Bond Blog

June 7, 2021

PGIM FIXED INCOME

FED TAPERING: CAN WE TALK?

By Ellen Gaske, PhD., CFA, Lead Economist G10 Economies, Global Macroeconomic Research Team

The rollout of the COVID-19 vaccines at the turn of the year shifted the narrative of the U.S. economic recovery from "when" to "how strong." Shortly thereafter, we began anticipating that the Federal Reserve might begin tapering its asset purchases by the end of 2021, which remains our base case looking ahead. This post discusses our rationale for this projected timeline, the new problems now emerging as the Fed continues its large-scale asset purchases, and how this reduction may differ from 2013's taper tantrum.

In the spring of 2020, when the COVID-19 crisis triggered a sudden-stop in economic activity and mad dash for cash in financial markets, the Fed responded quickly, opening the playbook it had developed 12 years earlier during the Financial Crisis. In short order, it dropped the Fed funds rate to zero - signalling it would be kept low-for-long - launched QE purchases of Treasuries and agency MBS, and added credit and liquidity programs designed to backstop other credit markets and to complement the massive fiscal support being deployed. The enormous, rapid fiscal and monetary responses to the crisis appeared to meet their objective - they provided a bridge to help the economy reach the other side of the pandemic.

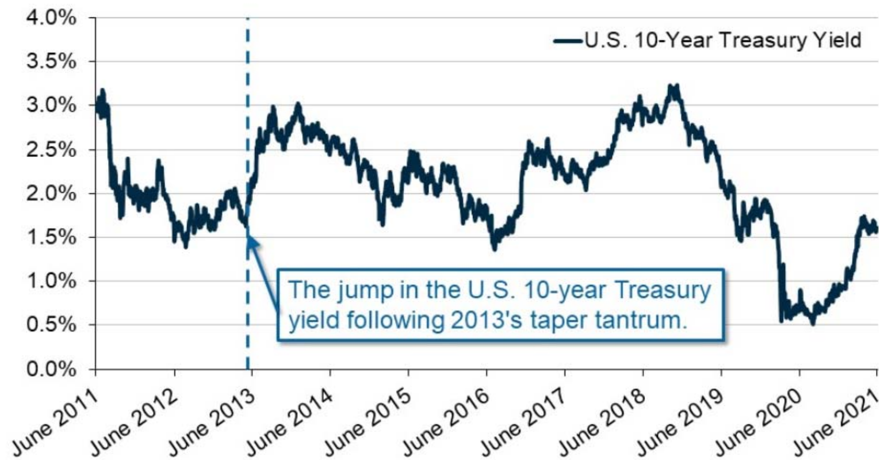
The path followed by the economy over the past year, however, provides an important reminder that although recessions rhyme - each entails a broad-based decline in activity that is sustained for some period - the trigger(s) and exact contours of each can differ, in some cases dramatically. The recession and recovery from the COVID-19 crisis serve as a case in point. The much sharper-than-expected V-shaped rebound surprised both the Fed and most economic forecasters, yet was front-run by an even stronger, more rapid rebound in risk asset prices.

At this point, U.S. GDP has now rebounded to its pre-COVID level and last year's feared drop in inflation expectations has reversed itself and then some. Given expected further strong gains in economic activity over coming quarters, we anticipate GDP will grow 6.5% this year. Supply bottlenecks, not insufficient policy stimulus, are the constraining factor at this point. In the labor market, the demand for workers appears to be recovering much faster than the supply, with job openings at record levels, and small businesses citing lack of available workers as a foremost concern. Employment is expected to improve by this fall, though, amidst further progress on vaccinations, additional school reopenings, and expiration of the boosted unemployment benefits in September, with half of the states so far adopting an even earlier end.

Against this backdrop, financial market participants have been ahead of the Fed in discussing an end to its QE purchases. Unlike in the early phases of the crisis 12 years ago, when the Fed devoted significant effort explaining to the public what QE was meant to achieve, comparatively little explanation or justification was required this time around. Market participants understood QE and its implications. And unlike the taper tantrum that ensued when then-Fed Chairman Bernanke broached the topic of tapering in May 2013 (Figure 1), this time, it has been market participants initiating the taper discussion. In recent weeks, though, a number of Fed officials have joined the conversation, indicating it is probably time to put the issue on the table.

For Professional Investors Only. All Investments involve risk, including the possible loss of capital.

FIGURE 1: THE FED-INDUCED TAPER TANTRUM OF 2013



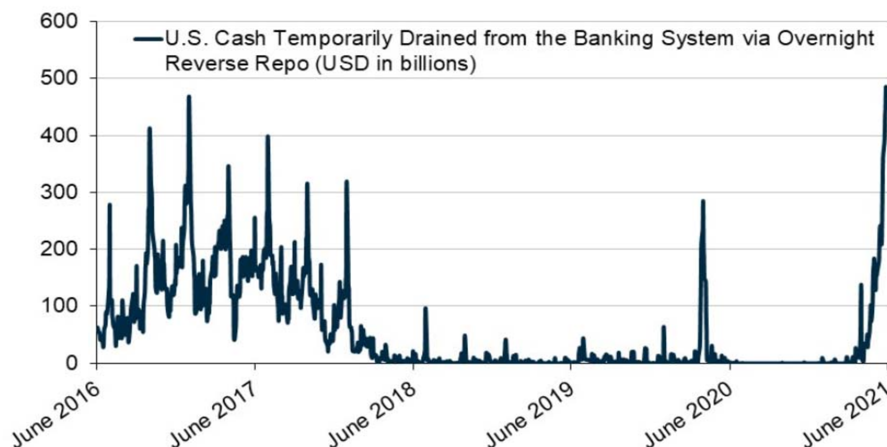
Source: Source: Bloomberg as of June 2021.

Can We Talk Technicals?

Beyond the strength of the economic and financial market recovery to date, several technical factors brewing since early March are likely hastening the tapering discussion. Like much of the private sector, the U.S. Treasury built up a war chest of cash during the pandemic, issuing more Treasury securities than required to fund its current cash needs and depositing the proceeds in its account at the Fed. That extra issuance effectively mopped up the equivalent amount of liquidity from the banking system. But with passage of the $1.9 trillion federal stimulus package in March 2021, the Treasury has been drawing down its balances at the Fed to meet the expenditure requirements in that package, effectively injecting those balances back into the banking system. At the same time, exemptions from Supplementary Leverage Ratio (SLR) capital requirements granted to large banks for their holdings of Treasuries and reserve balances at the Fed during the COVID crisis expired at the end of March 2021. Bank demand for these assets presumably declined given the higher capital requirements.

Consequently, short-term interest rates have become "soggy," with several portions of the money market now experiencing slightly negative nominal rates and the Fed funds rate trading closer to the bottom of the Fed's targeted band of 0.0%-0.25%. Use of the Fed's reverse repo facility, a means for absorbing excess liquidity and helping to put a floor under money market rates, is now seeing a surge in activity (Figure 2).

FIGURE 2: THE SURGE IN U.S. OVERNIGHT REVERSE REPO USAGE



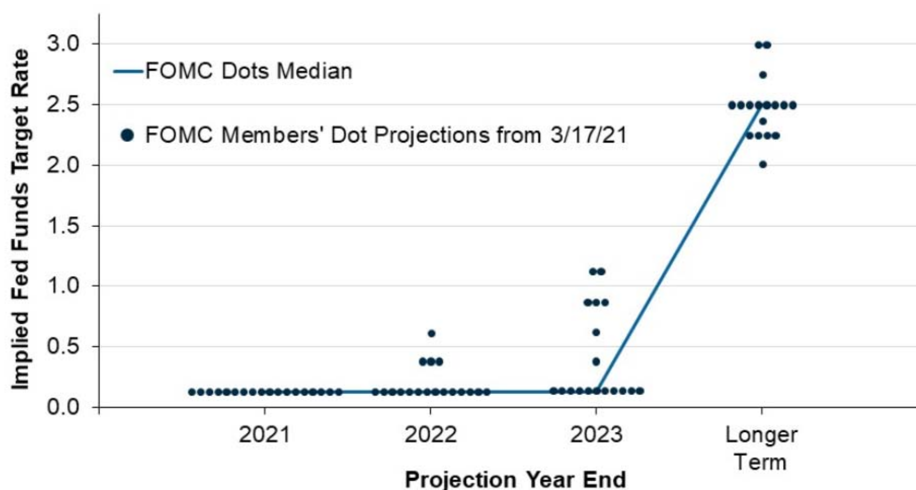
Source: Bloomberg as of June 2021.

The Fed is also considering a tweak to its administered rate (interest rate on excess reserves, IOER), as it has done a few times in recent years in order to keep the Fed funds rate closer to the mid-point of its targeted range. Meanwhile, the Fed is buying the lion's share of net new agency MBS originations - risking the possibility of damaging private market functioning the longer that trend persists. In short, the flood of liquidity that the Fed continues to provide through its QE purchases is now itself requiring policy "fixes."

What if the Forecasts are Wrong?

What if the forecast for a continued strong recovery proves wrong? While we expect growth to moderate to 4.5% in 2022, next year's growth slowdown will likely be cushioned by some of the caution displayed to date. Households, government agencies, and state & local governments have not come close to spending all of the fiscal stimulus received. In fact, households have been saving and paying down debt at a record pace, which should support consumption going forward. But if growth and/or inflation surprise to the downside next year, the Fed could ease financial conditions further by signaling the Fed funds rate will likely be kept at zero for even longer than its forward rate guidance now suggests (Figure 3).

FIGURE 3: IF GROWTH OR INFLATION SURPRISES TO THE DOWNSIDE, THE FED COULD POSTPONE ITS PROJECTION FOR LIFTOFF



Source: Bloomberg as of June 2021.

Given the strength of the recovery to date and signs that the Fed's liquidity injections may be becoming excessive, the Fed's tapering decision appears closer at hand. The Fed will likely want to see at least another quarter of improving economic activity - waiting until Q4 2021 to begin tapering would allow Fed officials to observe whether recovery of the economy, and the labor market in particular, actually make significant further progress. Until then, we anticipate that the ongoing talk about and prior experience with tapering will continue to condition and prepare financial markets for the Fed's eventual reduction in asset purchases.

This material reflects the views of the author as of June 7, 2021 and is provided for informational or educational purposes only. Source(s) of data (unless otherwise noted): PGIM Fixed Income.

Important Information

PGIM Fixed Income operates primarily through PGIM, Inc., a registered investment adviser under the U.S. Investment Advisers Act of 1940, as amended, and a Prudential Financial, Inc. ("PFI") company. Registration as a registered investment adviser does not imply a certain level or skill or training. PGIM Fixed Income is headquartered in Newark, New Jersey and also includes the following businesses globally: (i) the public fixed income unit within PGIM Limited, located in London; (ii) PGIM Netherlands B.V. located in Amsterdam; (iii) PGIM Japan Co., Ltd. ("PGIM Japan"), located in Tokyo; (iv) the public fixed income unit within PGIM (Hong Kong) Ltd. located in Hong Kong; and (v) the public fixed income unit within PGIM (Singapore) Pte. Ltd., located in Singapore ("PGIM Singapore"). PFI of the United States is not affiliated in any manner with Prudential plc, incorporated in the United Kingdom or with Prudential Assurance Company, a subsidiary of M&G plc, incorporated in the United Kingdom. Prudential, PGIM, their respective logos, and the Rock symbol are service marks of PFI and its related entities, registered in many jurisdictions worldwide.

These materials are for informational or educational purposes only. The information is not intended as investment advice and is not a recommendation about managing or investing assets. In providing these materials, PGIM is not acting as your fiduciary. These materials represent the views, opinions and recommendations of the author(s) regarding the economic conditions, asset classes, securities, issuers or financial instruments referenced herein. Distribution of this information to any person other than the person to whom it was originally delivered and to such person's advisers is unauthorized, and any reproduction of these materials, in whole or in part, or the divulgence of any of the contents hereof, without prior consent of PGIM Fixed Income is prohibited. Certain information contained herein has been obtained from sources that PGIM Fixed Income believes to be reliable as of the date presented; however, PGIM Fixed Income cannot guarantee the accuracy of such information, assure its completeness, or warrant such information will not be changed. The information contained herein is current as of the date of issuance (or such earlier date as referenced herein) and is subject to change without notice. PGIM Fixed Income has no obligation to update any or all of such information; nor do we make any express or implied warranties or representations as to the completeness or accuracy or accept responsibility for errors. All investments involve risk, including the possible loss of capital. These materials are not intended as an offer or solicitation with respect to the purchase or sale of any security or other financial instrument or an y investment management services and should not be used as the basis for any investment decision. No risk management technique can guarantee the mitigation or elimination of risk in any market environment. Past performance is not a guarantee or a reliable indicator of future results and an investment could lose value. No liability whatsoever is accepted for any loss (whether direct, indirect, or consequential) that may arise from any use of the information contained in or derived from this report. PGIM Fixed Income and its affiliates may make investment decisions that are inconsistent with the recommendations or views expressed herein, including for proprietary accounts of PGIM Fixed Income or its affiliates.

The opinions and recommendations herein do not take into account individual client circumstances, objectives, or needs and are not intended as recommendations of particular securities, financial instruments or strategies to particular clients or prospects. No determination has been made regarding the suitability of any securities, financial instruments or strategies for particular clients or prospects. For any securities or financial instruments mentioned herein, the recipient(s) of this report must make its own independent decisions.

Conflicts of Interest: PGIM Fixed Income and its affiliates may have investment advisory or other business relationships with the issuers of securities referenced herein. PGIM Fixed Income and its affiliates, officers, directors and employees may from time to time have long or short positions in and buy or sell securities or financial instruments referenced herein. PGIM Fixed Income and its affiliates may develop and publish research that is independent of, and different than, the recommendations contained herein. PGIM Fixed Income's personnel other than the author(s), such as sales, marketing and trading personnel, may provide oral or written market commentary or ideas to PGIM Fixed Income's clients or prospects or proprietary investment ideas that differ from the views expressed herein. Additional information regarding actual and potential conflicts of interest is available in Part 2A of PGIM Fixed Income's Form ADV.

In the United Kingdom, information is issued by PGIM Limited with registered office: Grand Buildings, 1-3 Strand, Trafalgar Square, London, WC2N 5HR. PGIM Limited is authorised and regulated by the Financial Conduct Authority ("FCA") of the United Kingdom (Firm Reference Number 193418). In the European Economic Area ("EEA"), information is issued by PGIM Netherlands B.V., an entity authorised by the Autoriteit Financiële Markten ("AFM") in the Netherlands and operating on the basis of a European passport. In certain EEA countries, information is, where permitted, presented by PGIM Limited in reliance of provisions, exemptions or licenses available to PGIM Limited under temporary permission arrangements following the exit of the United Kingdom from the European Union. These materials are issued by PGIM Limited and/or PGIM Netherlands B.V. to persons who are professional clients as defined under the rules of the FCA and/or to persons who are professional clients as defined in the relevant local implementation of Directive 2014/65/EU (MiFID II). In certain countries in Asia-Pacific, information is presented by PGIM (Singapore) Pte. Ltd., a Singapore investment manager registered with and licensed by the Monetary Authority of Singapore. In Japan, information is presented by PGIM Japan Co. Ltd., registered investment adviser with the Japanese Financial Services Agency. In South Korea, information is presented by PGIM, Inc., which is licensed to provide discretionary investment management services directly to South Korean investors. In Hong Kong, information is provided by PGIM (Hong Kong) Limited, a regulated entity with the Securities & Futures Commission in Hong Kong to professional investors as defined in Section 1 of Part 1 of Schedule 1 (paragraph (a) to (i) of the Securities and Futures Ordinance (Cap.571). In Australia, this information is presented by PGIM (Australia) Pty Ltd ("PGIM Australia") for the general information of its "wholesale" customers (as defined in the Corporations Act 2001). PGIM Australia is a representative of PGIM Limited, which is exempt from the requirement to hold an Australian Financial Services License under the Australian Corporations Act 2001 in respect of financial services. PGIM Limited is exempt by virtue of its regulation by the FCA (Reg: 193418) under the laws of the United Kingdom and the application of ASIC Class Order 03/1099. The laws of the United Kingdom differ from Australian laws. In South Africa, PGIM, Inc. is an authorised financial services provider – FSP number 49012. In Canada, pursuant to the international adviser registration exemption in National Instrument 31-103, PGIM, Inc. is informing you of that: (1) PGIM, Inc. is not registered in Canada and is advising you in reliance upon an exemption from the adviser registration requirement under National Instrument 31-103; (2) PGIM, Inc.'s jurisdiction of residence is New Jersey, U.S.A.; (3) there may be difficulty enforcing legal rights against PGIM, Inc. because it is resident outside of Canada and all or substantially all of its assets may be situated outside of Canada; and (4) the name and address of the agent for service of process of PGIM, Inc. in the applicable Provinces of Canada are as follows: in Québec: Borden Ladner Gervais LLP, 1000 de La Gauchetière Street West, Suite 900 Montréal, QC H3B 5H4; in British Columbia: Borden Ladner Gervais LLP, 1200 Waterfront Centre, 200 Burrard Street, Vancouver, BC V7X 1T2; in Ontario: Borden Ladner Gervais LLP, 22 Adelaide Street West, Suite 3400, Toronto, ON M5H 4E3; in Nova Scotia: Cox & Palmer, Q.C., 1100 Purdy's Wharf Tower One, 1959 Upper Water Street, P.O. Box 2380 – Stn Central RPO, Halifax, NS B3J 3E5; in Alberta: Borden Ladner Gervais LLP, 530 Third Avenue S.W., Calgary, AB T2P R3.

© 2021 PFI and its related entities.

留意事項 2

※本資料はPGIMフィクト・インカムが市場動向に関する情報提供としてプロの投資家向けに作成したものです。PGIMフィクスト・インカムは、米国SECの登録投資顧問会社であるPGIMインクの債券運用部門です。

※本資料は情報提供を目的としたものであり、特定の金融商品の勧誘又は販売を目的としたものではありません。また、本資料に記載された内容等については今後変更されることもあります。

※記載されている市場動向等は現時点での見解であり、これらは今後変更することもあります。また、その結果の確実性を表明するものではなく、将来の市場環境の変動等を保証するものでもありません。

※本資料に記載されている市場関連データ及び情報等は信頼できると判断した各種情報源から入手したものですが、その情報の正確性、確実性について当社が保証するものではありません。

※過去の運用実績は必ずしも将来の運用成果等を保証するものではありません。

※本資料は法務、会計、税務上のアドバイスあるいは投資推奨等を行うために作成されたものではありません。

※当社による事前承諾なしに、本資料の一部または全部を複製することは堅くお断り致します。

※"Prudential"、"PGIM "、それぞれのロゴおよびロック・シンボルは、プルデンシャル・ファイナンシャル・インクおよびその関連会社のサービスマークであり、多数の国・地域で登録されています。

※PGIMジャパン株式会社は、世界最大級の金融サービス機関プルデンシャル・ファイナンシャルの一員であり、英国プルーデンシャル社とはなんら関係がありません。

PGIMジャパン株式会社
金融商品取引業者 関東財務局長（金商）第392号
加入協会 一般社団法人日本投資顧問業協会、一般社団法人投資信託協会
PGIMJ82116