Preparing for Bond Tapering

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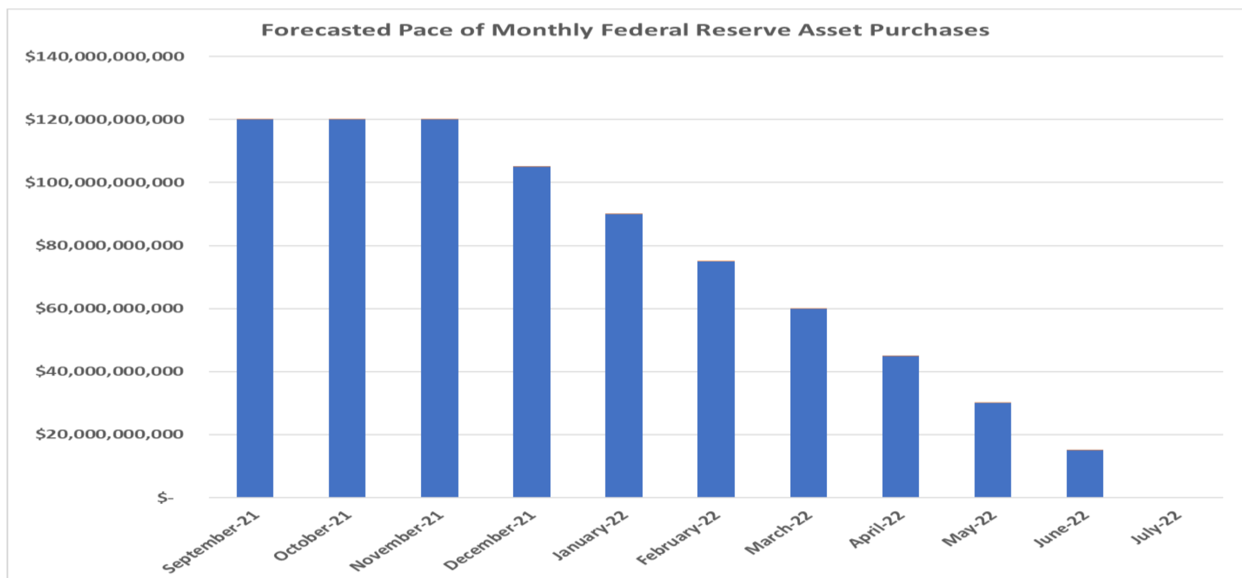
By Brian Luster

JACKSON HOLE, WYOMING

In his speech at the August 27, 2021 Jackson Hole symposium, Jerome Powell (Chairman of the Federal Reserve) stated, "if the economy evolved broadly as anticipated, it could be appropriate to start reducing the pace of asset purchases this year." Shortly thereafter, investment strategists and economists across the country began to converge on the idea that the Fed is likely to preannounce the timing of its plans for bond tapering at their November 2021 meeting and then begin to implement this plan in December. With less than 4 months left, this begs the question, how should investors prepare for tapering?

A BRIEF HISTORY OF TAPERING

In response to the economic impact of COVID-19, on March 15, 2020, the Federal Reserve cut interest rates to 0% and restarted its large-scale asset purchase program, more colloquially known as Quantitative Easing. At its current pace, the Federal Reserve purchases $80 billion of US Treasury securities and $40 billion of mortgage-backed securities every month. As the economy has begun to recover, Federal Reserve officials have begun to discuss the timing as to when they will begin to slowdown – or taper – the pace of these monthly purchases. We believe the Fed will reduce the rate of its purchases by $15 Billion per month, beginning in December, culminating in a growth rate of $0 per month by July 2021.



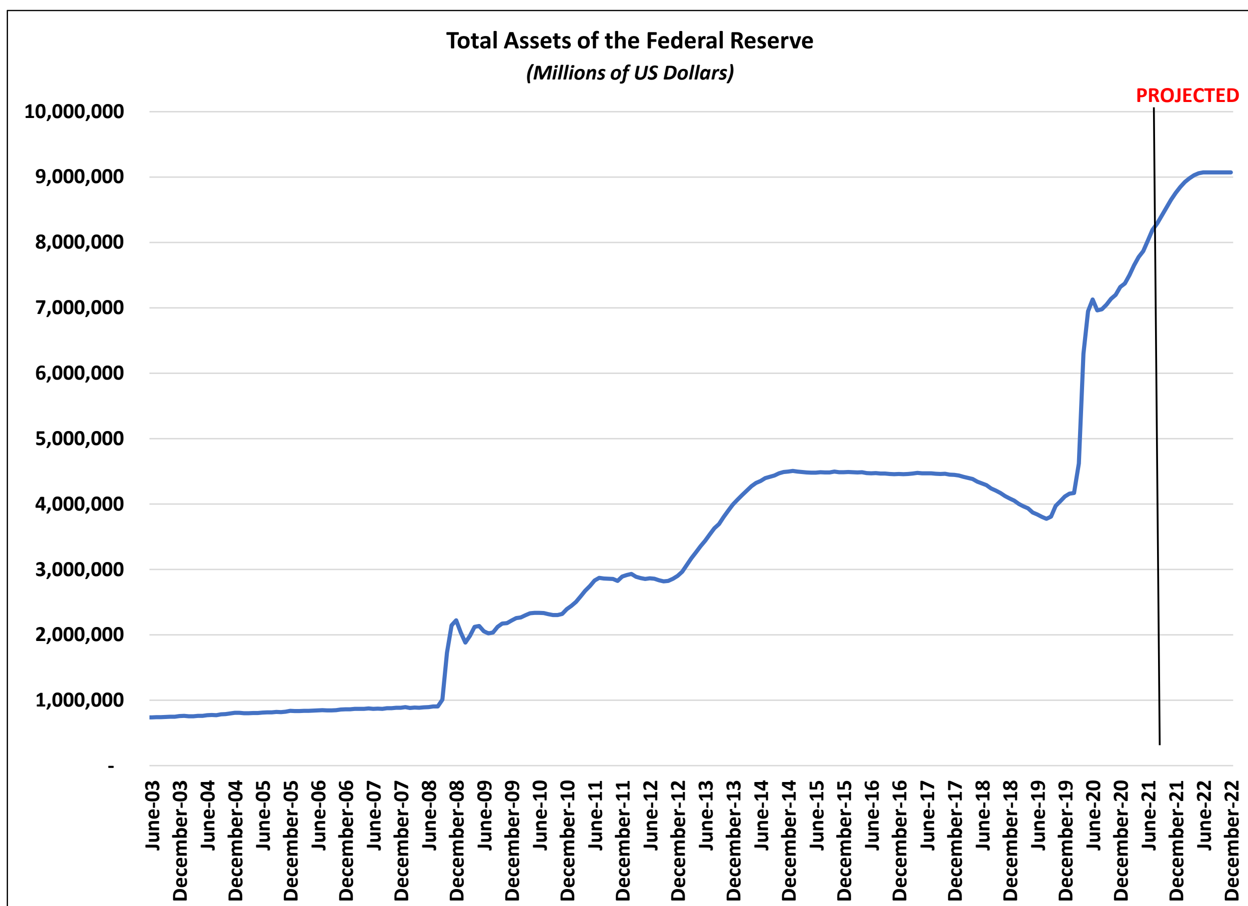
Source: Collective Family Office. Assumes rate of reduction of $15 billion per month beginning in December of 2020.

THE IMPACT OF QUANTITATIVE EASING

Quantitative Easing – or QE – has proven to be a successful tool of the Federal Reserve in lowering long-term interest rates, and thus supporting the economy, by making it cheaper for businesses and consumers to borrow money. Through their purchases of US Treasury and mortgage-backed securities, the Fed drives up demand (prices) for these bonds, thereby lowering the cost (interest rate) necessary for the Federal Government and Consumer to borrow. As a result, the Federal Government was able to fund its fiscal stimulus programs, consumers were able to purchase homes and cars, and businesses were able to fund capital equipment, expand their labor force, and refinance existing debt.

TAKING YOUR FOOT OFF OF THE GAS

This then begs the question – when the Fed begins to taper, will that not reverse economic growth? Before you get concerned that tapering will lead to rising interest rates – which it inevitably will – it is important to understand that given our forecasted pace of tapering, the Fed will continue to increase its balance sheet through July of 2022. This can best be understood by thinking about the impact of a driver taking their foot off the gas pedal. Their car will continue to move forward, albeit at a slower speed compared to when their foot pressed completely down on the pedal. Eventually though, their car will come to a complete stop. We expect the Fed's Balance sheet will stop growing in a meaningful way around July of 2022. This will restrain any upward pressure on long-term interest rates for at least the next 11 months.



Source: Collective Family Office, Board of Governors of the Federal Reserve System (US), Assets: Total Assets: Total Assets (Less Eliminations from Consolidation): Wednesday Level [WALCL], retrieved from FRED, Federal Reserve Bank of St. Louis; ttps://fred.stlouisfed.org/series/WALCL, September 9, 2021.

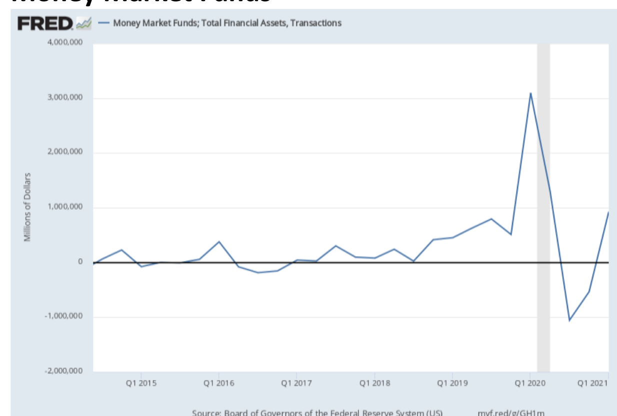
WHAT ABOUT SHORT-TERM INTEREST RATES?

Once the Fed has ceased its asset purchases, it will be in a better position to begin to raise short-term interest rates from their current level of 0-0.25%. We expect this first interest rate hike to occur in the fourth quarter of 2022, likely in December of 2022. We would then expect an additional four interest rate hikes throughout 2023.

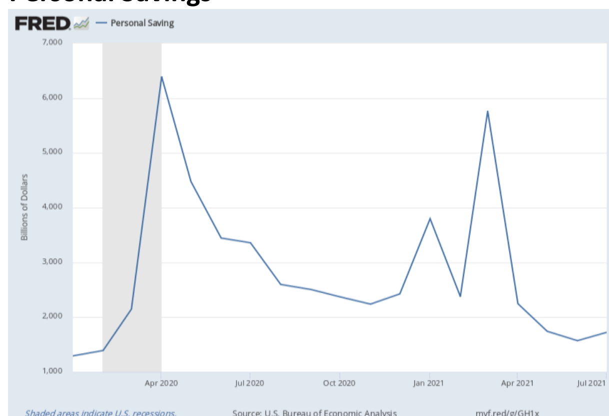
INVESTMENT IMPLICATIONS

Yet even with the likelihood of short-term interest rates rising to 0.5% by December 2022, and 1.5% by the end of 2023, equity markets are expected to remain beneficiaries of current and future fiscal stimulus throughout that time. In fact, House Speaker Nancy Pelosi has promised to vote on the $1 Trillion infrastructure package by September 27, and the market expects a Reconciliation package of $2.5-$3.5 trillion to pass around the same time. When considering that aggregate household savings is $645 billion above pre-COVID levels[1], and money market funds are over $400 billion above pre-pandemic levels[2], there remains a massive amount of liquidity chasing too few investments.

Money Market Funds



Personal Savings



Source: Collective Family Office. U.S. Bureau of Economic Analysis, Personal Saving [PMSAVE], retrieved from FRED, Federal Reserve Bank of St. Louis, September 9, 2021. Board of Governors of the Federal Reserve System (US), Money Market Funds; Total Financial Assets, Transactions [MMMFTAQ027S], retrieved from FRED, Federal Reserve Bank of St. Louis, September 9, 2021.

Given current valuations, the service sector economic recovery, and a continued commitment from the federal government to spend money to support growth when businesses and households falter, we continue to favor value over growth, small cap over large cap, and international over domestic equities based on valuations and fundamentals, as these asset classes are likely to be the strongest beneficiaries of the service sector recovery. Given the nature of our anticipated drivers of equity performance, we expect heightened global equity market volatility, and suggest investors consider incorporating hedging strategies into their equity allocations when available and appropriate.

Fixed income investors are expected to benefit from maintaining short duration in their investment portfolios and seeking out alternative sources of income by incorporating preferred stocks, high yield bonds, emerging market debt, private debt, and other similar strategies into their portfolios.

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[1] *U.S. Bureau of Economic Analysis, Personal Saving [PMSAVE], retrieved from FRED, Federal Reserve Bank of St. Louis, September 9, 2021. Comparing 4Q2019 to 2Q2021.*

[2] *Board of Governors of the Federal Reserve System (US), Money Market Funds; Total Financial Assets, Transactions [MMMFTAQ027S], retrieved from FRED, Federal Reserve Bank of St. Louis, September 9, 2021. Comparing 4Q2019 to 2Q2021.*

IN CONCLUSION

Tapering is simply the pulling back of monetary stimulus. It does not decouple us from global interest rates (yields are low everywhere – in fact, there are over $16 trillion in negative yielding sovereign bonds outstanding) nor does it take away from demand for goods and services associated with the post COVID economic reopening (businesses need to restock inventories and reinvest in Capital Ex). What it does tell us is that bonds, with their already unattractively low yields, may begin to face capital compression as demand for Treasuries and mortgage-backed securities by the Federal Reserve wanes, causing interest rates to begin their ascent. As such, we expect investors will be best served by maintaining an overweight to equities over fixed income and keeping the duration of their bond portfolios short.

ABOUT THE AUTHOR

BRIAN LUSTER is a Principal and Chief Investment Officer of Collective Family Office located in York, Pennsylvania. With over 20 years of Wealth Management experience, Mr. Luster has previously served as Founder and CEO of a boutique Multi Family Office in New York City, as the Managing Member and Portfolio Manager of a long/short US event-driven value-oriented hedge fund in New York, and as a Senior Wealth Manager for BNY Mellon Wealth Management in Central Pennsylvania.

An avid thought leader, he has authored over 60 articles covering investing, tax, trust & estate planning, family governance, and next generation education, featured in such publications as Forbes, Barron's, The Wall Street Journal, Private Asset Management Magazine, Family Office Elite, and The Huffington Post.

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