The long-awaited unwinding road begins

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In the November Federal Reserve Open Market Committee (FOMC) meeting, Fed policymakers left interest rates near zero but also announced a plan to start winding down or 'tapering' its bond purchasing program[1].

What happens now?

The Fed has been purchasing $120 billion worth of bonds each month driving up bond prices[2]. By buying bonds, the Fed was supplying the market with easy money and sending bond prices higher. Higher bond prices in turn lowers interest rates, as they move in the opposite direction. This program, known as quantitative easing (QE), was done initially in an effort to help the economy through the pandemic by injecting liquidity and stability in the markets. Thereafter, the program was maintained to drive strong economic growth by keeping borrowing costs low across the economy, since bond markets help determine the rates of consumer loans such as auto loans and home mortgages. The program was akin to a fire hose on the financial fire of this pandemic. Going forward, the Fed wants to turn down the full force of this fire hose. Starting November 2021, the Fed will reduce its bond purchases by $15 billion per month until it phases it out by mid-2022. The key is to understand that tapering does not mean the Fed stops purchasing assets, but it reduces the pace of expansion. The Fed also stated that it was willing to change the pace of its tapering if economic conditions warrant. Finally, the Fed also clarified that winding down its bond purchases does not imply an interest rate hike is imminent either.

Why is the Fed taking its foot off the gas pedal?

The Fed has two main responsibilities: maintain price stability (i.e., manage inflation) and ensure full employment. On one hand, the economy has yet to recover nearly 5 million jobs lost during the pandemic[3]. While on the other hand, the Fed is also facing higher inflation amidst widespread supply shortages. Thus, the Fed is caught in a delicate balancing act to ensure it does not turn off the fire hose too soon in the event the fire is not out, but also ensuring that it does not turn it off too late before it floods the house. The bond tapering program is showcasing that the Fed is likely lowering the force of the fire hose to ensure it does not exacerbate already high inflation. The Fed also appears to be putting an emphasis on reaching maximum employment next year as a necessary condition to consider any future interest rate hikes, and to ensure the full effect of the pandemic fire has been put out.

How will this impact investors?

As the Fed pares back the amount of support, the ultimate aim is to send longer-term interest rates back to "normal" over the long term without derailing the economic growth. This likely has several implications for investors; however, we'll highlight two potentially significant consequences.

Stock market: The Fed's actions to inject liquidity and keep rates at near zero has been a huge boon for the stock markets. Low interest rates make stocks more attractive in comparison to bonds and other fixed income investments. U.S. stocks have rallied hard since the pandemic lows of March 2020 and the S&P 500 index now sits near all-time highs. As the Fed scales back some of its support, it's likely that markets are pricing in reduced support, as well as normalized returns going forward. In other words, investors should be ready to for a potential bumpier ride as the Fed scales back stimulus.

Mortgages: Part of the Fed's bond purchases included mortgage-backed securities, aimed to keep mortgage rates low. Home prices and demand for mortgages have surged over the past year fueled by low interest rates. Going forward however, with elevated inflation and a less supportive Fed, the risk for interest rates likely remain to the upside in the months ahead. In other words, it's likely mortgage and other borrowing costs could rise over time.

All in all, the news of reduced support from the Fed came as no surprise to Wall Street as central banks have been

telegraphing this for months. Stock markets continued their march forward. Looking ahead, it appears Fed policymakers will proceed with caution, but this could still lead to equity market volatility and a faster rise in rates depending on inflation and economic growth expectations.

Undoubtedly, the Fed has the challenging task of managing market expectations in the face of elevated inflation risk.

[1] Federal Reserve Board - Federal Reserve issues FOMC statement
[2] Fed Dials Back Bond Purchases, Plots End to Stimulus by June - WSJ
[3] https://www.bloomberg.com/news/features/2021-10-14/why-aren-t-out-of-work-americans-going-back-to-their-jobs

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