Fed tapers asset purchases amid rising inflation and growing economic uncertainty

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4 November 2021

As expected, the US Federal Reserve yesterday announced it will reduce its purchases of financial assets each month in a tapering process that is set to conclude in the middle of next year.

Starting this month, the Fed will cut its purchases of US Treasury bonds by $10 billion followed by the same amount in December. The purchases of mortgage-backed securities will be reduced by $5 billion per month.

The Fed said, while there could be adjustments next year if warranted by changes in economic outlook, it expected there would be similar monthly reductions. This means the $120 billion per month asset purchasing program that began as a result of a meltdown of financial markets in March 2020 at the start of the pandemic would come to an end in June 2022.

In his prepared remarks for a news conference at the conclusion of the Fed's two-day meeting, chair Jerome Powell reassured financial markets the decision to wind back asset purchases did not mean a rise in the central bank's base interest rate—now at virtually zero—was imminent.

"Our decision today to begin tapering does not imply any direct signal regarding our interest rate policy," he said. "We continue to articulate a different and more stringent test for the economic conditions that would need to be met before raising the federal funds rate."

He also made the point that even after the Fed's balance sheet stopped expanding "our holdings of securities will continue to support accommodative financial conditions."

The Fed now has more than $8 trillion of financial assets on its balance sheet, with its holdings having doubled in response to the March 2020 crisis.

The Fed has led the way in a massive expansion of asset purchases, with the Bank of America estimating that since the global financial crisis of 2008 the world's central banks have pumped $23 trillion into the financial system through various quantitative easing programs.

The Fed decision, and particularly its insistence that its base interest rate was not going to increase any time soon, was warmly received on Wall Street, with the three major indexes all closing at record highs.

The S&P 500 rose by 0.7 percent, with the Dow rising by 0.3 percent to finish well over the level of 36,000, which it reached for the first time on Tuesday. The NASDAQ index gained around 1 percent.

However, it has been a different story in bond markets which have seen major turbulence over the past two weeks as fears that inflation, far from being "transitory," as the Fed has continually claimed, is becoming entrenched.

Major hedge fund investors which bought into the Fed's "transitory" claim have been hit by significant losses as yields in the short-term bond market rose significantly on inflation fears. Bonds have been sold off and their prices have fallen causing the yield to rise (they have an inverse relationship).

As the *Financial Times* (FT) reported earlier this week: "Short-dated borrowing costs have surged everywhere. US two-year yields hit 0.55 percent on Friday, their highest since before the pandemic and up from 0.21 percent a month ago."

The numbers may be small, but in terms of bond market trading they are significant. Earlier this week, the sell-off in short-term bond markets forced the Reserve Bank of Australia (RBA) to abandon its attempt to maintain the yield on a 2024 bond at 0.1 percent when its rate in the market rose to 0.8 percent.

Faced with the prospect it would have to buy all the bonds available in the market to maintain its policy, the

RBA threw in the towel.

James Athey, a bond portfolio manager at Aberdeen Standard Investments, told the FT bond markets were likely to remain "choppy" as investors were forced to abandon their bets that rates would remain low.

"A lot of people had swallowed the central bank guidance that this inflation was all transitory, and now they've been burnt," he said. "You're just seeing this bloodletting as people get stopped out of their positions, and it could go on a while longer."

A comment on Bloomberg used stronger language. It said that hedge fund managers had watched a "nightmare scenario" playing out on the world's bond markets. It noted that as "losses piled up" they became so big that some firms halted some trading in a bid to contain the damage.

It noted that even some of the "most sophisticated traders had been caught flat-footed by the rapid shift in sentiment" that had raced through the markets.

Shifts in the bond market are reflecting the increasing prospect of stagflation—rising prices combined with lower growth.

The yields on short-term bonds are rising in the expectation of increased inflation, while those on longer-term bonds have tended to fall, in the expectation that growth rates will decline.

With its claim of "transitory" inflation being exposed, the Fed adjusted the language of its monetary policy statement. It said the upward pressure on prices was "expected to be transitory" whereas it had said in previous statements that inflation was largely driven by "transitory factors."

There have been warnings that the volatility in bond markets could extend to the stock market. The FT reported in an article this week on comments by Bank of America analyst Riddhi Prasad who warned that stock market investors were becoming complacent about risks.

"Equities—and equity volatility—should not miss the forest for the trees, as they've never been more dependent on the Fed and the Fed has never been more dependent on economic data, which itself has never been more volatile," he said.

The Fed had "never been more uncertain on their own outlook" and this was "a precarious backdrop for such a self-confident equity market."

The article also cited comments by a Goldman Sachs analyst there was a risk of a combined equity and bond sell-off as "growth decelerates further and inflation remains sticky."

The uncertainty at the Fed over the direction of the economy were reflected in Powell's opening statement.

In the first half of the year, he said, economic activity expanded at 6.5 percent, reflecting progress on vaccinations, the reopening of the economy and strong policy support. But in the third quarter "real GDP slowed notably from this rapid pace."

Powell did not make the point, but the annualised growth rate in the three months to September was the lowest since the economic "recovery" from the pandemic recession began.

He noted that as with overall economic activity, the pace of improvement in the labour market slowed with the rise in COVID cases. "In August and September, job gains averaged 280,000 per month, down from an average of about 1 million jobs per month in June and July."

There were "sizable price increases" in some sectors of the economy with the result that "overall inflation is running well above our 2 percent longer-run goal" and "supply constraints have been larger and longer lasting than anticipated."

He said the tools available to the Fed could not ease supply constraints and it was "very difficult to predict the persistence of supply constraints or their effects on inflation."

He held out the prospect that complex global supply chains would return to their normal function "but the timing of that is highly uncertain."