Why the Fed Will Taper Asset Purchases

The message from the FOMC's recent deliberations now should be clear: large-scale asset purchases cannot go on forever and the time to wean financial markets from this palliative is drawing nigh. No one at the Federal Reserve, not even the erstwhile progenitor of quantitative easing Chairman Bernanke, believes that these and earlier unconventional interventions in capital markets can resolve the US economy's lingering ills. Their purpose always was to staunch the bleeding from an unprecedented financial crisis whose origins were deeply rooted in the excessive leverage of global banks. Banking crises can quickly transform recessions into protracted depressions and a serious central bank should do whatever it can to prevent the sins of bankers from spreading collateral damage to the rest of the populace. The Federal Reserve already has weaned itself from the early interventions in commercial paper and other short-term instruments as well as from the ill-advised Treasury-sponsored asset purchases prior to the Lehman default.

Similarly, the FOMC will extricate itself first from purchases of long-dated Treasuries and subsequently from mortgages. The latest minutes of the July meeting suggest that members merely are negotiating 'when' and 'how fast' to exit QE. Even though the timing of the initial adjustment supposedly is conditional on a 'sustainable' recovery and improvement in the labor market, these hurdles now appear so low as to be almost irrelevant. One might best think of the decision to begin to taper purchases as an exercise in compromise between the hawkish participants who are uncomfortable with unconventional policies and the veteran core FOMC members who realize that the decision to taper is tantamount to a decision to end quantitative easing since it will be difficult to change course once set in motion. In any event, Chairman Bernanke will not leave his legacy in limbo by deferring this critical decision to his successor.

Why has sentiment shifting toward a gradual tapering of purchases while the economy still is sputtering? For one thing, FOMC members understand that large-scale asset purchases on their current scale are unsustainable in the extreme. Second, the benefits of intervention in terms of reducing long-term interest rates appear to have reached the point of diminishing returns. Third, economic conditions have changed, albeit not entirely as Fed officials had wished. And fourth, protracted purchases of Treasuries in particular pose a real risk of encouraging the very behavior that the Fed would like to unwind – namely, leveraged carry trades and other perverse risk-taking with destabilizing tendencies for financial markets whose frailties were the essence of the Fed's headaches in the first place. In short, perpetual QE would likely sow the seeds of the next financial crises, if not at home then probably elsewhere in world's highly interconnected financial system. Note that none of these causes for concern are related to the platitudes so often seen in the media about Helicopter Ben printing money and creating inflation. FOMC members remain more concerned about deflation than inflation and about the weak demand for credit rather than an excess supply.

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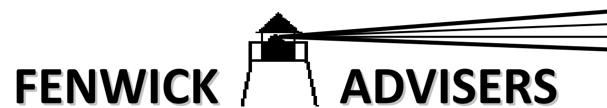
The hard reality is that the Fed's portfolio simply would become 'too big' if purchases continued at the current pace indefinitely. Let's posit such a number, say $16 trillion in US Treasuries, or namely all of them. At that level, the Fed would be the sole financier of government, akin to the Reichsbank in 1923 or Banco Central do Brasil in 1985. At that point, continued government budget deficits would beget inflation for decades to come and the Fed would lose all credibility as the world's premier central bank. Clearly, we are nowhere near that tipping point. Nonetheless, Treasury purchases of $480 billion per year ($40 billion per month) are beginning to loom much larger as the federal budget deficit shrinks. At fiscal yearend in September, the federal government is likely to report a fiscal deficit of $650 billion, which roughly corresponds to net new issuance of Treasuries. Further deficit reduction would mean that the Fed was buying all new issuance of federal debt. Few FOMC members would be comfortable with that predicament for very long. In a similar vein, the Fed now is purchasing about half of all net new issuance of mortgages. Continued market intervention on such a large scale is beginning to make many FOMC members nervous even if they do not express their concerns in these terms; sooner or later they all should be anxious about becoming the scapegoats for government profligacy.

The strongest argument for exiting QE, however, is the potential for promulgating perverse risk-taking behavior by financial market participants, notably those with access to leverage. In retrospect, it seems clear that much of the selling of long-dated treasuries and EM debt since March reflected the unwinding of leveraged carry trades, for which margin calls rather than duration per se were the immediate cause for selling. In my opinion, the sharp selloff in Treasuries was an eye-opener for many FOMC members who were surprised by how pervasive the leveraged carry trade had become and were forced to rethink whether or not it was advisable for the Fed to continue as the buyer of last resort. Granted, those leveraged trading positions now are greatly reduced, yet as long as the Fed continues to promise to be the big buyer at the end of the carry period, carry traders will return in force, thereby leading to renewed mispricing of securities including US Treasuries which are the premier global benchmark for credit risk.

Asset price bubbles are bred during good times when credit is cheap and capital is plentiful. And indeed the world is awash in excess savings in search of too few good investment opportunities. Now is as good a time as ever to exit this unsustainable policy while the US economy is on a stable footing and financial markets already have absorbed much of the imminent change in policy. Besides, winding down purchases of assets does not forebode either outright sales from the Fed's portfolio or an early hike in the fed funds rate. Indeed, I doubt the Fed will ever sell its portfolio but rather will let securities mature in their time. After all, there is no guarantee that the global economy will fare better in 2014 and as the FOMC undoubtedly will remind us, monetary policy is likely to remain accommodative for a long time.



In short, I believe market participants already realize that the Fed will taper soon and have adjusted accordingly. After some temporary volatility, I believe treasury yields will settle lower by yearend. I realize this view is somewhat aggressive and increasingly unfashionable as the day of tapering draws closer. Yet as long as the Fed is committed to keeping short-term rates low for a long time, then the current US yield curve already looks relatively steep while global growth remains subpar. I expect the next significant moves in rates to be a parallel shift in the yield curve when the Fed gets closer to its first rate hike sometime in 2015 and a subsequent flattening of the curve as the Fed gradually reverts to the 'new' neutral Fed funds rate in the range of 2% to 3%. As long as the Fed does not dawdle too long in its exit plan, the yield curve ultimately should flatten again reflecting low inflation and a gradual, predictable path to normalizing rate is the somewhat distant future.

The tricky question for portfolio managers is whether to ride out this evolution of the US yield curve. As investors in creditor nations that are strongly inclined to repay their debt and able to do so under most any conditions, we do not tend to make draconian adjustments to duration and credit quality. One can get too cute and lose focus on the ultimate goal, which is to be repaid principal with a competitive return. The key for us is to be prepared for the next phase of this interest rate cycle as we believe the 'tapering' phase is largely priced in.

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