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On the Fed's Menu: A Taste of Tapering (But Hold the Tantrum, Please)

Will rates soar in the wake of bond-purchase cutbacks? Not necessarily.

On September 22, 2021, the Federal Open Market Committee (FOMC) concluded its scheduled two-day policy meeting stating that a "moderation in the pace of asset purchases may soon be warranted." Translation: the tapering of bond purchases is at hand and the Federal Reserve (Fed) will soon begin reducing its current $120 billion in monthly buys and, eventually, ending the program altogether.

The word *taper* has become a cautionary term for some during the past decade as it has come to represent the Fed's willingness to start removing accommodation from the markets. Many investors, still scarred by the infamous "Taper Tantrum" of 2013, immediately associate taper with higher interest rates. On May 22, 2013, then Fed Chair Ben Bernanke stated to the Joint Economic Committee of Congress that the FOMC "*could in the next few meetings, take a step down in [its] pace of purchases if its members see continued improvement and expect that improvement to be sustained*."

From that point forward, US 10-year Treasuries rose from 2.03% to a peak high of 3.01% on December 31, 2013. Less well-remembered: The actual reduction of bond purchases did not begin until the last month of 2013.

Nevertheless, many market watchers associate tapering with higher rates. Indeed, there's been some rate creep of about 30 basis points[1] since the September 2021 Fed comments. That said, there's no guarantee rates will rise meaningfully in response to the bond-buying pullback. The reasons are threefold:

- History suggests otherwise
- It's not just a US story
- The Fed's learning curve

History Suggests Otherwise

Although it may have seemed counterintuitive at the time, rates actually began to fall when the Fed began cutting purchases in December 2013. As the Fed was reducing purchases by $10 billion a month—ultimately ending new purchases by October 2014 (though reinvestments continued until October 2017)—the 10-year Treasury was declining right along with the level of buys. Treasury rates shrank from the peak level of 2.89% in December 2013 to 2.30% in October the following year, when the Fed buying ceased. The rate drop didn't stop there: it fell below 2.00% and hit 1.70% by January 2015 (see **FIGURE 1**).

Key Points

- If history is any guide, rates could eventually fall in response to the Fed's tapering of asset purchases. A short-term spike can't be ruled out, but the long-term direction of rates may defy expectations.
- Global events outside the United States have been known to trigger flights to quality which, if reprised next year, could put downward pressure on rates.
- The infamous "Taper Tantrum" of 2013 could, in retrospect, be attributed to a lack of clear communication. The current Fed leadership appears to have taken this lesson to heart.

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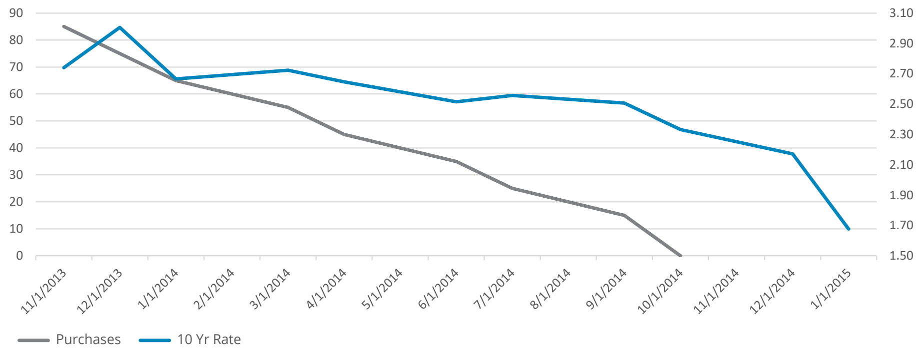
FIGURE 1

10-Year Treasury Rates: A Short Blip Upward Followed by a Mostly Downward Slide

The 2013-2014 tapering of Fed bond purchases vs. benchmark interest rates



Source: Federal Reserve and Hartford Funds. The left-side scale shows Federal Reserve asset purchases in billions of dollars. The right-side scale shows 10-year Treasury rates.

A succession of significant global events in 2014 contributed to the steady decline in the US 10-year Treasury rate.

Not Just a US Story

A succession of significant global events occurred in 2014, each in its own way contributing to the steady decline in the US 10-year Treasury rate. Many of those events had nothing to do with the United States. For example:

- The European Central Bank became the first central bank to introduce negative rates, which had the effect of sending money elsewhere in search of positive returns.
- The price of oil dropped 50% from June to December due to excess supply and a surprise decision in November by the Organization of Petroleum Exporting Countries to maintain production at status-quo levels. The shakiness in the energy markets sent emerging markets wobbling as the US dollar finished the year up 12.80%.
- Finally, several geopolitical events—e.g., Russia's annexation of Crimea and the territorial takeovers by the Islamic State in Syria and Iraq—added to a flight to quality and a search for yield, both of which helped keep rates from rising. It demonstrated again that, in times of stress, US debt is still considered the safest investment.

The Fed's Learning Curve

The Taper Tantrum of 2013 caught most market-watchers by surprise and became a learning lesson for the Fed. After Bernanke's remarks, rate hikes were thought to be imminent. Yet the Fed held back raising its target rate until December 2015, despite the Fed's bond-purchase program having ended 14 months earlier. In retrospect, it's plausible that a lack of clear communication from the Fed led to a sharp short-term market reaction.

Since then, Fed members have been extremely careful in their wording around policy changes. They telegraph their intentions well in advance via official press conferences, Fed minutes, or speaking events held by Fed members. Policy pronouncements appear well-orchestrated and designed to not unnerve the markets. In this instance, Fed Chair Jerome Powell has gone on record multiple times saying the Fed is a long way off from raising rates. Powell's consistency appears to be providing relative certainty for markets and may be helping to limit a runaway rise in rates.

So, here we are again. The Fed is poised to start tapering, and nominal rates appear to be creeping higher again. Certainly, there are valid reasons for higher rates. While not yet announced, FOMC minutes indicated the upcoming round of tapering could end between June and July of 2022. The pace of tapering is a bit quicker than last time around—which could be a catalyst for higher rates—but that remains to be seen.

In addition, much like in 2014, significant events are taking place outside the US once more—including a growth slowdown in China coupled with regulatory uncertainty. Low vaccination rates in many parts of the world, along with non-existent COVID-19 mitigation policies in other areas, create the potential for slower growth.

Finally, as of October 2021, Bloomberg estimates there is still almost $12 trillion in negative-yielding debt outstanding. Turmoil and limited opportunities outside the US generally lead to increased demand for the non-negative rates that US issuers can provide. Foreign entities have already added more than $100 billion in US debt since November.[2]

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What About Inflation?

Inflation is the wildcard and remains top-of-mind for most investors, with inflation expectations currently at their highest point since, coincidentally, 2013. Supply-chain disruptions, including transportation bottlenecks, labor shortages, and semiconductor scarcity, continue to dominate the inflation headlines. On October 14, 2021, the price of oil breached $80 for the first time since October 2014.[3] As of September 30, 2021, the 5-year average of the US 10-year Treasury was 1.96%, so it’s certainly feasible that we might see rates rise to that level.

That said, policy leaders here and abroad are taking several steps designed to limit inflation’s impact to the short or medium term. These steps include recent directives aimed at keeping shipping ports running 24 hours a day, 7 days a week, in order to ease congestion. Also, both the US and Russia have committed to ensuring that adequate energy resources will be supplied to global customers through the winter. None of these measures ensures inflation won’t eventually get out of hand, but they could potentially mitigate runaway expectations.

Summary

While even the mention of the word taper has in the past been a catalyst for short-term rate spikes, the process of reducing this type of monetary accommodation eight years ago did not, in fact, coincide with higher rates over the long term. Exogenous factors outside the US can play just as big a role as the Fed in the level of US rates. Inflation is certainly a wild card that, in theory, could potentially push nominal rates higher. However, inflation can also have the opposite effect and push real rates more to the negative side as well. So, while yet another round of tapering appears to be imminent, there’s no guarantee it will be accompanied by higher rates in the near term.

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[1] A basis point is a unit that is equal to 1/100th of 1%, and is used to denote the change in a financial instrument. The basis point is commonly used for calculating changes in interest rates, equity indices and the yield of a fixed-income security.

[2] "Major Froeign Holders of Treasury Securities," treasury.gov. Data as of 10/18/21.

[3] Source: Bloomberg. Oil-price quote refers to West Texas Intermediate crude-oil futures contracts.