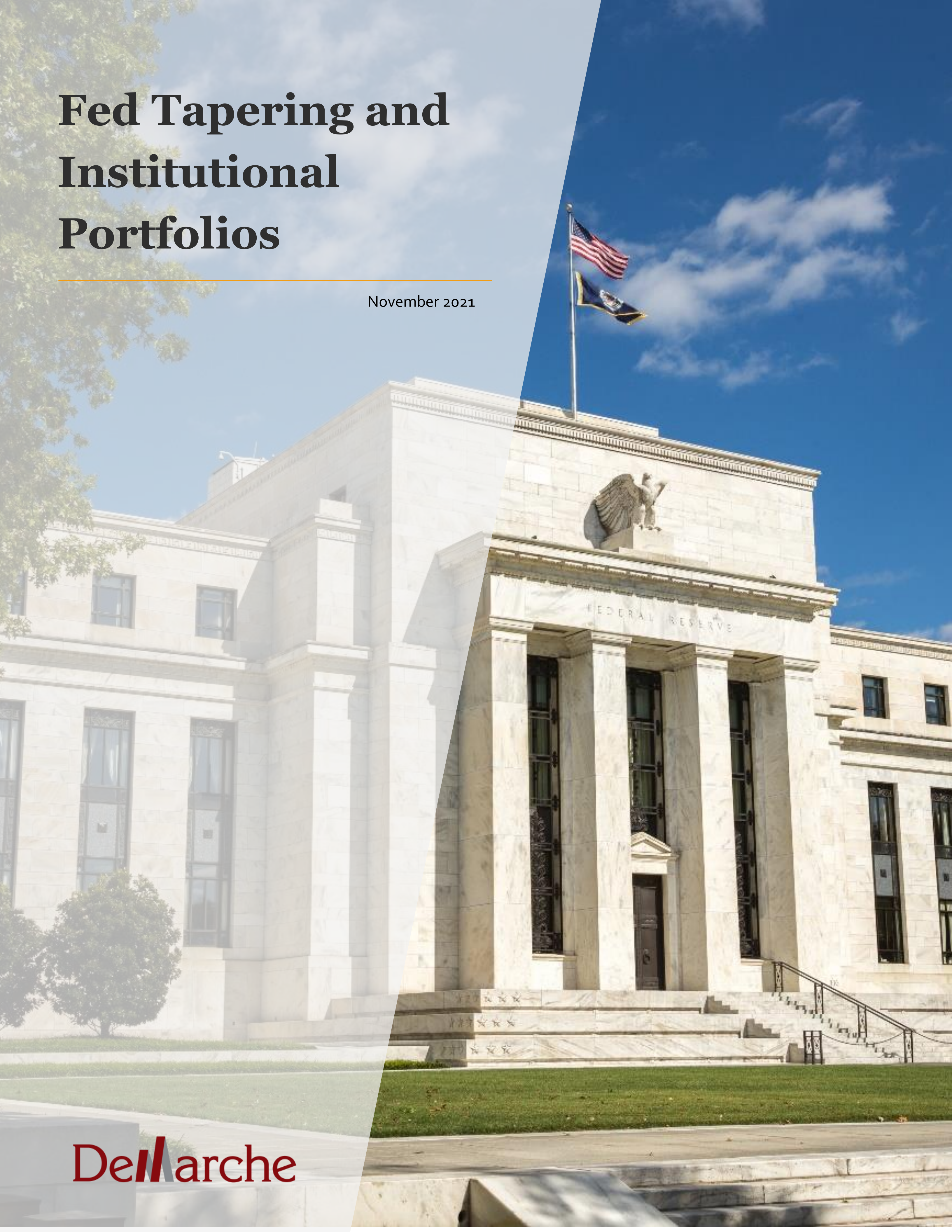
Fed Tapering and Institutional Portfolios

November 2021



DeMarche

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Point of Discussion

Abstract

With the Federal Reserve's announcement that they will be begin tapering their asset purchases, we set out to educate readers on the history of quantitative easing, how it has been used in the past, how the market has reacted historically, and what investors may expect this time. Based on a likely increase in rates across the curve, investors may want to examine their current asset allocation against the backdrop of the Fed's planned actions and forthcoming the risks and opportunities in the fixed income market.

On Wednesday, November 3, 2021, the Federal Reserve (Fed) announced that it would begin the process of tapering its quantitative easing activity. This announcement was not unexpected, as they had been forecasting this move for months. Tapering will have implications for the US economy, fixed income markets, and investors' portfolio positioning. What brought us to this point, what is tapering exactly, and what should investors do about it? These are the questions that we seek to answer this month in our monthly research paper.

A Brief History

The Fed's primary objectives are to simultaneously maintain inflation within a targeted range while supporting economic growth and full employment. We are witnessing the balancing act of achieving these objectives play out before our eyes as the Fed navigates policy decisions following the rebound off of the pandemic lows. While one of the key monetary policy tools at the Fed's disposal is the ability to set the Fed Funds Rate, this tool is limited once interest rates become very low. In 2007, the rate was set at 5.25%, but in the wake of the Global Financial Crisis it was systematically lowered to 0 – 0.25% by December 2008.

Another tool the Fed can use, once changing the Fed Funds Rate loses effectiveness, is Quantitative Easing (QE). Although used heavily by central banks across the world since the Global Financial Crisis (GFC), it is not a new concept. In fact, it was employed in the US as early as the 1930s[1]. In more recent times, the Fed began employing QE in 2008. QE consists of the Fed purchasing large amounts of assets, typically Treasuries and Mortgage Backed Securities (MBS) in an effort to drive economic growth through lending. This effectively lowers interest rates, particularly on the longer end of the Treasury curve. By providing banks with more capital to lend, and at lower rates, the Fed makes it more attractive for companies and consumers to borrow and invest. The Fed has performed QE in different forms four times since the 2008-2009 GFC: QE1 at the end of 2008, QE2 at the end of 2010, QE3 in 2012-2013, and QE4 in response to the pandemic in 2020.

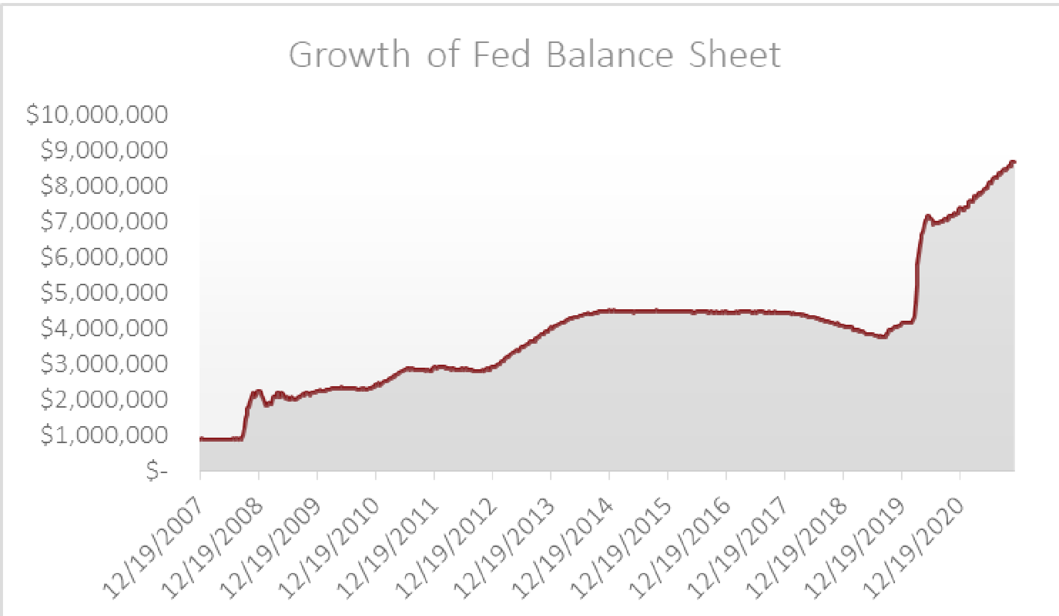
Tapering

The process of reversing this supportive economic stance is called tapering – reducing the volume of bonds the Fed is buying until they are no longer purchasing any new bonds and instead either maintain

[1] Anderson, R. G. (2010). The First U.S. Quantitative Easing: The 1930s. Economic Research Federal Reserve Bank of St. Louis, (17). https://doi.org/10.20955/es

the balance sheet at current levels, or let it be naturally reduced over time by not replacing bonds that mature.

After each QE, the Fed performed a tapering action. After QE1 rolled out in November 2008, it ended in February 2010. At this point the Fed had a balance sheet of $2.3 trillion and in November of the same year announced a purchase of an additional $600 billion in Treasuries by the end of the second quarter of 2011. This left them with a total balance sheet of $2.8 billion at that time. Over the next several years the Fed continued this process on and off until January of 2014, when they slowly started to taper. In the ensuing years, the Fed was tasked with managing a balance sheet between $4 and $5 trillion, and by September 2017, they announced that they would begin to "normalize" the balance sheet by allowing portions of the existing bonds to roll off and not be replaced.



If you then fast forward to the COVID-19 pandemic, the Fed swiftly stepped in to provide liquidity when the country went on lockdown and the markets started falling dramatically in response. The amount of support provided by the Fed was unprecedented – bringing the balance sheet to over $7 trillion by the end of May 2020. As of the end of October 2021, this number was over $8 trillion. The Fed has once again announced that they intend to begin tapering their asset purchases.

Naturally, the process of reducing the amount of liquidity being pumped into the market by the Fed is generally seen as a headwind for economic growth. Historically, both the equity markets and the fixed income markets have reacted accordingly, responding with falling equity markets and increasing bond yields. One rather dramatic example of the markets reacting to tapering occurred in 2013. Then Chairman of the Federal Reserve Board Ben Bernanke announced on June 19, 2013 that the Fed was to begin tapering soon. The markets reacted violently, with the S&P dropping almost 3.5% before recovering sharply, and the 10 year Treasury jumping from 2.19% to 2.74% in a short period. These volatile swings were dubbed the "Taper Tantrum." Thereafter, the Fed has taken a lesson from that experience and been careful to forecast their upcoming potential policy decisions well in advance, often repeatedly, in an attempt to avoid market surprises that would create similar volatility. The current Fed chair, Jerome Powell, has been diligent to ensure clear communication of the Fed's expectations of tapering following each of the Fed's meetings in 2021.

When Chairman Powell announced on November 3rd that the Fed would begin the tapering process by reducing the amount of bonds to be purchased by $15 billion a month, the decision was already largely expected by the market. That number has now been increased to $30 billion a month, after the Fed decided to more aggressively fight rising inflation. As a result of the November announcement, the 10 year Treasury yield increased only very modestly and equity markets didn't dip. The pace at which Mr. Powell has announced that the Fed will be tapering means the Fed's QE asset purchases will end by the first quarter of 2022. After the tapering of their balance sheet is completed, it is likely (and has been discussed by Fed governors already) that the Fed will begin to raise the Fed Funds Rate in an attempt to get back to a point where it has the ability to once again lower the rate again in the future. This also will be key to helping manage inflation, which has been running significantly higher in recent months than it has over much of the past decade.

Impact on Investor Positioning

What then does all of this mean for institutional investors and what might you expect over the coming months? First, you may want to take a look at your current asset allocation and positioning. As rates rise across the curve, it is often thought that holding securities on the shorter end of the curve is a more conservative position, allowing portfolios to avoid feeling the full brunt of interest moves that longer duration securities are likely to feel (moves in interest rates more strongly impact longer duration bonds). Second, floating rate securities such as bank loans can be a good way to hedge the interest rate risk inherent in a tapering and subsequent rising rate environment. Third, asset owners should be aware of their exposure to below investment grade securities. It is possible that during a time of more stressed markets, liquidity could dry up in these riskier areas of the market, forcing unfavorable mispricing. Therefore, being conscientious about the kinds of fixed income you hold could help mitigate unintended risks of exposures that may lead to losses. If it has been a while since your last asset allocation study, this may also be an opportune time to re-examine your objectives and current allocations.

Bloomberg Aggregate As of 11/29/2021

Current Yield 1.49% Duration 6.6

Net Basis Point Change in Yield

	+300	+225	+150	+75	+0	-75
	-2.8	-1.6	-0.6	0.5	1.5	2.5

Expected annualized return for subsequent five-year period

Assumes no change in "spreads" between credits and Treasuries, and "parallel" shifts in yield curve.

Appropriately informed investors need not fear uncertain markets and environments. As the Fed seeks to reverse what has been a period of unprecedented economic support, being educated and prepared can go a long way toward fortifying your portfolio to weather the markets ahead.

Put Research to Work

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Sources Utilized:

- *Federal Reserve System Board of Governors*
- *Federal Reserve Economic Data-WALCL Assets (Federal Reserve Bank of St. Louis)*
- *Diamond Hill*
- *PIMCO*
- *Bloomberg*