

SPOTLIGHT ON...

Tapering

WHAT IS TAPERING?

Tapering is the reduction of the rate at which a central bank buys new assets. It's most commonly used when talking about the reversal of quantitative easing (QE) policies. Where central banks print money to buy assets such as government bonds.

The aim – or at least, one of the aims – of QE is to reduce the cost of borrowing across the entire economy. This makes it cheaper for those with debts to pay their interest bills. It should, in theory at least, also make it more appealing for companies to borrow money to invest in expanding their businesses. This in turn should help to boost economic growth.

WHY DO CENTRAL BANKS BUY BONDS?

When an economy is in downturn, like it was in 2008-09, or at the start of the pandemic, banks reduce funding such as loans, given an increased risk default as well as an overall reduction in available liquidity. At such times, central banks step in and reduce interest rates and buy bonds to induce liquidity into the economy. Essentially increasing money supply in the economy by swapping out bonds in exchange for cash.

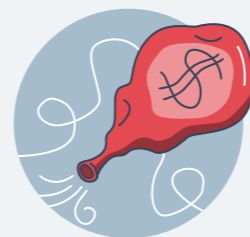
With interest rates at their lowest, banks do not get any interest for the idle funds (and for the extra liquidity) and are therefore induced to give loans to genuine borrowers to enable them to grow their business and uplift the economy.

THE TAPER TANTRUM

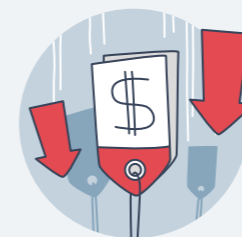
The phrase, taper tantrum, refers to the 2013 collective reactionary panic after investors learned that the Federal Reserve was slowly putting the brakes on its quantitative easing programme. At the time, markets feared that less QE would spell lower asset prices and the result was a sharp rise in bond yields.

The ensuing period of turbulence became known as the 'taper tantrum'. This resulted in the Federal Reserve taking several months longer than expected to slow down the pace of QE. In the end, the taper tantrum panic was unjustified, as the market continued to recover after the tapering programme began.

WHAT'S THE IMPACT?



Deflation
Tapering leads to deflation, pulling money out of the system and making the cost of living more affordable but increases unemployment.



Reducing asset prices
A side-effect of QE has been to drive up asset prices across the board, from bonds to shares to property prices. As a result, investors tend to like it when central banks add more QE but aren't so happy when they reduce it.



Rising interest rates
Bond purchases by central banks have helped keep interest rates low. And tapering of these purchases represents a teeing up of future rate hikes. Meaning that investors will be selling bonds in anticipation of higher rates and less central bank support.

ARCHITAS VIEW



We expect central banks to play a key role in fixed income markets in the coming months. As they cautiously move away from the extraordinary policy easing through bond buybacks that were introduced during the pandemic.

However, we believe that when central banks start tapering it should be viewed as a positive assessment of the economy and consumer confidence. The only sticking point is that communication is key to ensure that markets don't start to panic. Given the scale of the recent bond-buying programme, the Fed will have to be very clear and united in their message, if they want to avoid a bond market reaction similar to what occurred in 2013.

With any large changes by a central bank such as tapering it is inevitable that there could be a degree of volatility, we can expect some capital outflows and consequently some exchange rate volatility. Which is why we always advocate a balanced portfolio.



TAPERING VS TIGHTENING

Tapering is not to be confused with tightening. When a central bank tapers its quantitative easing programme, it reduces the value of assets that it's buying each month. When a central bank tightens its quantitative easing programme, it will no longer add any assets to its balance sheet and will instead reduce the assets it holds by selling them instead.

TAPER TANTRUM 2.0

After a string of strong employment and inflation reports, central bank policy makers including the Federal Reserve, the ECB, the BoE and the BoJ are examining the potential for a start to tapering bond purchases as soon as November 2021.

The fear is we might see a repeat of the 'taper tantrum' in 2013. Back then, the decision to taper bond buybacks triggered an increase in long yields of around 100bp in just three months. An equivalent increase now would result in a marked tightening of global monetary policy.