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Fixed Income Commentary
Bernanke's Taper Tinkering

For at least the past five years, the Fed has cast an exceedingly long shadow over the capital markets. For this reason, understanding Fed policy has been central towards proper guidance and direction of investor capital allocations. Since Chairman Bernanke's trial ballooning surrounding a potential "taper" of the Fed's QE policy, longer maturity Treasury interest rates have soared over 100 basis points. Yet, after multiple rounds of stimulus, the U.S. economy has continued to disappoint on the metrics that matter most to its constituents: job creation and economic growth. Given this, what are the prospects for policy going forward and what does this mean for the fixed income investor?

In order to properly deconstruct the current environment, we can place today's dynamics within the larger context. Financially repressive policies were launched in 2008 in response to the global financial crisis and the systemic risks that were posed by the calamitous decline in asset prices. As such, the Fed was determined to counter the risks posed by an out of control deleveraging and, as such, extended monetary policy into new and experimental directions. Judged by the level of financial stabilization that was initially achieved, QE1 can be judged "safe and effective" in the treatment of systemic risk. Encouraged by this observation, the Fed initiated QE2 in 2010 in order to ease policy further at the "zero bound" and in so doing buy deflation insurance. In effect, the Fed recognized that by lifting market expectations of future inflation that it could effectuate lower real rates and so "stimulate" growth. QE2 appeared to have some success on this front, so let's call the second round "effective" and reserve judgment as to whether engaging in blatantly pro-inflation policies is "safe."

The most recent round of QE – QE3 or QE infinity – differed from the prior rounds of central bank purchases in at least two essential ways. First, the commitment was open-ended; there was no ultimate cap on how much the Fed could expand its balance sheet. Second, the policy action was intended to address the mandate for "full employment" and hence the intimation was made by senior Fed officials that the program might go on for as long as 2017, or until labor slack had been eradicated. In effect, the Fed was looking to take a weak recovery and make it strong by stuffing the banking sector with ever more excess reserves and taking upon itself an expanding portfolio of securities. Possibly the Fed was hoping for a "big bang" effect to wake the American economy from its torpor.

Regardless of the motivation, investors and even Fed officials are increasingly aware that monetary policy is not magic (i.e. is not a "panacea", in the words of the Fed Chairman) and that QE3 is failing to meaningfully lift the rate of hiring. Simultaneously, investors are recognizing that the Fed's extraordinary policy regime is out of place five years after the events that launched them. Zero rates and QE have begotten distorted decision-making that appears to have taken the form of an excess of capital flows into real-estate, leveraged finance, the emerging markets, and stocks. Asset prices appear to have become at least moderately decoupled from fundamentals as evidenced by such dynamics as rapidly rising real-estate prices unsupported by stagnant wage and job growth. Consequently, many outside (and inside) the Fed have a deeper appreciation that QE3 may both lack efficacy in the treatment of a weak recovery and may not be safe given the side effects that are being manifested. Alas, higher asset prices are not the cause but rather the consequence of economic growth.

For these reasons, we believe that the end of QE3 is nigh, and that financially repressive policies may be generally tapered over the course of 2014. As such, we view there to be elevated risk of further rate rises and that these rate rises may occur against a backdrop of slow growth that might, as a result, become slower. For this reason, the valuation of many risk assets may become rather stretched in the quarters ahead.

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