CITY NATIONAL ROCHDALE
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On the Radar

FAQS ON THE MARKETS AND ECONOMY

What did the Fed decide at their recent meeting?

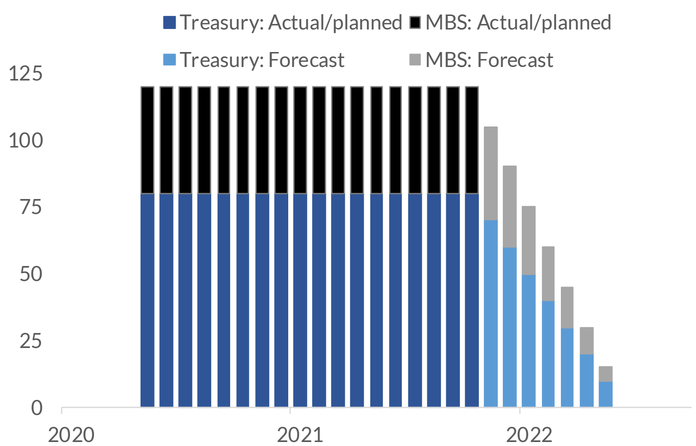
As widely expected, the Fed announced that beginning this month, they will reduce their monthly purchases of bonds by $15 billion ($10 billion of Treasuries and $5 billion of mortgages). They currently buy $120 billion per month (chart). All 11 voting members of the FOMC unanimously approved the decision. If they stick to their schedule, they will be done by June.

The decision is not a tightening of monetary policy. Instead, this is the Fed's first step in normalizing monetary policy. It is just an easing of the stimulus they are adding to the economy (letting up off the gas pedal, not stepping on the brakes). The next move in normalization will be the raising of short-term interest rates. That will not be for a while. The Fed expects to keep the interest rate unchanged until after the bond purchases have ended and the labor market conditions have reached levels consistent with maximum employment.

The term "Transitory Inflation" got a makeover. The Fed has adopted a new language describing inflation, and it is a little more descriptive. For the past several months, they have referred to it as "Inflation is elevated, largely reflecting transitory factors." Now they are saying, "Inflation is elevated, largely reflecting factors that are expected to be transitory. For example, supply and demand imbalances related to the pandemic and the reopening of the economy have contributed to sizable increases in some sectors."

The Fed Bond Buying Program

$, billions, purchase per month



Source: Federal Reserve.

The tapering announcement was pretty much as advertised by the Fed, so there was no critical movement in the market. However, their new comment on inflation shows that the transitory factors will be with us for some time. Over the coming weeks, Fed policymakers will give speeches giving us more details about their inflation outlook and thoughts about raising interest rates. We do not expect a hike in the fed funds for at least one year.

KEY QUESTIONS

GDP grew by just 2.0% in Q3; is there concern?

Should equity investors be worried about tapering?

Is the bond market in the midst of another taper tantrum?

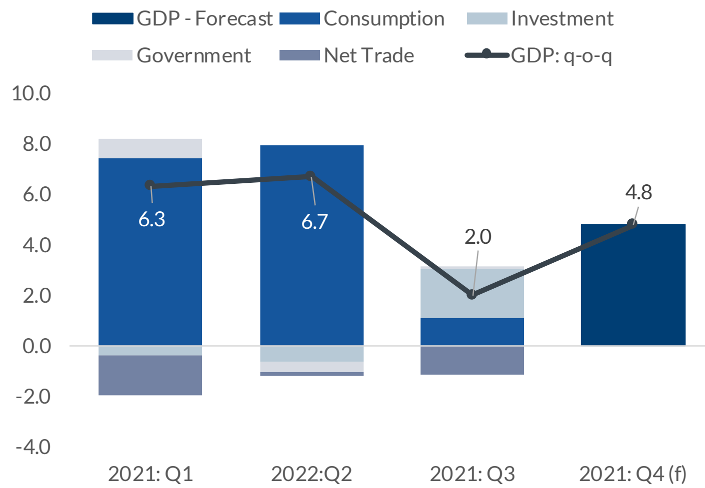
GDP grew by just 2.0% in Q3; is there concern?

There was a sharp slowdown in growth from the first half of the year, which averaged 6.5%. Long gone is the infusion of government stimulus, the excitement of businesses reopening, and rising vaccination rates that fueled spending (chart, Consumption section of first two columns). Q3 spending slowed, being impacted by a surge in virus cases and a deepening in supply bottlenecks. As a result, consumer spending in Q3 was just 1.6%.

The economy does not have a demand problem, which is common with most post-recession periods. Instead, it has a supply problem. Fortunately, supply problems can be fixed faster than demand problems, but they cannot be fixed overnight. We expect GDP Q4 will rebound as COVID-19 cases continue to fall and supply chains start to become unglued. But unblocking supply chains will not be fully completed until late next year, at the earliest. As a result, the goods-producing sector will continue to be limited by global supply chain disruption.

GDP: Actual and Bloomberg Forecast

%, annual rate



Sources: Bureau of Economic Analysis, Bloomberg.

Should equity investors be worried about tapering?

Fed stimulus has been a powerful source of fuel for the recovery in stock prices since March 2020 lows, and a transition to less policy support is bound to bring some anxiety to markets. However, given our outlook for a multi-year expansion and strong corporate profit growth, we don't think it will be a significant headwind for equities.

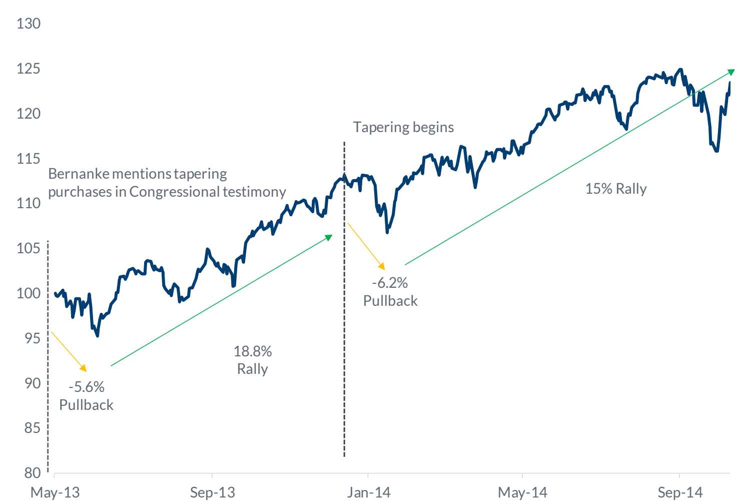
The experience following the 2013 "Taper Tantrum" is informative. After then-Fed Chairman Ben Bernanke caught investors by surprise, signaling plans for gradual reductions in asset purchases, the S&P 500 underwent a brief 5.8% pullback that lasted 23 days.

However, markets subsequently stabilized as the economic recovery continued to gain traction, and investors grew increasingly comfortable with the idea of a less supportive Fed. Indeed, from the time Bernanke announced quantitative easing (QE) would be reduced in May 2013 until QE finally ended in October 2014, the S&P 500 increased over 20%.

Tapering is only the first step on what will be a long path toward monetary policy normalization in this cycle. We still believe actual policy tightening is a ways off, with the first rate hike not likely for another year or so.

S&P 500 Performance During 2013 "Taper Talk" & 2014 Taper

indexed to May 22, 2013



Source: Bloomberg.

Still, it should be reassuring that policymakers believe the economy is starting to move beyond the COVID-19 crisis and will need less of a helping hand. Meanwhile, officials have learned their lessons from 2013 and have provided markets with plenty of advance notice of their intentions to avoid any surprises.

Is the bond market in the midst of another taper tantrum?

A tale of two tapers

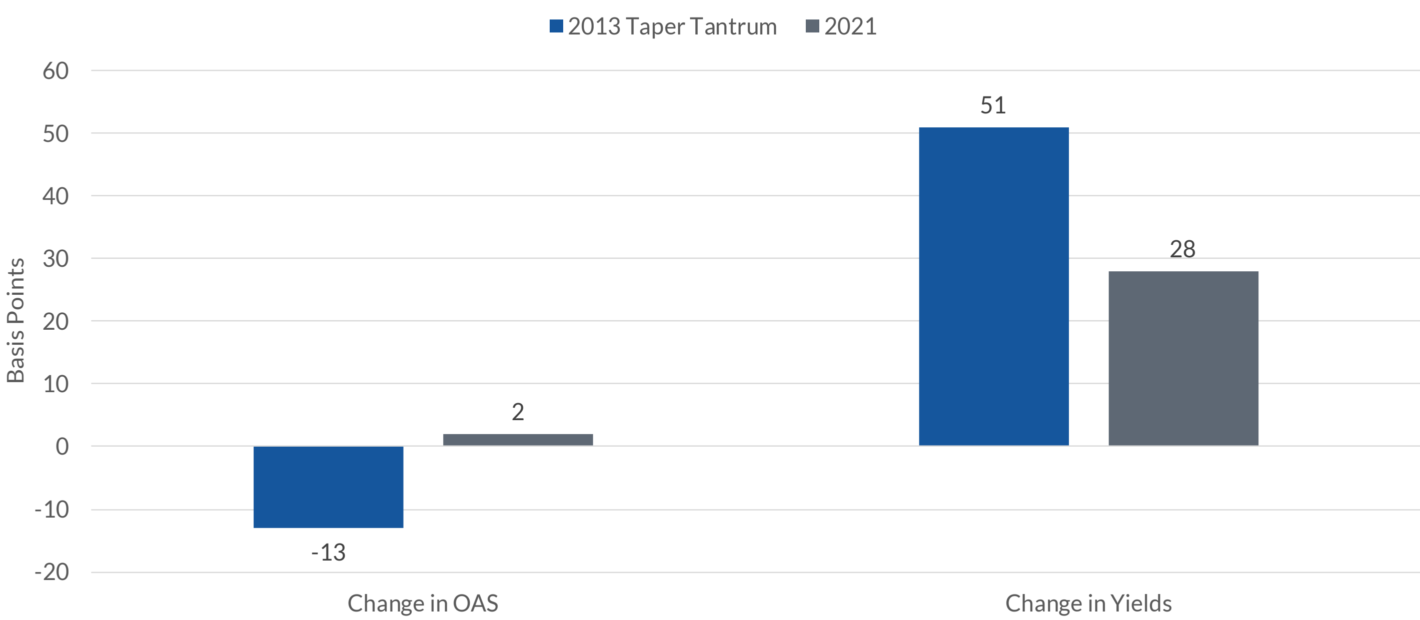
Taking a quick glance at the chart, one can be forgiven in concluding that the bond market is experiencing another taper tantrum. Investment-grade credit spreads have held steady or decreased while Treasury rates are on the rise. These two metrics do not tell the entire story. In May 2013, then-Fed Chair Ben Bernanke surprised the market with an announcement that at some point in the near future, the Fed would begin reducing the amount of quantitative easing (QE) it had been providing since the Great Financial Crisis. This unexpected shift in policy unnerved the markets, resulting in an uptick in equity and interest rate volatility.

Since March 2020, the Fed has been buying Treasuries and mortage-backed securities (MBS) at an increased rate due to the need to buttress market stability at the onset of the COVID-19 pandemic. This time around, the bond market had expected a reduction in QE as the world makes progress fighting the pandemic, and Federal Reserve, particularly Chair Jerome Powell, has been very clear and consistent for months concerning forward guidance around tapering. The Federal Reserve learned from the 2013 messaging error, and the 11/3/21 formal taper announcement did not worry the markets.

Treasury yields have increased year to date for very different reasons. The market is not pricing in additional risk premiums to compensate for unknown Fed actions. The market is now pricing in elevated and more persistent levels of inflation coupled with higher levels of annualized GDP growth.

The reduction in QE is a positive step forward in the normalization of Fed policy, and investor expectation and behavior.

Federal Reserve Tapering and the Influence on U.S. Treasury Rates



Source: Bloomberg.
*OAS and yield figures are based on the Bloomberg Barclays U.S. Intermediate Treasury and the Bloomberg Barclays U.S. Intermediate Corporate Indices.

Index Definitions

The Standard and Poor's 500 (S&P 500) is a stock market index tracking the performance of 500 large companies listed on stock exchanges in the United States.

The Bloomberg Barclays Global US Treasury-Intermediate Index is an unmanaged index that includes all publicly issued, U.S. Treasury securities that have a remaining maturity of greater than or equal to 1 year and less than 10 years, are rated investment grade, and have $250 million or more of outstanding face value. You cannot invest directly in an index.

The Bloomberg Barclays US Intermediate Corporate Bond Index measures the investment grade, fixed-rate, taxable corporate bond market.

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