The Intended Consequences of Exiting QE: Re-pricing Credit Risk

A lot of ink has been spilled on why financial markets have responded so strongly to speculation about the possibility that the Federal Reserve might begin to taper its asset purchases as early as this summer, which at most is a very low probability event. The selloff began with US Treasuries whose yield for a 10-year note rose from a recent low of 1.56% on March 5 to 2.29% on June 11. Such a large move in a benchmark yield was bound to have broad repercussions on asset prices, especially those that had been swept up in the euphoria of low funding costs that supposedly would last at least until yearend. The list of overbought securities was a long one ranging from Japanese equities and high yield and bonds to emerging market currencies and equities of US house builders. Many of these securities had the attributes of carry trades – namely, leveraged plays on low funding costs that supposedly would remain lucrative as long as QE remained in place and short-term rates stayed near zero. As investors stretched for yield, they had to venture to ever weaker creditors and longer maturities. The risks in these positions hence became a combination of duration and credit quality, both of which were vulnerable to a premature re-pricing of the benchmarks against which these risks are calibrated.

The Fed's 'Mixed' Messages

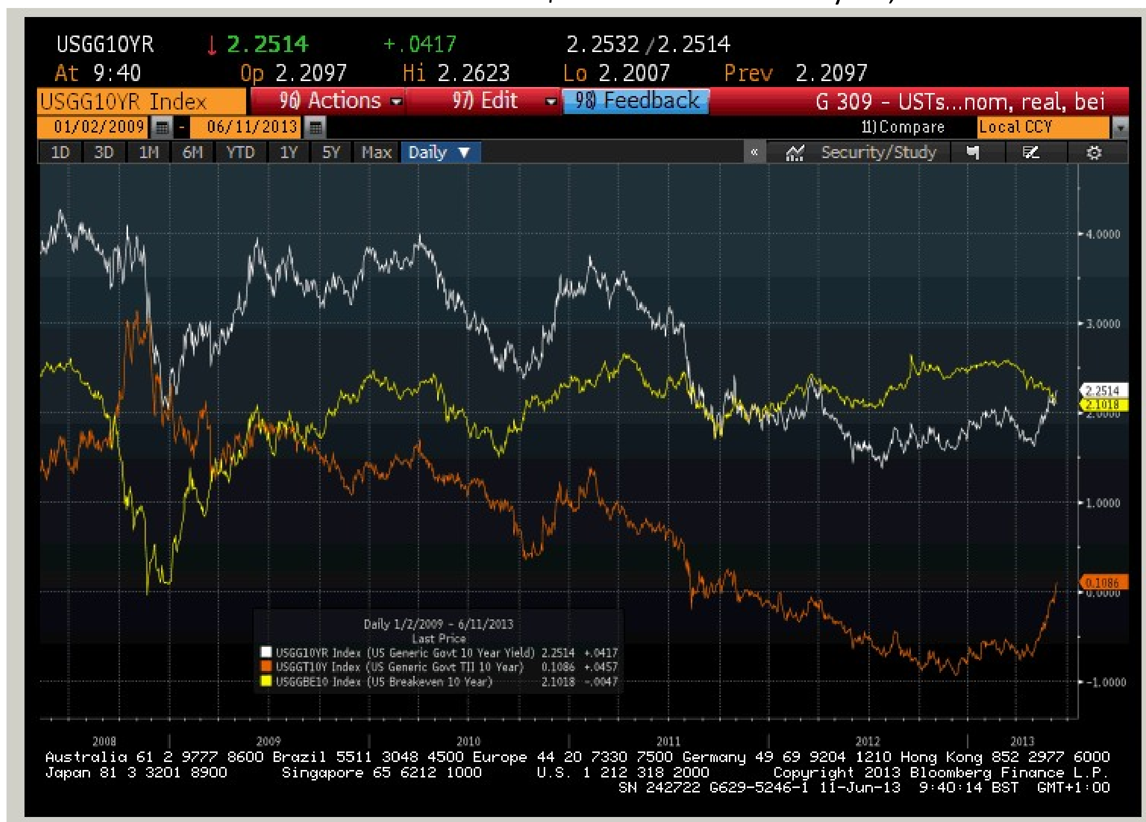
The most often cited source of this mid-cycle correction was the reaction of some members of the FOMC who expressed concern at their April meeting that market participants expected the Fed to extend its asset purchases well into 2014 based on a slim thread of economic data suggesting slower US growth in the second quarter. In contrast with that euphoric perception, the minutes of the April FOMC meeting dutifully cited that "a number of participants expressed willingness to adjust purchases downward as early as the June meeting if the economic information received by that time showed evidence of sufficiently strong and sustained growth." Granted, a minority of FOMC members would be so quick to recalibrate and few people would characterize the subsequent economic data as evidence of sufficiently strong and sustained growth.

So why are the hawkish members so anxious about extending asset purchases? Some cite their diminishing returns and the uncertain consequences of procrastinating on an exit from QE that should be viewed as inevitable. After all, the Fed already is buying half of new mortgages issued and its holdings of US Treasuries are an increasing share of marketable securities. There are limits to this strategy and in effect some FOMC members are telling us what amount of Fed holdings would make them anxious. Namely, the current program would add about $1 trillion to the Fed's portfolio that now is about $3 trillion. Waiting until mid-2014 to taper purchases would leave the Fed with about $4.5 trillion of securities and counting. No one wants to move quickly – a downward adjustment of perhaps $20 billion/month would be most likely when it eventually happens – so a belated change in plan would put the Fed's holdings north of $5 trillion by

yearend 2014. In effect, the hawkish members are saying that $5 trillion is getting beyond their comfort level. In gauging the likely timetable for tapering purchases, one should weigh the message from the flow of economic data against this arbitrary, albeit not unreasonable, threshold for members' discomfort level for the Fed's portfolio size. A good rule of thumb for judging the timing of the first recalibration is the rate of growth in real GDP: faster growth than the Fed's forecast of 2.5% this year will bring forward the date whereas slower growth will postpone an adjustment. On that basis, the most likely date remains around yearend.

How High Can Yields Go?

We continue to expect the yield on the 10-year note to settle at 2.25% at yearend even in the face of somewhat stronger US growth this fall. Historical norms on Treasury yields are not particularly useful is gauging the course of events. Clearly, economic fundamentals are not consistent with much higher yields anytime soon. Commodity prices are falling, global growth is slowing most everywhere except the US and Europe has little prospect of an early recovery. Likewise, the deleveraging of US households will take several more years and European banks have barely begun to clean up their balance sheets. Neither can inflation expectations, which are stable or even ebbing in many countries, explain the backup in yields to date or serve as a rationale for higher yields during the remainder of 2013. Nor are the US government's finances to blame; if anything, markets seem to underestimate the improvement budget balances at both the local and federal levels. The unified federal deficit could shrink to $650 billion this fiscal year, or 4.2% of GDP.



What is true, though, is that the market needed to discount the normalization of real interest rates at some point. Indeed, the real yield on the inflation-linked 10-year index shown in the figure above has risen even more (about 100 basis points) than that on the 10-year note itself (about 75 basis points). The negative real yields that were widespread in March and April were unrealistic and could not persistent indefinitely. Institutional investors are well paid to anticipate events and adjust accordingly, not merely to wait and see. Not surprisingly, for example, the vast majority of market participants respond that the **flow** of Fed asset purchases affect interest rates, even though research indicates that the **stock** of securities held in the Fed's portfolio are what matters. So investors who were overweight duration and credit risk had little choice but to swim with the tide as yields rose and prices fell. Large positions were pruned in a chain of reactions not dissimilar to the contagion that spreads in the wake of a credit event. Absent a material change in fundamentals, however, this self-enforced pruning also has a self-balancing tendency, namely yields at some point become attractive again and new buyers emerge to snatch up bargains. Look for the best credits to recover first.

Duration versus Credit Risk

While the unwinding of carry trades might have been predictable as was the impact of higher benchmark yields on other bond prices, the high degree of contagion to high yield and emerging country bonds markets and even equities seems less obvious. Various pat rationales miss the simple point that negative real interest rates, like high inflation, favor debtors in the extreme because they allow issuers to refinance at unsustainably low rates that redistribute revenue in favor of issuers. By contrast, positive real interest rates set a higher hurdle for performance, namely issuers must be able to grow out of their debt burdens. Thus, the sudden shift to positive real rates set in motion a broad reassessment of credit risk. Not surprisingly, some of the debtors with poor growth prospects were hit hardest including the periphery of Europe, Brazil and large swaths of the high yield universe that are dependent on sales to developed countries.

Perhaps more surprising has been the extraordinary correlation between credit and equities. The graph below plots the European STOXX price index and that of the ITRAX total return index for 125 European corporate bonds. While a consistent inverse relationship might be expected, since the advent of negative real interest rates these two indices have moved in virtual lockstep like a perfectly symmetric Rorschach test. Credit is driven equity prices independent of broad macro fundamentals even though interest expense rarely constitutes the most important consideration in equity valuations. Hedging behavior may have contributed to this tight correlation but if so that would merely reinforce the concern of FOMC members who felt negative real rates were contributing to frothy speculation in financial markets.

Neutral Rates – the new normal

We have not seen the end of this preoccupation with Treasury yields. It likely will rear its head again when the FOMC gets closer to tapering asset purchases and also prior to the first rate hike that is not expected until 2015. Investors are beginning to realize that central banks may not need to raise rates as much as they did during the era of high inflation that spanned the past four decades. The Fed's neutral policy rate – that is, the rate at which the Fed can exercise sufficient monetary control to achieve its 1-1/2% to 2% inflation target – probably is much lower today, perhaps only 2% to 3%. In short, the requisite real funds rate may be as low as 0 to 1%, which is roughly where real 10-year yields are today. Greater discussion of this issue would help to convey the Fed's ultimate end game in exiting QE over the next several years, but unfortunately there is not a consensus among FOMC members as to what the neutral rate is. Many members apparently still hold to the old norm of 3-1/2% to 4% that prevailed for decades. One cannot expect a sudden shift in such an important operational toolset, although it should rank high on the list of unknowns worthy of further analysis. Investors will want to know where the Fed is headed long before the first rate hike if a repeat of the recent market correction is to be avoided.

Implications

Ironically, the early selloff in fixed income gives the Fed more time to assess the economy's recovery and to avoid the mistake of tapering asset purchases too soon. A lot of froth in prices has been drained from the market which now can refocus on the fundamentals of credit and valuations. Meanwhile, the Fed has gained a valuable insight into how potent its message can be. Words alone have achieved what policy actions sometimes cannot – to contain the exuberance of markets. The loser may be the ECB whose slow-moving train wreck faces renewed challenges from periphery countries whose debt has been re-priced. We also may hear fewer complaints about currency wars from emerging countries now that the unintended currency implications of the Fed's QE are being unwound. Australia's RBA has shown a possible remedy, at least for those countries that have inflation under control. In a world that is deleveraging, decelerating and de-globalizing, policy rates should have room to decline further. Only China and a few emerging countries are behind the curve on inflation and already are pushing the limits of their potential GDP. For them, the challenge will be to engineer a broad rebalancing of the economy without causing a major credit event, whereas the much of the developed world faces the daunting task of finding new engines of growth in a sea of debt. Only the US seems to have the home-grown means to resuscitate itself, if the Federal Reserve can extricate itself from unconventional policies whose unintended consequences can be more troublesome than their intended ones.

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