INVESTMENT STRATEGY BRIEF

TAPER TIME?

ONLY WHEN THE ECONOMY IS READY

May 25, 2021

The Federal Reserve won't taper until it's sure it can. As such, the tapering decision (whenever it comes) should simply be taken as further confirmation of a return to normal. We expect other forces to keep interest rates low and we remain constructive on risk-taking.

Northern Trust
Global Asset Allocation

Jim McDonald
Chief Investment Strategist
jxm8@ntrs.com

Wouter Sturkenboom, CFA, CAIA
Chief Investment Strategist EMEA & APAC
ws65@ntrs.com

Dan Phillips, CFA
Director, Asset Allocation Strategy
dp61@ntrs.com

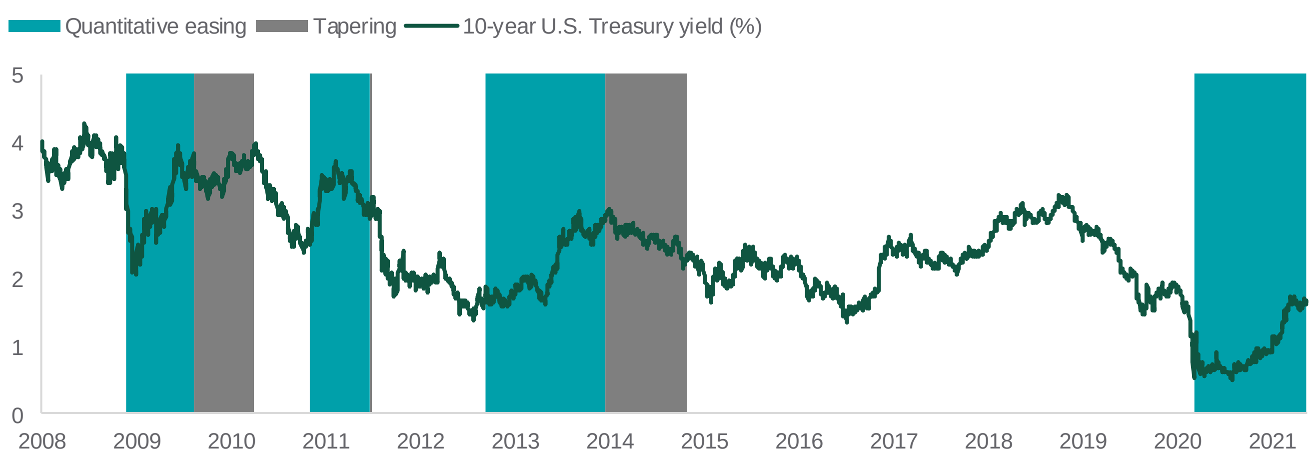
Colin Cheesman, CFA
Investment Analyst
cc327@ntrs.com

Previous tapers have led to falling — not rising — interest rates. As seen in Exhibit 1, the 10-year U.S. Treasury yield has a history of rising during periods of quantitative easing (QE) and falling during tapers (and beyond). This is opposite of what one might expect. What's going on? In these past examples, investors feared the Fed's (premature) tapering was putting the economy — and, by extension, the financial markets — at risk. The resulting "flight-to-safety" pushed interest rates down. We wouldn't expect the same flight-to-safety response today as the economy seems to be on more stable footing. But, interestingly, any tapering now (when it comes) may still push interest rates lower — as less money printing may reduce investor inflation fears.

There is always someone ready to step in and buy. The knee-jerk reaction to any tapering announcement is that less bond purchases mean less bond demand. However, lost in that train of thought is how the broader market responds and who takes on the role of marginal buyer. The biggest candidate to step in and buy this time? Pensions. Thanks to a stock market that's up dramatically and a state and local cash windfall from the Biden administration (some of which will make its way into pension funds), pension funding statuses have improved materially. Generally, a better funding status means a greater fixed income allocation — and a new home for those Treasuries (and mortgage-backed securities) the Fed no longer wants.

EXHIBIT 1: THE TALE OF TAPERS

Longer-term interest rates – as represented by the 10-year U.S. Treasury yield – have a surprising reaction to Fed involvement.



Source: Northern Trust Asset Management, Bloomberg, Federal Reserve Bank of New York. Data from 12/31/2007 through 5/21/2021.

Policy coordination — and what it means for interest rates. Over the past several years — and especially during the worst of the pandemic — one could be forgiven for believing fiscal and monetary policy were joined at the hip. The respective policymakers may not be in "direct contact" but the smoke signals being sent both ways are clear enough. Far from meaningless speculation, this has practical implications. As the Biden administration's two-part $4 trillion infrastructure bill is reduced in size through negotiation, the Fed may not feel the same need to provide its "unique" financing; tapering could end early, but the pool of available bonds to buy would also shrink. Regardless of the eventual size of the infrastructure bill, the amount of financing needed over the next year will pale in comparison to that spent over the last. Even the full $4 trillion in infrastructure bills would be a reduction from the past year's $5 trillion-plus in pandemic relief. And while not all of that pandemic relief money was immediately spent, neither will the infrastructure appropriations — instead spent over *eight* years, and some of that likely tax-financed.

European monetary policy will remain supportive. On the back of an improvement in the growth and inflation outlook for Europe there has been increased speculation about a taper by the European Central Bank (ECB). This is very premature, and likely somewhat due to a misunderstanding regarding the ECB's different purchase programs. The ECB's Pandemic Emergency Purchase Program (PEPP) is €1.9 trillion in size and scheduled to end in March 2022. Changing the amount of weekly PEPP purchases without changing the program's overall size is not a taper, even though commentators often think it is. A true taper would occur if the PEPP envelope is shrunk in size or if the size of the second purchase program, the Asset Purchase Program (APP), is reduced. The APP is open-ended and runs at €20 billion a month. We do not foresee any tapering by the ECB this year and, by extension, no pressure on the Fed coming from Europe. If anything, relatively low yields in Europe will continue to act as an anchor on U.S. rates.

Market implications: The taper timeline will not materially impact financial markets. We don't place too much importance on when and how the Fed will taper, as we don't believe it will materially impact the economy or financial market functioning — at least not broadly speaking. The Fed has been down this path before and should be able to exit its bond purchase program with minimal market disruption. Other investor demand will fill the void, as fundamentals (modest longer-term growth, transitory inflation) support still-low interest rates. There are many risks to watch for in the current market environment, but the Fed tapering isn't one of them.