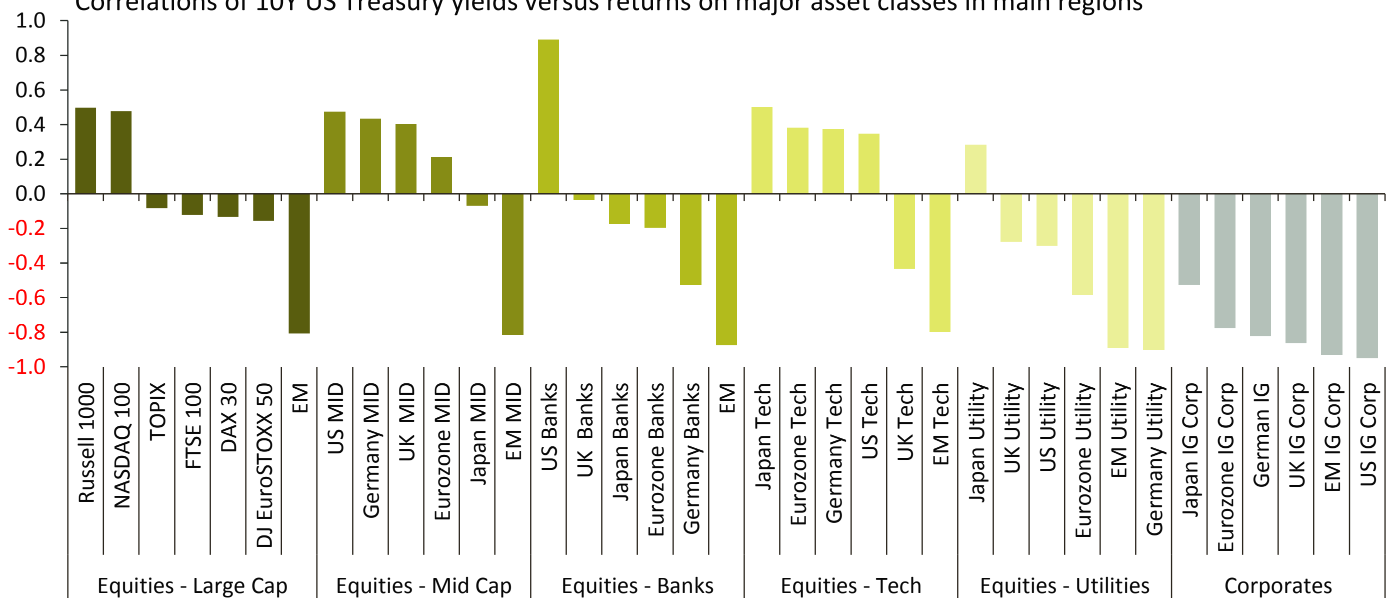
Three-thinking ETPs

Summary

- **Rumours of QE tapering are short circuiting the rally on equity markets. Once data releases from the US reassert the upbeat growth outlook, the bull run in equities should resume**
- **The positive reaction to rising bond yields is most significant for US large and mid-cap stocks. Mid-cap and lowly geared stocks in UK and Europe will also benefit**
- **Investors with a bullish view on US broad and technology-focused equity markets and UK mid-cap stocks may consider:**
    1. **Boost Russell 1000 3x Leverage Daily ETP (3USL)**
    2. **Boost NASDAQ 100 3x Leverage Daily ETP (QQQ3)**
    3. **Boost FTSE 250 2x Leverage Daily ETP (2MCL)**

Fed tapering since May has been bullish for growth orientated and low gearing stocks

Correlations of 10Y US Treasury yields versus returns on major asset classes in main regions



Source: Boost ETP Research, Bloomberg. Data to 14 August 2013

Tapering is not policy tightening, it is unwinding extraordinary stimulus while leaving ordinary stimulus through the near-zero policy rates untouched. The markets’ initial response to tapering rumours have been negative but correlations between bond yields and stock market returns since mid-June show a bullish reaction in US equities. US banks have benefited the most while to a lesser extent, mid-cap and lower leveraged segments of US and European equities have also benefited. Investors may consider bullish positions in US broad and tech based equity indices, such as the Russell 1000 and NASDAQ 100, along with UK mid-cap equities, such as FTSE 250.

Any hint of data coming out of the US suggesting QE tapering is initially met with a negative response by the markets. Thursday markets’ reaction on news of initial jobless claims falling to 6 year lows has been no different. However, since the Fed hinted at exiting QE as soon as mid- 2014, US stock markets have risen, with the S&P 500 breaking new highs of above 1700 at the start of August.

With improving US jobs data, the markets’ perception is that the recovery in the labour market is becoming

sustainable. This has helped US stocks' upward momentum more than the rise in interest rates has helped to undermine it. As the chart shows, since the Fed first announced its plan to taper QE on 19 June, the performance of US main stock markets has been positively correlated to increases in long-term bond yields. However, the markets had begun to anticipate an end to QE well ahead of the announcement, when long term interest rates in the US started to rise as early as May. The result since has been that while the 10Y US Treasury yields have risen by more than 100 bps, the S&P 500 has gained 7%.

Banks' profit outlook bolstered by a steepened yield curve

US banks have benefited the most from the Fed's QE policy, and they may well continue to do so in the near future. As the USD 85bn in monthly stimulus money has revived credit market trading and commercial lending, so too has the anticipated unwinding of stimulus. This is helping US banks take advantage of substantially improved carry trades. With a significantly steepened yield curve, the Fed's near zero interest rate policy virtually guarantees US banks' access to the Fed's cheap, short-term funding facilities to be deployed more profitably. The fact that banks beat analysts' Q2 US sector earnings highlights how the unwinding of QE has had anything but a positive impact on US banks' bottom line. This explains why the positive correlation between long term bond yields and US banks since May is so high (0.89).

At the same time, QE tapering rumours have had minimal impact on the main stock markets in Europe and Japan. As shown in the chart, the performances of UK, German and Eurozone equity benchmarks are uncorrelated to increases in US long-term bond yields. While US yields have risen, Europe's equity markets have fallen mainly because investors have shunned or sold bank stocks on worries of Eurozone's distressed sovereign bonds coming under renewed borrowing pressure as US yields increase. The healing process on Europe's credit markets has kept a lid on bond yield so far, and provided default fears continue to dissipate, Eurozone bank stocks may overcome QE tapering pressures.

Mid-cap sector's strong showing confirms upbeat growth outlook

The overall strong performance of large-cap stocks in Europe and the US may be affected by their exposure to EM, many of which have become proxies for China's growth story (Apple, Caterpillar, BMW, LVHM, etc.). Given the slowing growth expectations of China and overall more downbeat sentiment of emerging markets, this may have obscured, if not limited large-cap stocks' positive reaction to rising US bond yields. Hence, the performance of US mid-cap stocks, which capture the domestic economic expectations better, may reflect a more accurate reaction for upbeat US growth. As can be observed in the chart, the reaction to QE tapering by US mid-cap stocks has been as upbeat as its large-cap counterparts. Sentiment in Eurozone's mid-cap stocks has been moderately bullish, too. This is likely because with US consumer spending recovering and a widening spread of interest rates between the US and Eurozone (undermining expectations of euro strengthening), improving the US export outlook. The positive impact to UK mid-cap stocks may be explained more by the improving growth outlook at home. With the Fed looking to unwind QE, the BoE is under pressure to follow suit.

Risk-on rotation sustained as defensive sectors' high indebtedness deteriorates the outlook

The upbeat outlook for growth is also shown in the contrast between correlations of bond yields with the performance of utility and technology stocks. Higher bond yields imply a higher future cost burden to the highly geared utility companies. Given the marked negative impact tapering rumours have had on corporate bonds (see chart), the low-beta, defensive plays have performed poorly as a result. Furthermore, if investors were genuinely concerned about growth, the allocation into high beta equity sectors should not have occurred. However, the tech sector's relative high correlation with bond yields suggests the higher risk, low leverage rotation in equities since Fed tapering has not dissipated. This rotation is also happening in the UK, where the FTSE 250 has outperformed the FTSE 100 this year.

While the +100 bps increase in US long term bond yields since May has been swift and substantial, the current levels bond yields remain relatively accommodative after coming off from artificially depressed levels. The still accommodative levels are anchored in the near-zero rate policy stance, which remains unchanged. This is why the QE tapering rumours that drive pressure on bond markets and push long term yields higher may only have a short-lived negative impact on equity markets. In the current market environment, investors sell on rumour and buy on fact. Hence, as soon as upbeat growth outlook

reasserts itself in the real economy, the rally on equities may continue.

Investors who share this sentiment may consider the following leverage ETF / ETP positions:

1. US broad and technology-based large-cap equities:
   a. Boost Russell 1000 3x Leverage Daily ETP (3USL)
   b. Boost NASDAQ 100 3x Leverage Daily ETP (QQQ3)
2. UK mid-cap equities:
   a. Boost FTSE 250 2x Leverage Daily ETP (2MCL)

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