Weekly Market Summary

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Anxious About Fed QE Tapering?! Relax, There's No Need to Worry!

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Latest Update on Coronavirus: Confirmed cases last at 93.637 million, with the death toll from the pandemic at 2,004,815. Norway said that Covid-19 vaccinations may be too risky for the very old and terminally sick, after 23 people died within a short time of receiving their first shot. Chancellor Angela Merkel is pushing to tighten Germany's lockdown, as the country's death toll soared by more than 1,500 for the first time since the start of the pandemic. The global death toll from Covid-19 could reach somewhere from 2.2 million to 5.1 million (?!) by the beginning of March while cases can rise to 110 to 170 million by that time, according to a study by researchers from the Chinese Centre for Disease Control and Prevention.

"*QE Tapering*" refers to the gradual reversal - not direct elimination - of a quantitative easing policy implemented by a central bank to stimulate economic growth (the latter involves increasing the supply of money in the financial system by buying government bonds and other securities from member banks / primary dealers). Whilst quantitative easing (QE) lowers the cost of money (market rates), tapering leads to a jump in yields and can result in an economic recession if implemented prematurely. The "*tapering*" terminology made it to the financial lexicon on May 22nd, 2013 when US Federal Reserve Chairman Ben Bernanke stated in a testimony before Congress that the Fed may taper, or reduce, the size of its bond program. At that time, 10-year Treasury yields were trading around 1.80% - though they quickly shot up to 2.75% by July the same year. Clearly, a significant chunk of the move had come in response to Bernanke's comments about the future of the Fed's asset purchase program!

Fast Forward to January 2021

In past weeks, economists and traders began sensing a split between Federal Reserve officials over when they may need to start pulling back on their massive monetary stimulus. That in turn drew a nervous reaction from investors who remember how markets were roiled during the 2013 taper tantrum. Regional Fed presidents – including Patrick Harker, Robert Kaplan, Raphael Bostic and Charles Evans – were all beginning to indicate an openness to discuss a 2021 taper (a reduction from the current hefty $120 billion monthly bond purchase level) should the economy recover strongly enough in coming months on the back of a rollout of Covid-19 vaccines to the US population, more fiscal aid and continued monetary support. In contrast, several others had continued calling the debate premature and Fed Vice Charmain Richard Clarida, the most senior central banker to weigh in, implied he does not expect any changes before 2022.

Just last December, a unanimous Federal Open Market Committee (FOMC) had suggested it would continue current monthly asset purchases - comprised of roughly $80 billion in Treasuries and $40 billion in mortgage-backed securities - until there was "*substantial further progress*" in meeting its goals on employment and inflation. Nonetheless, investors - taking no chances – have pushed up yields on longer-duration Treasuries and steepened the spread between rates on two- and 10-year debt to around the widest in more than three years (2s/10s spread last at 97 bps, with 2-year Treasury rates anchored at 14 bps – a reflection of the Fed's "clear" commitment to keeping the overnight Fed funds rate near zero through at least 2023). Ten-year Treasury yields broke the psychological 1.00% chart resistance on January 6th, after mostly trading in a 0.50% -0.95% range throughout the past nine months.

Market players were last left awaiting more guidance from Jerome Powell in his first comments of the year. The Fed Chair was scheduled to speak on Thursday at a virtual event hosted by Princeton University. "*It is good to plan ahead and try to anticipate, but I don't want to put specific dates on things,"* St. Louis Fed President James Bullard had noted on Wednesday during a virtual Reuters event. "*We should just leave it at that, substantial further progress, and see how that develops.*"

Powell's "Now is Not the Time" Argument!

Fed Chair Jerome Powell made it clear yesterday that the US central bank would be cautious in easing off its support for the economy, and that such action was anything but imminent. "*We're a long way from maximum employment, there's plenty of slack in the labor market*," he said, suggesting also that weakness in global economies would weigh on progress in the US.

"*We know we need to be very careful in communicating about asset purchases*," Powell noted. "*Now is not the time to be talking about exit. I think that is another lesson of the global financial crisis, is be careful not to exit too early*." And if inflation picks up substantially, he added, the Fed has policy tools to counteract that. "*Too low inflation is the much more difficult problem to solve.*" (careful what you wish for, Jerome! 😊). Mr. Powell also reiterated that there was a long way to go to get the economy back to full health. "*When the time comes to raise interest rates, we will certainly do that*," he said. "*And that time, by the way, is no time soon*."

Still, continued optimism (or wishful thinking?) for many more economic stimulus packages, potentially worth trillions of dollars, have kept US Treasuries under pressure - with the 10-year yield continuing to hover around 1.10%. Overnight, Joe Biden confirmed that he will ask Congress for $1.9 trillion to fund immediate relief for the pandemic-wracked US economy, a package that risks swift Republican opposition over bid-ticket spending on Democratic priorities including aid to state and local governments. "*We have to act, and we have to act now*," Biden said yesterday. He added that he would lay out a second, broader economic recovery plan next month at a joint session of Congress. That initiative will include money for longer-term development goals such as infrastructure and climate change, the transition team said (to infinity and beyond!)

Goldman Sachs Group Inc. has lately boosted its 2021 year-end forecast for the 10-year Treasury yield to reflect the new balance of power in Washington. Democrats will have unified control of the federal government when President-elect Joe Biden takes office next week, and that "*should translate into a greater fiscal impulse than under our previous divided government baseline*," GS strategists said in a recent note. They raised their year-end forecast for the 10-year yield to 1.5% from 1.3% to reflect "*revived reflationary themes*" in US rates. The yield ended 2020 at 0.913% and traded as high as 1.186% on January 12th.

From our end, we have said it before, and we will say it again: Central bankers may pretend they will able to calibrate this delicate stimulus extraction, but this must been seen as a white lie and a necessary bluff to keep financial markets and traders reassured – at least for the near future! Jerome Powell and Co. have little idea how to unwind their ballooning QE experiment, though they clearly understand that the world economy and financial assets have never been more sensitive to interest rate rises and addicted to low yields!

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