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Would tapering Quantitative Easing lead to higher bond yields?

Notwithstanding the fact that it's still two months until we ring in the New Year, and the markets could throw in plenty of surprises between now and then, 2013 will likely be remembered as a year where two 'themes' have dominated the mainstream financial media, had a huge impact on consensus thinking and had a profound impact on asset markets the world over:

- The global economy was finally recovering from the worst of the Global Financial Crisis and growth would strengthen. 'Escape velocity' was nearby.

- The Federal Reserve would begin to taper if not outright cease its $85 billion a month quantitative easing (QE) programme in late 2013

This theme first gained attention as early as January of this year, when reports in Bloomberg appeared suggesting that the majority of Federal Reserve Open Market Committee Members (FOMC) saw QE3 ending by the middle to end of 2013, a strange prognostication, in hindsight, considering that QE3 only began in September 2012 in the first place, and was actually expanded in December of last year.

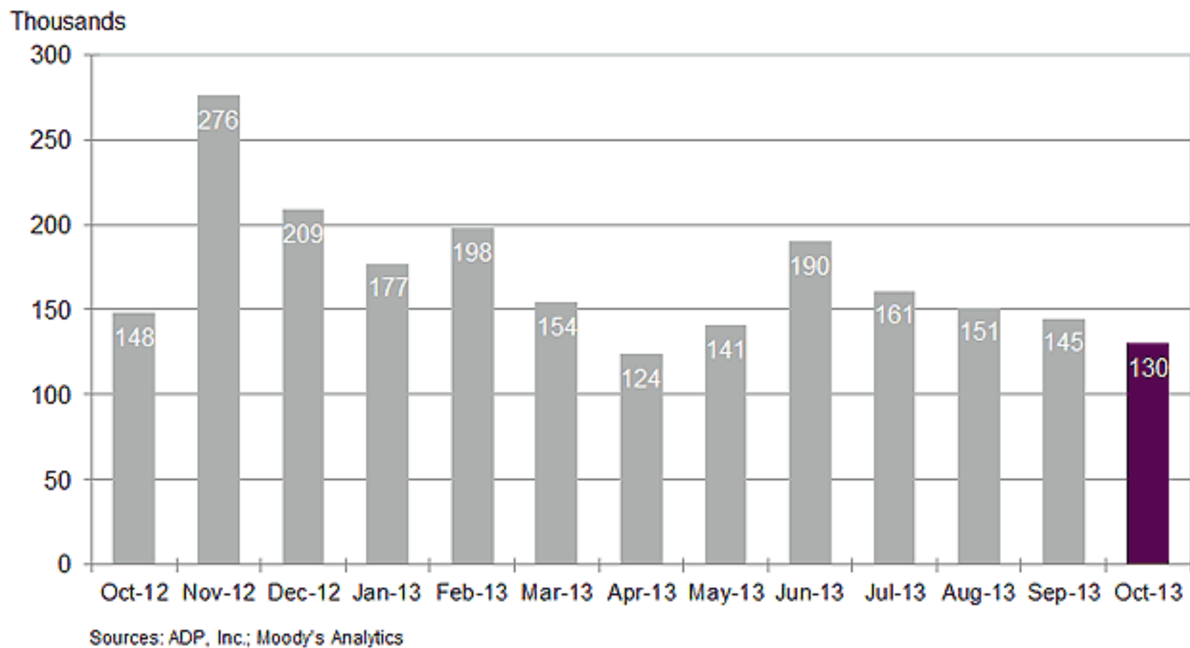
Nevertheless, these themes have dominated discourse this year, and have seen a strong rally in 'risk assets' (equities, listed real estate, listed infrastructure and direct property in many countries), whilst precious metals in particular have been sold off aggressively, as the lack of official inflation, rebounding asset markets, relative stability in Europe and an expectation that the Fed would end QE have all dented the 'safe haven' demand for gold and silver.

Bonds have also fallen, with many calling 2013 as the end of the three-decade-long bull market in bonds that began in the early 1980s.

However, with the October Federal Open Market Committee (FOMC) meeting just completed, and with the Fed deciding again to maintain its monthly asset purchase programme at $85 billion a month, it is now apparent that tapering of QE is unlikely to occur to any degree in 2013, whilst ending it outright is completely off the table.

As such, it would appear that at least one of the major themes of the year (tapering) has turned out to be false, and the reason that the Fed will not taper QE is because the other theme, that of a ***sustainable and strengthening*** economic recovery is also proving to be false, best evidenced by the declining jobs growth figures we saw last week out of the US with non-farm payrolls, which have been trending down for months, and confirmed overnight with the

release of the ADP National Employment report, which shows a declining trend of job growth since the end of last year.



Source: ADP National Employment Report

With such lukewarm economic numbers, the Fed does not want to be seen 'adding to the uncertainty', especially in light of the recent US Government shutdown and the debt-ceiling debate, which will no doubt return to mainstream attention early next year.

As such, they are keen to 'maintain support' for the markets, at least for the time being, remembering of course that the whole point of undertaking the various QE programmes over the past few years has been to lower yields and therefore borrowing costs in the economy at large, hopefully stimulating higher levels of economic activity.

What is the Fed afraid of?

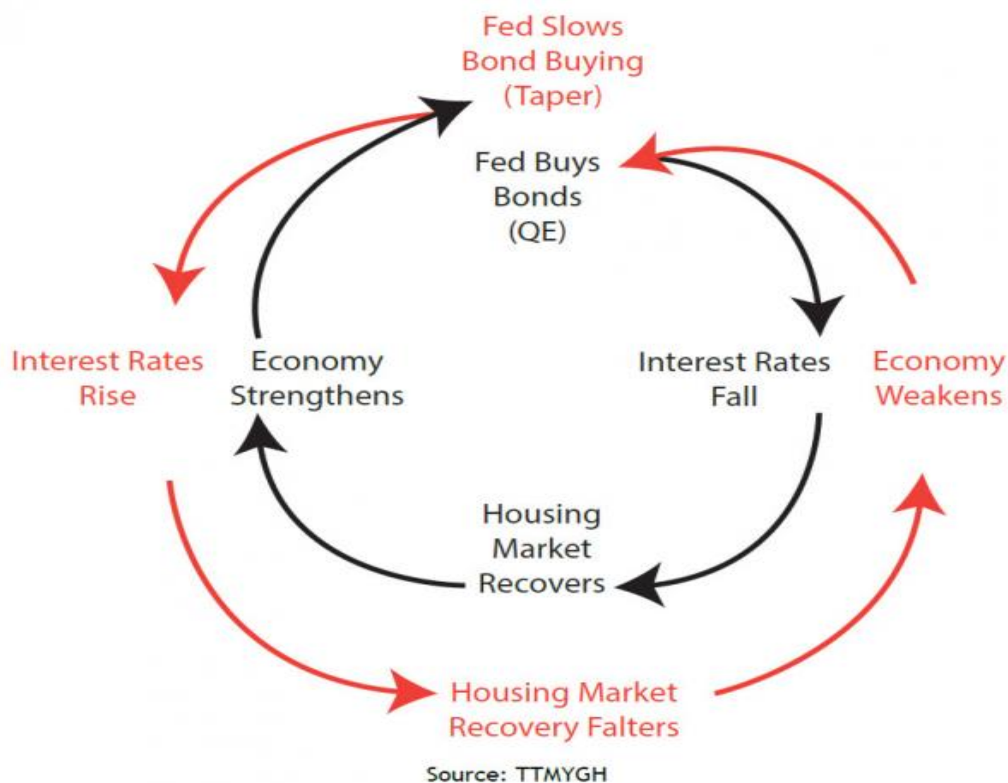
The chart below represents the mainstream consensus around the threat to the economy from a potential tapering of quantitative easing. It was produced by Grant Williams, of Vulpes Asset Management and the author of the must read "Things that make you go Hmmm" report, which you'll find easily enough if you type that title into Google (no doubt alongside a link to the 1991 classic song by C+C Music Factory).

I don't know Grant personally but have heard him speak and in my opinion at the very least, he "gets it", the risks of QE and financial repression in general, the imbalances that still plague the global economy and continue to worsen, and the unsustainable path we are on.

Grant's reports are always very interesting, highly informative and have the added benefit of generally being quite amusing, not something easy to achieve when talking economics, debt, deficits and the like.

I highly recommend that anyone who has an extra 30 minutes of reading time a week spend it reading through his publication, whilst those of you who use Twitter, can also follow Grant via his handle @ttmygh.

Going back to the chart, whilst it accurately reflects the consensus opinion as to the risks of Fed tapering, in that their absence from the bond market would mean higher yields (borrowing costs) and therefore slower growth, it doesn't actually doesn't gel with what's happened in the bond market in periods where the Fed hasn't been printing money via QE since 2008.



Quantitative easing & the US Bond Market – theory vs. fact and what's happened since 2008

The Theory – what's meant to happen to bond yields in the absence of QE

The theory behind rising bond yields in the absence of Fed QE programmes is simple enough.

The Fed, as the largest buyer of government bonds in the marketplace today, obviously has a significant impact on prices, with the argument being that they

help push bond prices higher (and bond yields lower) by printing such an enormous volume of money, which is used to purchase these bonds.

Theoretically, if the Fed were to stop printing money, then the US Treasury loses the biggest purchaser of its freshly-issued debts.

As with any market, if the biggest purchaser is absent from the market, it's logical to expect prices to fall (which means rising yields in the case of bonds)

The argument also states that, at present, private investors, i.e. those who would have to buy the bonds that the US Treasury wants to issue, would demand a higher rate of return than is currently on offer lending to the US Government.

This argument is very logical, especially when you consider than interest rates for lending to the US Government have essentially never been lower, whilst the amount of debt the government owes (it recently topped $17 trillion) has never been higher.

Indeed, despite mainstream financial theory claiming that government bonds are a 'risk-free' asset, in reality they are 'return free' assets now, in that the 2.50% or so you'll get for lending money to the US Government barely covers inflation, and leaves you exposed to inflation and default risk.

The threat of the rising yields is obviously worrying economic commentators and asset managers, as obviously higher interest rates would indeed hurt the US 'economic recovery'.

Indeed we've witnessed it already in the past 6 months as rising bond yields have seen mortgage applications (both for new mortgages and refinancing) fall over 50%, leading to thousands of job losses for companies like Bank of America and Wells Fargo.

Therefore, the consensus opinion, accurately summarised in the neat graph that Grant has put together, is easy to grasp, and it is undoubtedly one of the main reasons that the Fed has, as yet, not tapered its QE programme in any way.

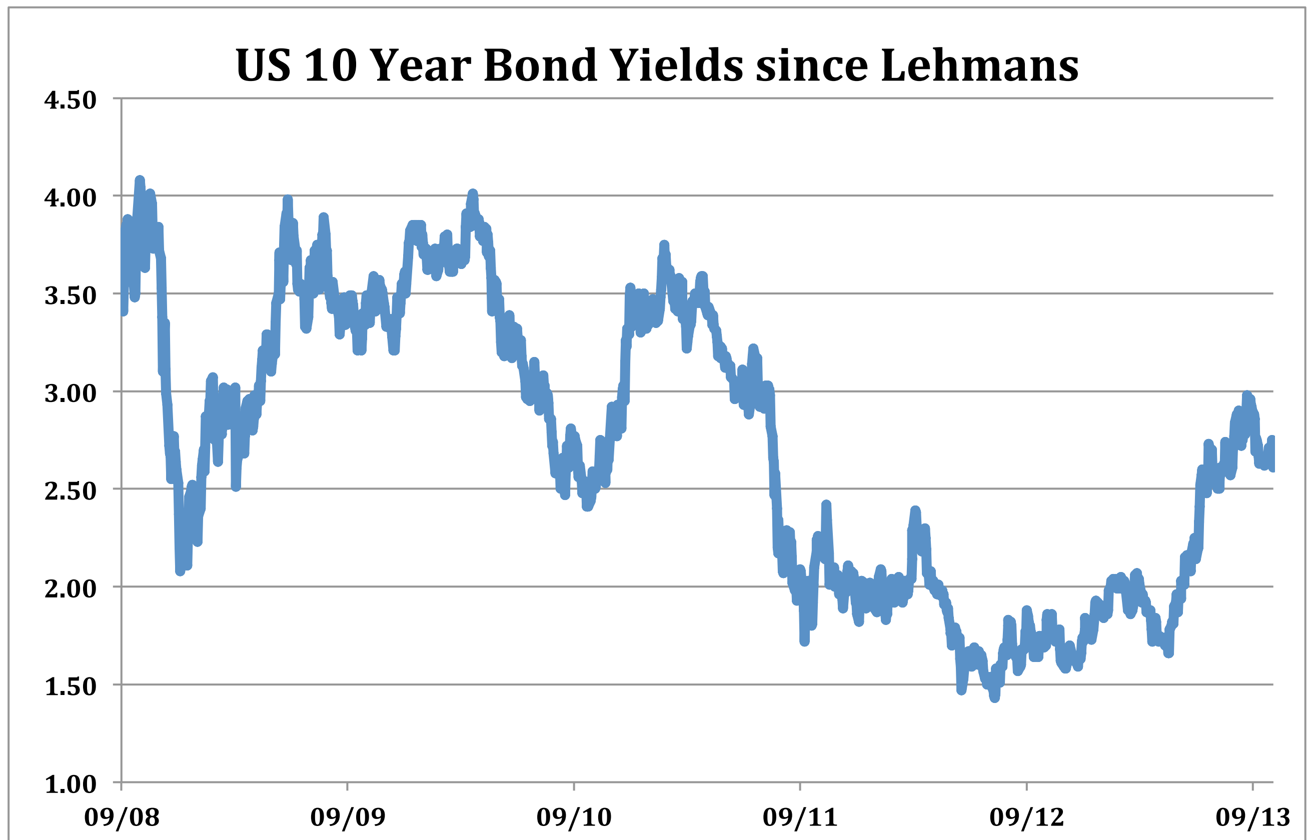
The problem with the theory is that the history of the 'post-GFC' era suggests that it's wrong, and that it should perhaps be lower bond yields that are the chief concern!

The Facts – what has happened to bond yields in the absence of QE

The following graph summarises movements in US Bond yields over the past 5 years, essentially since Lehman Brothers went bust on September 15 2008, when yields on US 10 year treasury bonds were trading at 3.47%.

I've chosen to use the 10 year yield as a gauge of US borrowing costs as it's the most commonly reference bond yield in the global marketplace, and essentially

marks the midpoint between the short (less than 5 years) and longer term (more than 10 year) obligations the US Government has.



As you can see, in late 2008 we saw a plunge in yields down to circa 2%, before a sharp rally all the way back to 4%. Yields oscillated around this point for some time, before plummeting to 2.5% by the latter part of 2010.

After reversing back above 3.5%, yields were in a sustained downtrend for nearly 2 years, dropping as low as 1.5%, the lowest level in hundreds of years.

Since that low point in late 2012 they've been on the way back up again, although they've again eased in the past couple of weeks.

The table below records the key months over this period where the Fed has either by word, or deed, influenced treasury and other bond markets through announcements regarding purchases of treasury and other bonds via its various asset purchase programmes.

Month	US 10 Year Bond Yield	Fed Action / Statement
Nov 2008	3.11	QE1 announced – up to $600bn in MBS/Agency Debt to be bought by Fed
Dec 2008	2.37	QE1 formally begins
Mar 2009	2.51	QE1 expanded - $750 billion in MBS and $300 billion of US Treasuries
Mar 2010	3.84	QE1 ends ($1.25 trillion in MBS bought, $300bn in Treasury bonds and $175bn in agency debt)
Nov 2010	2.67	QE2 announced - $600bn of longer dated US Treasuries to be bought
Jun 2011	2.96	QE2 ends
Sep 2011	1.88	Operation Twist begins – $400bn of longer dated debt (6-30 year maturity) purchased by selling shorter term debt (under 3 years)
Jun 2012	1.65	Operation Twist extended – additional $267 billion rotation occurs
Sep 2012	1.75	QE3 begins - $40bn in MBS to be purchased monthly – no time or $ value expiry on programme
Dec 2012	1.72	QE3 expanded - $45bn a month in US Treasuries to be purchased on top of $40bn in MBS – no time or $ expiry on programme
May 2013	1.66	Fed taper talk begins in earnest
May 2013	2.03	Fed taper talk intensifies
Jun 2013	2.33	Bernanke states sees end of QE in 2014
Sep 2013	2.99	Highest bond yields since late 2010 – 'peak' of taper certainty
Sep 2013	2.69	Fed decides not to taper QE3 as widely expected and maintains $85bn monthly programme
Oct 2013	2.68	Janet Yellen nominated to replace Ben Bernanke as new Fed Chair
Oct 2013	2.54	Fed maintains $85bn monthly QE programme

As you can see when looking at this timeline of Fed actions, and the yields on government debts at the time these policies were implemented, QE hasn't necessarily 'worked', at least if the definition of 'worked' is lowering borrowing costs.

When QE1 was announced, yields were 3.11%. When it finished, yields were 3.84%

When QE2 was announced, yields were 2.67%. When it finished, yields were 2.96%

Note also that between QE1 ending in March 2010 (yields at 3.84%), and QE2 starting in November 2010 (yields at 2.67%), yields fell dramatically, even though the Fed wasn't actively printing money and buying bonds throughout this period.

When QE3 started in September 2012, yields were 1.75%, and this had barely budged (to 1.72%) when it was expanded in December of last year.

Today, even though QE3 is still running at $85 billion a month, and even though the Fed has printed nearly $1 trillion this year, all of which should have theoretically pushed bond prices higher (and yields lower), yields on 10 year US Treasuries are much higher currently than they were at the start of the year, sitting at 2.54% currently (31st October 2013).

The past 5 years demonstrate clearly that the Fed buying bonds doesn't mean yields will necessarily fall, whilst their absence from the bond market clearly doesn't mean yields will necessarily rise either.

What does this all mean?

The first and most obvious point is that it shows that the 'market' (made up of pension funds, insurance companies, foreign governments, sovereign wealth funds, asset managers and individuals), is more powerful than the Fed.

In the periods where the Fed has been buying bonds through its QE programmes, other market participants have been selling, and deploying the capital into other areas, including equities, listed infrastructure and real estate (typically bucketed as 'growth assets' although some might argue about infrastructure).

Foreign governments selling Treasuries are likely just bringing capital back home, and in China's case, there's next to no doubt some of this repatriated cash is being used to buy physical gold.

Therefore, whilst the Fed hopes its QE programmes push borrowing costs lower, the opposite has occurred, as market players feel there are better returns on offer outside the Treasury market and sell their holdings, knowing full well they have a willing and able buyer in the Fed.

Conversely, in periods where the Fed hasn't been printing, yields have actually fallen sharply, signifying a desire on behalf of market participants to hold US Treasury paper in these periods.

And whilst there are several reasons for this, ultimately it boils down to the fact that with Fed QE absent, there is little reason to be bullish on 'growth assets' like those mentioned above.

And the reason for that is pretty simple. We aren't getting much growth at all in the world, especially when one factors in the multiples of sovereign debt that are being accumulated on an annual basis in order to generate these historically weak growth rates.

Therefore, in periods where the Fed is absent from the markets, investors are rightly fearful of a large drawdown in asset valuations (potentially similar in magnitude to the GFC), and run to what they perceive as the relative safety of the US Treasury market, still the largest and most liquid sovereign bond market on the planet.

For anyone wanting a short read on this subject this article covers the movement in yields during the past few years.

The fear of a stock market correction in the absence of Fed QE is not misplaced. For example, in the period between March and November 2010 (QE1 ending and QE2 starting), whilst bond prices strongly, with yields falling from 3.84% to 2.67%, equity market investors were punished, with the Dow Jones Industrial Average falling close to 15%.

Were it not for the launch of QE2, the fall in the Dow may not have been arrested, and it could have gotten a lot worse for equity market investors.

For reference, the London PM Fix for gold was USD $1115.50 on the 31st March 2010, and USD $1346.75 on the 29th October that same year, meaning precious metal investors gained 21%, substantially outperforming those who were in the equity market during this period.

Conclusion

Whilst it is quite logical to expect that the Fed tapering QE would lead to higher bond yields, and this may be what does in fact occur, history shows that it's possible for the opposite to happen, and for yields to fall, meaning rising bond prices.

Nevertheless, rising bond prices would likely come at the expense of the stock market, as a rotation of capital away from equities and into bonds would see equity prices decline, by a potentially significant amount.

Furthermore, with the US Government still running annual deficits well above $500bn (and headed back toward $1 trillion per annum in the next few years

according to the latest Congressional Budget Office update), Fed absence from the bond market would lead, in all likelihood, to a serious decline in the real economy.

By definition, if the Fed isn't buying any of the hundreds of billions of dollars of Treasury paper that is being issued, private investors will have to, entailing a huge shift of capital away from the more productive private sector towards Washington.

This would undoubtedly lead to a sharp contraction in what is already very weak private sector growth, potentially tipping the US back into a recession.

In such an environment, a potentially significant repricing of all asset markets would likely be on the cards too.

For this reason, I expect analysis of the impact of QE tapering, and the cessation of QE in its entirety to remain theoretical only, as the Fed is well aware of the fact it has boxed itself into a corner in terms of supporting asset markets and the economy, and there is no easy way out.

Like their counterparts around the world, the Fed has moved well and truly beyond the realm of central banking, morphing almost seamlessly into the role of central planner, responsible not only for improving the real economy and employment prospects for the entire population, but maintaining price stability, funding the social welfare state through loans to the Treasury, and providing permanent support for asset markets and investors too.

It is an impossible task and one they will surely fail at. The ramifications of this failure will be social, political and economic and they will be felt for years down the line all around the globe.

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