31 August, 2021

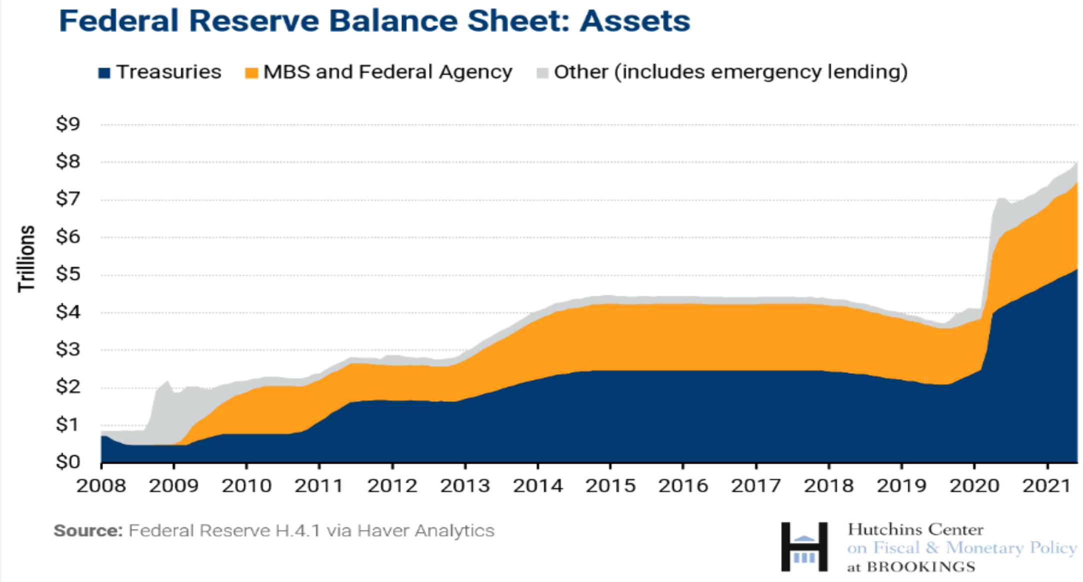
How would Fed Tapering affect the market? Will it be different this time?

Is it the time for the Fed to start “Tapering”?

In response to the economic impact to COVID-19, the Federal Reserve reduced the short-term interest rate to zero on March 15, 2020 and restarted its ultra-loose monetary policies, known as quantitative easing. Until now, the Fed still promise buying $80 billion of Treasury notes and $40 billion of agency mortgage-backed securities (MBS) each month, in order to support the economic and job market recovery.

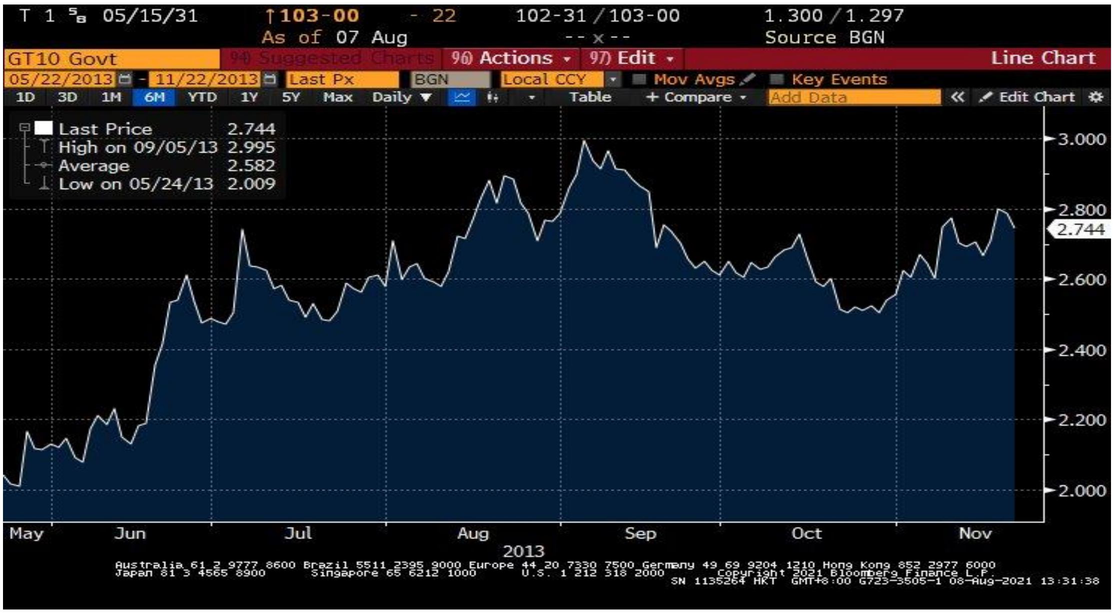
Through widespread of vaccinations and worldwide governments’ stimulus raised optimism over the economic recovery. From recent economic data showed that CPI is rising at 5.4% YOY and PPI is rising at 7.8% YOY in July. Investors globally are increasingly worried that pandemic-driven stimulus measures could spark a rapid rise in inflation and force central banks to start tapering, such as reducing bond purchases, raising interest rates or taking other tightening measures, potentially holding back the pace of economic recovery. In last December, Fed Chair Powell said the Fed will continue the asset purchases at the current pace until there is a substantial further progress has been made towards the Fed’s maximum employment and price stability goals. Now, as the economy recovers further and the price increases at a relatively rapid rate, maybe it is the timing for the Fed to begin reassessing the pace and composition of its asset purchases.

The asset purchase by Fed under pandemic era



The word 'tapering' firstly introduced to the financial market was in a testimony by Federal Reserve Chair Ben Bernanke on May 22, 2013. Since then, it has been widely used by the Fed officials and the financial market to refer to the possible tightening of monetary policy, especially the bond purchases program. Even though Fed did not really lower the pace of asset purchase after Bernanke had mentioned about the word tapering in May 2013, the bond market was shocked and the 10-year government bond yield had sharply increased from 2% to 3% in just few months. Eventually, Fed firstly began to taper was in December 2013, reducing the pace of asset purchasing from $85 billion per month to $75 billion per month, and then the asset purchase amount reduced by $10 billion at each subsequent meeting until Oct 2014.

U.S. 10-Year Treasury Bond Yield: After Bernanke proposed 'tapering', the yield at that time rose sharply from about 2% to near 3% in a short period of time



Source: Bloomberg

Instead, S&P 500 Index only made temporary declines in 2013 by 5% and soon rebounded

Source: Bloomberg

All indices of the S&P 500 declined at that time right after Bernanke proposed 'tapering', the real estate sector fell almost 13%, the utility sector was down about 7% one month later

Source: Bloomberg

Will it be different this time?

The background for these two tapering is not totally the same. In reaction to the 2008 global financial crisis and ensuing recession, the Federal Reserve executed an ultra-loose monetary policy in order to provide more liquidity to the financial market as well as to the economy. The 2008 global financial crisis was led by the collapse of U.S. housing market and the subprime mortgage and the financial market overly leveraged on the related investment products. In 2020, Fed executed another round of even more ultra-loose monetary policy. But this time is due to the occurrence of COVID-19 which has significantly shaken the global economy.

The Fed has kept on and off purchasing bonds for 5 years before it started the tapering in 2013. However, the Fed balance sheet was just up US$ 3 trillion which is far less than the balance sheet increment recorded in the past one and half year. During the past one and half year, the Fed balance sheet had increased by more than US$4 trillion.

It took 5 years for the U.S. stock market to recover from the market collapse in 2008 and before the Fed started the tapering, the stock market was just only 10% higher than level before the market collapse. However, the stock market only took less than a year to fully recover all the drawdown due to the occurrence of COVID-19 and is even 20% higher than the peak before the outbreak of the pandemic.

The announcement of reducing bond purchases by the then chairman Ben Bernanke was not well received well by investors who responded immediately by selling bonds, depressing the price of bonds as a result, and shooting up the yields. Although this time, ‘tapering’ has long been well informed by the Fed and thus the market is much well prepared than in 2013, we still believe when the Fed really announced the tapering, there will still be some short-term uneasy and negative reactions in the market, such as upward pressure to bond yields and downward pressure to stock markets. Therefore, the start of tapering, even if it may not really lead to any immediate negative impact on economic growth, it does not mean that it will not have any short-term pressure to the financial markets.

Source: Bloomberg, CNBC, BBC News, Yahoo Finance, Financial Times, Investing.com, Forbes, Reuters, WSJ, SCMP

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