Faster taper – limited impact

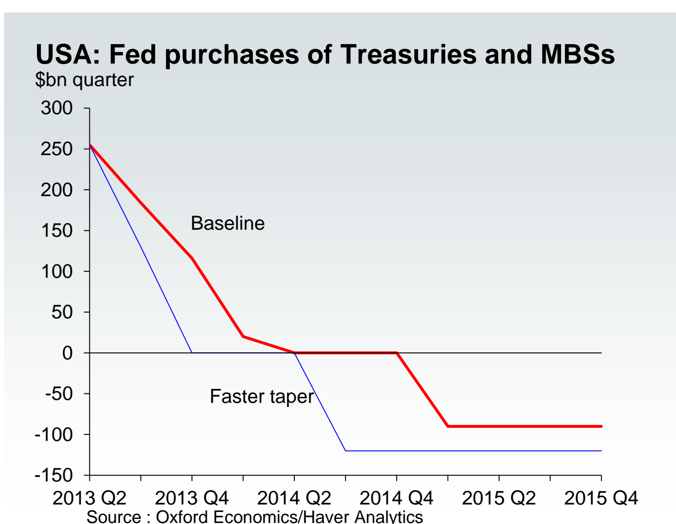
Markets took fright after Ben Bernanke's press conference on 19 June at the prospect of an early end to QE. Bond purchases might be tapered off sooner, as the Fed now expects unemployment to fall to its target of 6.5% next year rather than in 2015. It is not yet clear whether any of the bonds bought as part of QE will eventually be sold off. While it is obvious that an end to the Fed's purchases will have an impact on output growth and asset prices, our Global Economic Model shows that the effects will be limited.

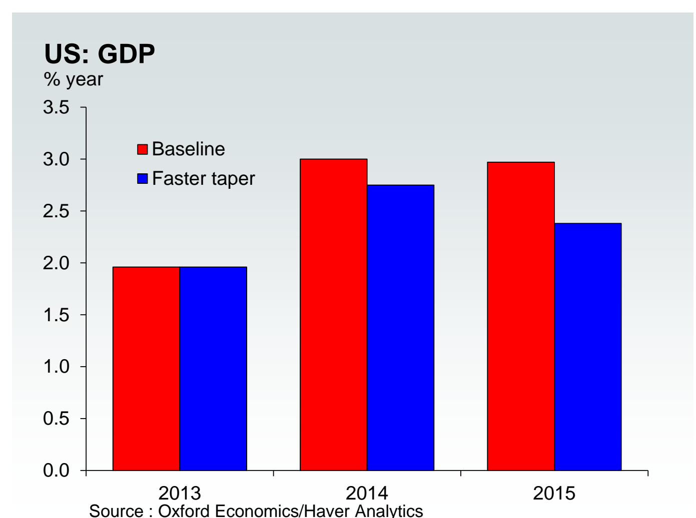
Bernanke gives a steer

Following its June meeting, the Federal Open Market Committee (FOMC) released new economic projections for output growth, unemployment and inflation. While the changes from the March forecasts were minimal, one crucial shift was that the Fed now expects unemployment to reach 6.5% in 2014. This is the 'threshold' rate which the Fed introduced at the end of 2012 beyond which current monetary policy will no longer hold. On this basis – and since the Fed also expects inflation of between 1.4% and 2% next year – it should not have come as a surprise that Ben Bernanke at his post-meeting press conference held out the possibility of lower QE purchases this year, with an end to them in 2014. There has already been substantial speculation about when the Fed would begin the taper, so what the Fed Chairman did was to give a steer as to timing, rather than to spring a new policy on markets. Nevertheless, global equity markets took fright the following day and sold off between 1.4% and 3%, while bond yields rose 13 basis points to 2.33%, their highest level for 15 months.

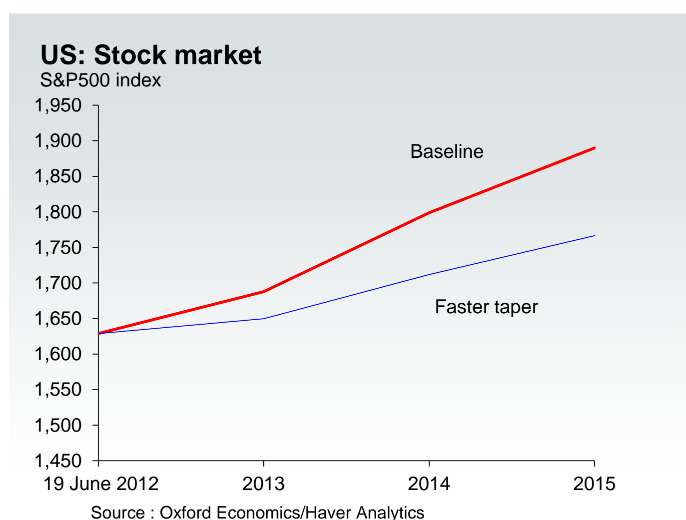
How much of an impact?

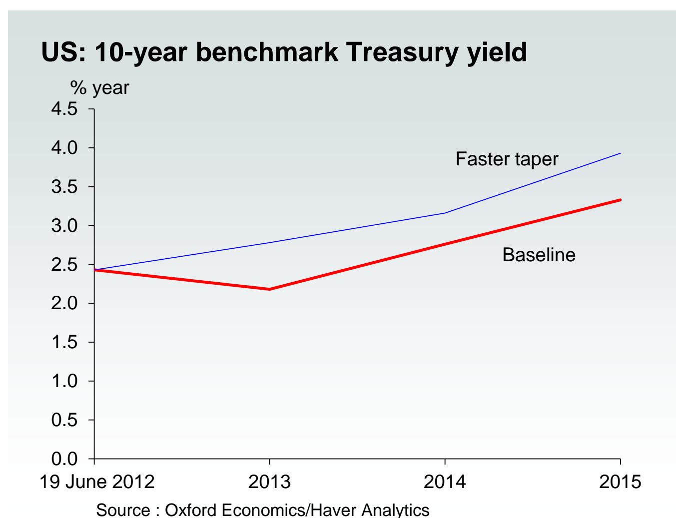
Obviously, the withdrawal of QE and the higher bond yields that this entails will have an impact on both asset prices and activity. But, while it is clear that the Fed will stop buying securities, it is not entirely clear whether it will then begin to sell them. In fact, the Fed has already said that it will not sell mortgage-backed securities, so any sales would be restricted to Treasuries. This also means that the impact of higher bond yields from the end of bond purchases will be intensified by any future sales.





Our baseline scenario assumes that the Fed begins to taper QE in Q3 2013, bringing purchases to an end in Q2 2014; and that the Fed then begins to sell Treasuries to the tune of $30 billion a month from Q2 2015 onwards. We have also modelled the impact of a faster process, where purchases end in Q3 2013; and Treasuries sales amounting to $40 billion a month begin in Q3 2014. This scenario looks just at the effects of the policy change and does not assume that output accelerates beforehand. If the Fed's earlier tapering was accounted for by initially faster GDP growth, the impact would be reduced.





Growth and asset prices would be weaker

The effect of a faster taper or larger sales would be to lower GDP growth by around 0.25 percentage points in 2014 to 2.75% instead of 3%; and by another 0.6 percentage points in 2015 (growth of 2.4% instead of 3%). Share prices (measured by the S&P500) would be about 5% lower in the faster scenario than in the baseline at the end of 2014 and about 6.5% lower at the end of 2015. For bonds, the benchmark 10-year Treasury yield would be 60 basis points higher at the end of each year than under the baseline scenario.

But growth will still be positive and asset prices will eventually rise again

While this is not good news, one or two points need to be made. First, both the baseline scenario and the faster taper scenario are forecasting continued output growth and higher share prices; the difference is one of degree, not of direction. Second, the longer-term impact on share prices may not be quite as negative as the model projects. What happened in previous periods of monetary policy tightening – 1994 and 2004 – can provide a guide. Of course, those two were triggered by rises in the Fed Funds rate, not by bond yields rising. However, in 1994, the yield on the 10-year Treasury stood at 5.94% on 4 February when the Fed began to tighten monetary policy. By the end of the year it was 7.84%, a rise of 290bps. By contrast, in 2004, the yield on the 10-year Treasury stood at 4.62% when the Fed began to raise interest rates; the yield then fell (Alan Greenspan's famous 'conundrum') and only rose sustainably above the initial rate some 20 months later, in February 2006. This episode is thus perhaps of less relevance in the current situation. However, in 1994, the Fed's tightening was generally unexpected and perceived to be severe, with the Fed Funds rate doubling from 3% to 6% over the course of a year. The S&P500 initially fell by close to 9% by early April and then began to trend erratically upwards. It regained its pre-hike level exactly a year after the first rate rise, after which it continued a relatively steady upward trend until the dot-com bubble burst in 2000. The episode shows that the medium-term impact of higher interest rates on share prices depends very much on circumstances, and need not be negative beyond an immediate reaction.

Fed action is a sign of sustainable recovery

Markets will undoubtedly sell off again once the Fed announces details of its taper. However, the Fed will only withdraw its easy monetary policy – and eventually begin to tighten – if it is convinced that the economy is on a sustainable recovery path. While bond markets will continue to sell off as the Fed eventually normalises long-term interest rates, equities should recover as it becomes clear that the economy is not going into a tailspin. What may feel like the beginning of a bear market is more likely to be a buying opportunity – albeit one accompanied at least in the near term by a substantial increase in volatility.

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