What's the Tapering Talk Got to Do with Us?

Range Bound Short-Term Interest Rates Likely Will Continue

Abstract

We do not foresee a meaningful rise in short-term interest rates even as the Fed may begin tapering bond purchases. The fed funds rate, the key factor affecting short-term rates, likely will not start to rise prior to mid-2015. Investors should continue to look for opportunities further up the yield curve with separate account solutions.

Introduction

Since early spring, financial markets have expected the Federal Reserve to pull back from its extraordinary asset purchases as the economy continues to recover. While Fed officials remain evasive about the timing of their next move, the talk of tapering, or the gradual reduction of the monthly purchases, has become a source of market volatility for equities and fixed income securities alike. After a long period of extraordinarily low interest rates, many market participants fear that any tapering of asset purchases may burst the bond market bubble, resulting in grave consequences.

As investors of cash and short-duration fixed income securities, we are keenly interested in this market development. Although long-term interest rates have backed up considerably, we remain skeptical of any significant upward move in short-term interest rates for the foreseeable future. We think investors at the short end of the yield curve, especially money market fund investors, likely will endure the near zero rate environment for another 18 to 24 months, at least.

In this commentary, we recount the genesis of the Fed's taper talk and the evolution of the Fed's "exceptionally low interest rate" language. We wish to point out the impact that the Fed's asset purchases have had on short-term yields versus the impact of the Fed Funds rate. With the prospect of a lingering low-yield environment and potential SEC regulation on money market funds, separate account solutions may offer some relief for the uneasy cash investor.

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The Exciting Story of the Taper

The Fed's monthly purchase program of Treasury and agency mortgage-backed securities (MBS) was put in place in September 2012, with the initial pace of purchases set at $40 billion of agency MBS per month.[1] At the beginning of 2013, and coinciding with the conclusion of "Operation Twist," the Fed began additional purchases of Treasury securities at a pace of $45 billion per month. The new program totaled $85 billion of asset purchases per month and was dubbed Quantitative Easing Round 3 (QE3). Unlike the previous two rounds of QE, Round 3 was open-ended and data dependent by design.

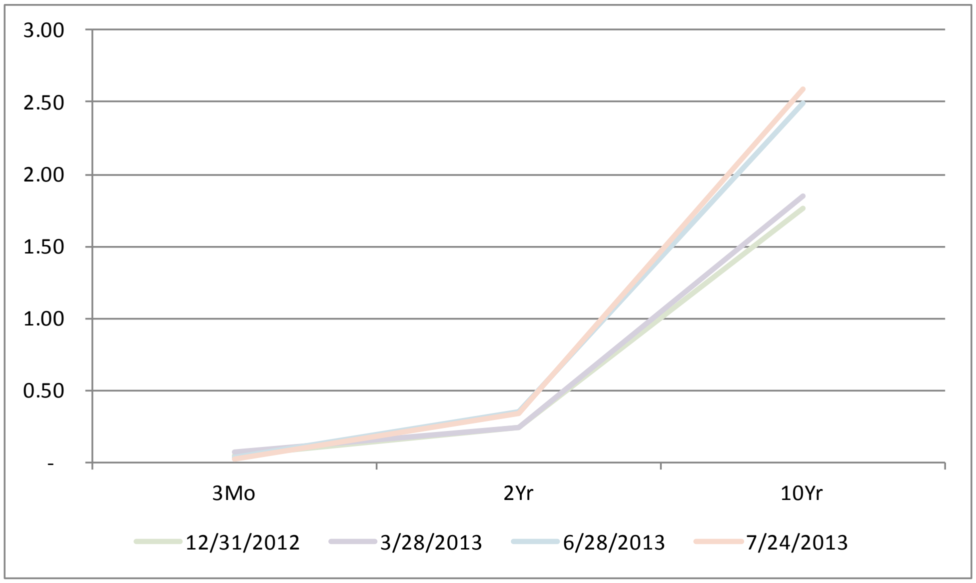
As discussion of an exit strategy from QE3 begins, the open-ended design has created a problem for the Fed; ending the program may be viewed by financial markets as the start of a monetary tightening cycle. Since it has been a major stabilizing force for the financial markets, the sudden removal of QE3 could result in major market upheaval. Thus, the Fed should act cautiously while gradually removing this accommodation, through a tapering of the purchases, to avoid causing panic in the financial markets.

As it turns out, QE3 taper chatter began on February 20, 2013, when the Fed released the minutes from the January 29-30 FOMC meeting. The minutes mentioned that some Fed officials felt an ongoing evaluation "may lead the Committee to taper or end its purchases before it judged that a substantial improvement in the outlook for the labor market had occurred." This comment caught markets off guard and, as a result, stocks sold off for the next four days. Since then, the timing and magnitude of the taper has become the focus of intense market attention, causing volatility in the major indices.

The next wrinkle came in the FOMC's statement following the April 30-May 1 meeting. The press release stated, "The Committee is prepared to increase or reduce the pace of its purchases" as the outlook for the labor market or inflation changes. This two-directional language, after some initial market confusion, was meant to dispel the notion that the taper signifies the start of a tightening cycle.

Nonetheless, bond yields rose from early spring into the summer months. The selloff intensified after the June 18-19 FOMC meeting when Chairman Bernanke said that the Fed could begin to taper later this year and completely end purchases by mid-2014. While rates recovered somewhat since then, the trend to higher long-term bond yields is unmistakable (See Figure 1).

Figure 1: Historical Treasury Yield Curve



Source: Generic Treasury yield history according to Bloomberg.

The Mundane Story of the Fed Funds Rate

What does all this angst surrounding the taper mean to short-duration investors? Not much, in our opinion. After four and a half years of ultra-low interest rates, one may be tempted to call a higher rate environment, which almost always ends badly for bond investors, a blessing rather than a curse. Despite this market sentiment, we likely will not see significantly higher short-term rates for the foreseeable future. This is because the fed funds rate, the key factor for short-term rates, likely will not start to rise prior to mid-2015.

In contrast to the volatile market responses to the taper, few market participants doubt the Fed's commitment to keeping the fed funds rate at the current level for the foreseeable future. Since the Fed lowered the rate to a range of 0% to 0.25% in December 2008, the language of "exceptionally low levels" of the fed funds rate for "an extended period" has been in every FOMC statement to date. In the August 2011 FOMC statement, the Fed introduced a timeframe for its "extended period" as "at least through mid-2013." The timeframe was extended to "late 2014" after the January 2012 meeting, and again to "mid-2015" after the September 2012 meeting. Finally in December 2012, the FOMC vowed to hold the fed funds rate steady at least as long as the unemployment rate remains above 6.5% and forward-looking inflation is below 2.5%.

What does this walk down memory lane mean for us? It means that the fed funds rate may stay where it is for quite some time even after the Fed ends its current asset purchase program, let alone the start of the tapering process. Given the current 7.5% unemployment rate and benign inflationary pressures, we expect that the timeframe for an increase in the fed funds rate will be at least a year after the expected end date for QE3. This means that short-term interest rates are not likely to be significantly influenced by the taper.

Tapering the Taper Talk

It is not a surprise that the taper talk fascinated the markets. The exceedingly low interest rate environment, coupled with relentless monetary supply, undoubtedly evokes fears of runaway inflation and the bond bubble bursting. These fears notwithstanding, we do not anticipate a meaningful rise in short-term interest rates, anchored by the fed funds rate, in the foreseeable future.

In fact, it is plausible that feverish speculation on the taper may have exacerbated low yields in the short-term market. The sell-off in longer-term bond yields may have resulted in fearful investors reducing their bond positions and parking cash in money market securities, worsening the supply constraint already in place.[2]

We concede that when the Fed does start tapering, there will be moderate relief on the supply constraint for securities eligible as repurchase agreement (repo) collateral, a major part of the short-term market. The process may result in slightly higher repo rates, other things being equal. Since the Fed's current program does not involve purchasing short-term securities, stopping it does not directly lead to an increase in Treasury securities available for cash investors.

Short-term rates continuing to be range bound may come as good news for people fearing higher rates and bad news for people hoping for the opposite. Meanwhile, forces at work that bring down yields on money market funds are not likely to quickly subside. We advise cash investors to continue to look for opportunities further up the yield curve with separate account solutions. With short-term rates range bound, this strategy continues to offer incremental benefit for investors unsure about the outcome of money market fund regulations and concerned with credit risk in uninsured deposits.

[1] See Statements of the Federal Open Market Committee (2009 through 2013). For all sources related to FOMC meetings, references are made with specific meeting dates. http://www.federalreserve.gov/monetarypolicy/fomccalendars.htm

[2] Chris Dieterich, Bond Investors Turn to Cash, The Wall Street Journal, Page C1, July 25, 2013 http://online.wsj.com/article/SB10001424127887323971204578625900935618178.html?mod=WSJ_hp_LEFTWhatsNewsCollection