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# Tapering: Fed to stick to flight plan

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**The Federal Reserve confirmed the beginning of tapering in November.** According to the statement posted after the FOMC's last meeting, monthly asset purchases will be reduced from the current USD 120 billion to USD 105 billion[1], with additional monthly cutbacks of the same scale until the program ends, in June 2022.

**We forecast an initial interest increase between the third and fourth quarter next year.** However, we believe the Fed will be careful to signal this movement well in advance, in order to avoid sudden market shifts. Eventual course corrections will require evidence of more persistent inflation or further tightening of the job market , with growing pressures on wages.

**Asset purchase programs started being used as a monetary policy instrument after the 2008 global financial crisis.** In addition to acting as a solution to promote monetary stimulus when the interest rate drops near zero, the program was initially designed to support the mortgage-backed securities market (MBS[2]), which was at the epicenter of the crisis. In the initial stage of QE (quantitative easing), the Federal Reserve purchased USD 1.25 trillion in mortgage-backed securities and another USD 175 billion in securities issued by federal agencies, in addition to USD 300 billion in Treasuries.

**Later rounds of QE were more heavily focused on the Treasuries market, in order to influence the interest rate slope.** In QE2, the Fed purchased another USD 600 billion in Treasuries. Operation Twist was rolled out shortly after that, when the Fed started purchasing long-term securities and selling shorter securities, with the goal of flattening the yield curve. In QE3, the Fed purchasied just over USD 1.6 trillion – approximately half in Treasuries and the other half in federal agency MBS.

**The first tapering of asset purchases was announced in mid 2013, taking markets by surprise and triggering the so-called taper tantrum of that year.** This led to a steeper curve slope, appreciation of the U.S. dollar, and volatility of stock markets and other risk assets. However, the asset purchases were only actually tapered in the beginning of the following year (partly due to the market's initial reaction), and would end by October.

**In total, assets in the Fed's balance sheet more than quadrupled between the 2008 crisis and the end of the QE in 2014,** to stabilize at just under USD 4.5 trillion by 2018. From that year on, the Fed kicked off a process of gradually reducing assets by not reinvesting the maturities in its portfolio.

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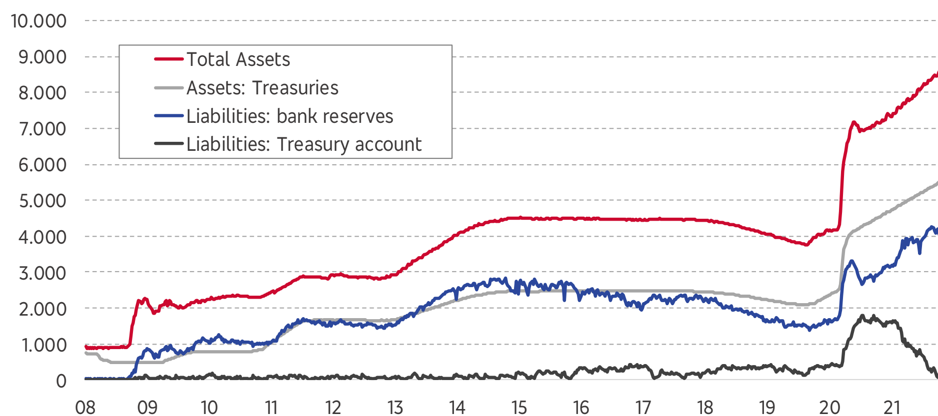
[1] Always maintaining a purchase ratio of 2/3 in Treasuries and 1/2 in mortgage-backed securities from federal agencies Fannie Mae and Freddy Mac.
[2] *Mortgage-backed securities.*

**Chart 1: Federal Reserve Balance Sheet**
USD billion




**Source:** Federal Reserve, Bradesco

**In the beginning of the pandemic, the Fed made massive interventions in several markets to ensure they continued operating normally**, increasing total assets from just over USD 4 trillion to USD 7 trillion. With interest rates back to zero, the Fed also started resorting back to QE as a monetary stimulus instrument, kicking off the monthly purchases of USD 120 billion that will start being tapered down this month.

**This is a turning point for the markets.** Discomfort with inflation and debate of whether it is indeed temporary, as the Fed has argued, has been brewing. After more than a decade of highly stimulative monetary policy, there is now talk about the possibility of a normalization, although there is still no consensus on what a normal monetary policy would look like. Some draw parallels between the current scenario and Arthur Burns' management at the helm of the Fed (1970-78), during the Great Inflation[3], which would only be controlled after the interest rate shock under the helm of Paul Volcker (Fed chair in 1979-87). On the other hand, the memory of the last decade is still strong, with structurally low inflation, creating the main challenge for central banks of avoiding deflation in a zero-interest world.

**Persistently low interest rates are a key factor to explain the valuations of stock markets and the performance of several other securities.** Discounting future cash flows at low interest rates leads to higher present values, while lower interest entails a low cost of opportunity and enables different investment projects that would otherwise be unsustainable.

**Monetary policymakers around the world are facing a huge challenge.** The fear is that mistakes could lead to accidents on both sides. If central banks don't do enough, there is a risk of a persistent inflationary surprise, eroding the real value of assets, with major implications in terms of wealth transfer between generations and social segments. If they overdo it, the risk is to derail businesses and investments, potentially bringing the economy a trap of deflation and low growth from the beginning of the last decade. Japan's experience since the 1990s comes to mind.

[3] Particularly due to the combination between high commodity prices, cost pressure, wage acceleration, expansionary fiscal policy, and stimulating monetary policy.

**That is why Central Banks will likely remain extremely cautious in steering monetary policy.** The tapering process will be rolled out in a slow and controlled manner in the U.S.. It is important to note that, during the tapering, the Fed is lowering the dose of liquidity injected into the economy very carefully. As shown in chart 1 above, the slope of total assets and Treasuries curves will be gradually reduced to a horizontal line in mid 2022. Discussion about an eventual reduction of assets is not even considered at the moment and, when it comes to be, it should repeat the experience of 2018-20.

**To assess the consequences of tapering*, it is also important to take a closer look at what has been happening to the Fed's liabilities.*** Chart 1 also shows some information in this regard. Early on in the pandemic, the Fed's security purchases became a sort of monetary financing for the Treasury, in practical terms. The Treasury's account balance with the Fed spiked sharply during the Fed's initial intervention. As Treasury disbursement grew during the pandemic, this balance "normalized". It is important to note that this trend is also related to Treasury managing its cash flow due to the debt limit, accumulating assets and preserving cash for as long as possible, using these funds as of July, when the cap limited its ability to issue new debts.

**But what really draws attention is that the main counterpart of the Fed's asset buildup throughout the pandemic was the increase in bank reserves.** Ultimately, the increase in liquidity was absorbed primarily by banks, which increased their voluntary deposits with the Fed. Since the onset of the pandemic, the Federal Reserve zeroed reserve requirements (March 2020) and started to pay interest on all voluntary bank reserve deposits (currently at a rate of 0.15% per annum).

**At first, the impact of tapering in the real economy will likely be limited.** While, on the one hand, the Fed will reduce the rate of asset accumulation, the main effect should be a proportional slowdown in voluntary bank reserve deposits. But besides impacting expectations, there's no reason to believe there will be major reductions in liquidity levels, leading to behavioral changes among economic agents.

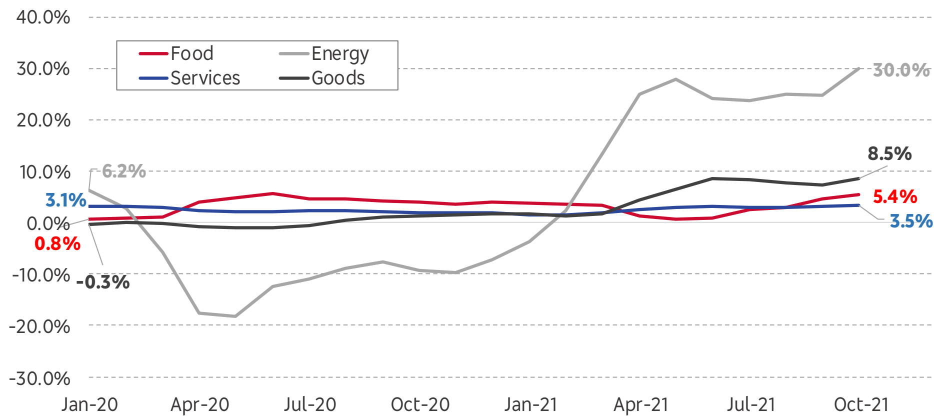
**The main issue for the markets is the timing of future interest hikes.** For now, the market prices the beginning of the hike cycle in the second half of 2022. Half of the Fed's board members also forecast at least the first interest rate hike cycle for next year, as per the dot-chart.

**We forecast a growth rate for the U.S. of 6.1% and 4.5% in 2021 and 2022, respectively.** Demand remains robust, but supply-side constraints imply downward risks to growth, without producing relief from inflationary pressures. The growing discomfort with inflation and the perception that price pressures are broadening and becoming more persistent have ultimately led the market to price the growing likelihood of more than one interest rate hike next year. There was an expectation that the Fed could sanction this perception in the last FOMC meeting, but for now the Fed has maintained its diagnosis that the current scenario likely stems from temporary factors.

**This level of caution will likely persist over the next few months.** In the announcement made after the FOMC meeting, the Fed even left the door open to speed up tapering as needed, but as the Fed's directors themselves have reaffirmed, the bar to justify the lift-off is higher than to kick off the tapering process.

**More than one interest rate hike will likely only occur next year if inflation persists at the current level of 6%.** In order for that to happen, the shocks in recent years (particularly in commodities, energy and industrial prices) would have to be repeated at a similar intensity – which seems to be unlikely – or inflationary pressures would have to become more broadbased.

**Chart 2: Consumer inflation components (CPI)**
% in 12 months




**Source:** BLS, Bradesco

**A broader inflationary event in the U.S. depends primarily on the dynamics of the job market and wage behavior.** For now, the jury is still out. On the one hand, the average wage in the private sector as a whole has basically kept pace with inflation (if at all). But restrictions on labor supply have resulted in significant real gains in some sectors – this is particularly true in the case of hospitality, which is one of the sectors that generates the most jobs in U.S. economy.

**Table 1: Hourly Earnings for production and non-supervisory positions**
% y/y

| | aug/21 | sep/21 | oct/21 | Since the Pandemic (annualiz.) |
|---|---|---|---|---|
| **Total private** | 4.8% | 5.5% | 5.8% | 5.7% |
| **Goods-producing** | 4.8% | 5.5% | 5.3% | 4.2% |
| **Mining and logging** | 4.3% | 3.7% | 3.8% | 1.2% |
| **Construction** | 4.5% | 5.9% | 5.2% | 4.0% |
| **Manufacturing** | 5.0% | 4.9% | 5.4% | 4.5% |
| **Durable goods** | 5.1% | 5.0% | 5.2% | 4.4% |
| **Nondurable goods** | 4.9% | 4.8% | 5.6% | 4.8% |
| **Private service-providing** | 4.9% | 5.5% | 5.8% | 6.0% |
| **Trade, transportation, and utilities** | 4.8% | 5.8% | 5.8% | 5.2% |
| **Wholesale trade** | 3.6% | 4.2% | 4.6% | 4.4% |
| **Retail trade** | 5.2% | 5.3% | 5.2% | 6.3% |
| **Transportation and warehousing** | 4.8% | 8.5% | 8.2% | 5.2% |
| **Utilities** | 2.8% | 3.0% | 3.1% | 3.9% |
| **Information** | 1.2% | 0.8% | 1.0% | 3.8% |
| **Financial activities** | 3.7% | 3.7% | 3.8% | 5.2% |
| **Professional and business services** | 4.8% | 5.5% | 6.6% | 6.0% |
| **Education and health services** | 6.7% | 7.2% | 7.2% | 6.5% |
| **Leisure and hospitality** | 12.1% | 11.6% | 12.4% | 7.0% |
| **Other services** | 3.7% | 3.5% | 4.1% | 4.9% |

**Source:** BLS, Bradesco

**For now, our base scenario is that monetary policy normalization will advance based on the Federal Reserve's flight plan.** Asset purchases will be zeroed in June 2022 and the Fed will raise the benchmark interest rate for the first time in the fourth quarter of next year, with additional increases for every two FOMC meetings (i.e. increasing 25bps per quarter). The factors that could lead the Fed to speed up the pace (and which would have more significant consequences for asset prices in other markets, including emerging markets) would likely be stronger-than-expected job market momentum, implying persistence in wage hikes and inflation in general.

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