DUCENTA SQUARED
ASSET MANAGEMENT

Monthly Fixed Income Insight

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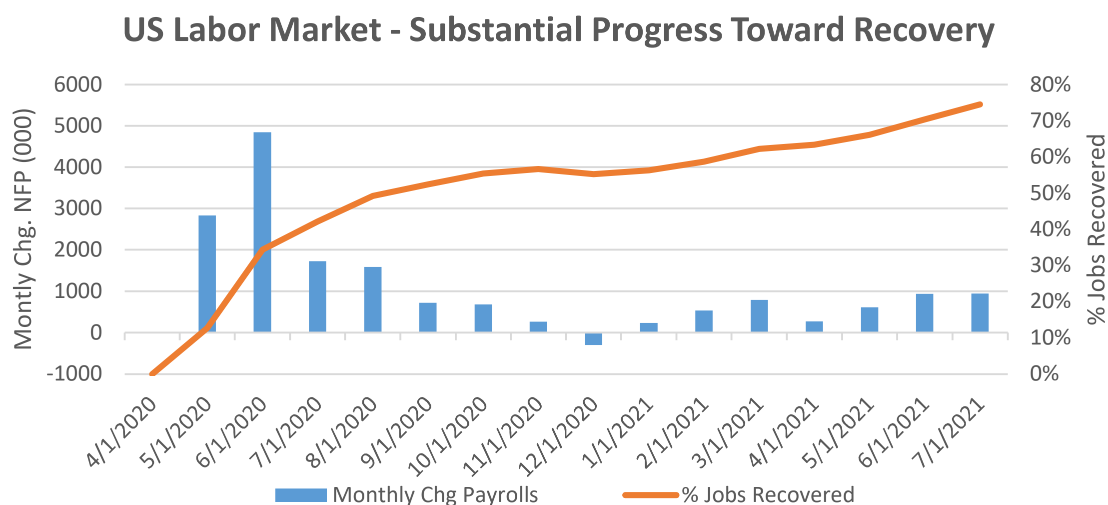
Time to Taper

The Federal Reserve has been cautiously inching towards reducing its quantitative easing asset purchases. As the economy started to recover from the pandemic, Fed Chairman Powell stated that it was "too soon to begin talking about talking about scaling back the asset purchases." Tapering discussions began in June FOMC meeting, and we believe the time has come for the Federal Reserve to reduce bond purchases. In this month's Fixed Income Insight, we share our outlook on what to expect as the Fed unwinds its quantitative easing program.

Substantial Further Progress?

At the end of 2020, Chairman Powell provided guidance that the $120 billion in monthly asset purchases would continue until the economy made "substantial further progress" with regard to the Fed's goal of maximum employment and an average inflation rate of 2%. At the time, total US employment trended at a level 9.7 million jobs below pre-COVID data, and the unemployment rate was 6.9%. Since then, the US labor market has roared back with 943,000 new jobs added in July, resulting in an average gain of 822,000 over the preceding three-month period, which lowered the unemployment rate to a post-pandemic low of 5.4%. These trends signal a fundamental recovery in employment despite generous unemployment benefits, the rise of the Delta variant, and childcare constraints. We expect the strength to continue with record labor demand exemplified by the 10.1 million job openings reported by the June 2021 Job Openings and Labor Turnover Survey. The graph below highlights the labor market improvement and the economy's progress towards full employment. Since the pandemic began, nearly 75% of the 22 million jobs lost have been recovered, while 5.7 million positions remain to be filled. The economy is moving towards the Federal Reserve's goals, and we believe the Fed and investors should check the box "substantial further progress" has occurred.



Source: Bureau of Labor Statistics

Timeline for Taper

In the past two weeks, several Fed governors and regional presidents communicated a timeline that involves a taper announcement before year end. Chairman Powell, meanwhile, remains adamant that the Fed will maintain its transparency and provide the markets plenty of "advanced notice" before the process begins. We believe the Fed will use its scheduled September 2021 meeting to provide advanced

notice of an intent to taper, followed by an official announcement in December that the process will begin in January 2022. However, another strong jobs report could push the timeline forward, but given the uncertainty surrounding the Delta variant and a preference to avoid surprising the markets, we think the Federal Reserve will err on the side of caution and not rush to announce a tapering of asset purchases. Additionally, we believe that the pace of tapering should follow the experience of 2013-2014, starting with a reduction in purchases of $10 billion per month for U.S. Treasuries and $5 billion in agency mortgages followed by gradual reductions at each Fed meeting and concluding in 12-months with net zero purchases. Reductions could be altered with incoming data, but the FOMC has a strong preference for a steady, predictable path for tapering.

Bond Market Reaction

The bond market should be well prepared for the of asset purchase reductions. The upcoming taper has been well telegraphed by the Fed, which should avoid any "taper tantrum" surprises. Another reason to expect a muted interest rate response is the Fed will be scaling back purchases at the same time the Treasury is reducing issuance. The recent report from the Treasury Borrowing Advisory Committee, recommended a reduction in U.S. Treasury auction sizes in November, the first decline in five years. In 2022, the committee projects cuts between 25% to 35% ($1 to 1.5$ trillion) in Treasury coupon issuance. With the Fed currently purchasing $960 billion per year, the reduction in Treasury supply more than offsets the decline in Fed demand. As a result, the path for interest rates will be determined by the incoming economic data, specifically inflation and employment, rather than the tapering of asset purchases.

Past performance is no guarantee of future results.
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