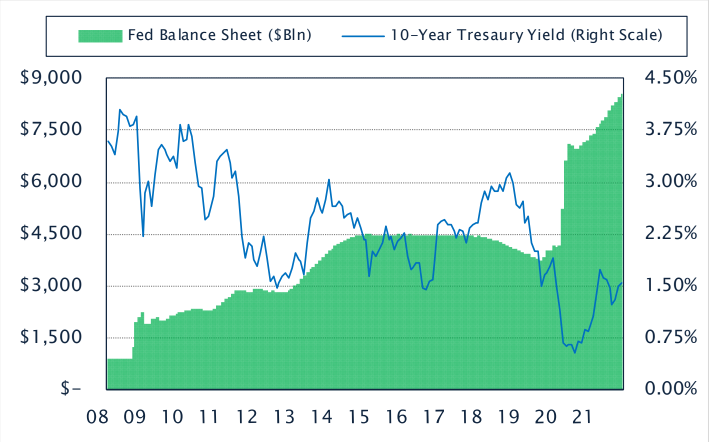
NOVEMBER 2021

Agincourt
Capital Management, LLC

INVESTMENT UPDATE

Now that the Federal Reserve has taken the first step in "normalizing" policy by announcing its plans to taper asset purchases, it's a good time to review the Fed's recent policies and take a look at what may be in store for bond investors over the coming months.

If you've been following the exploits of the US central bank for the last dozen years, you're already aware that the Fed has expanded its range of tools in managing the US economy. Traditionally, the Fed pursued its twin mandates (stable consumer prices, and full employment) by adjusting the Fed funds rate—the rate banks charge each other for borrowing funds overnight. For decades, the Fed made periodic adjustments (hikes and cuts) to the overnight lending rate to either encourage or tamp down economic growth. If they pushed the funds rate high enough it slowed the economy and kept inflation at bay; alternatively, cutting the cost of overnight borrowing encouraged borrowing, which boosted economic growth and supported the labor market.



That worked well enough, at least until inflation—and inflation expectations—had been snuffed to the point that short-term rates moved closer to zero with each recession. The Fed funds rate hit a low of 5.875% in the 1980s, 3.00% in the 90s, and 1.00% in the early "aughts." When the global financial crisis crushed US economic growth prospects in 2008, the Fed dropped the funds rate to zero, and found itself out of policy bullets. Zero percent interest rates for overnight money sounded good, but households and businesses, concerned about jobs, profitability, and the prospects for future needs, wanted to be able to lock in low rates for years, not days.

In order to bring down longer rates and try to pull the economy out of a very deep ditch caused by collapsing home prices and its impact on household wealth, the Fed pulled out a new tool: quantitative easing, or QE. The Fed would buy up government bonds—Treasuries and agency-issued mortgage-backed securities (MBS)—in large enough quantities to lift bond prices and drive down longer-term interest rates.

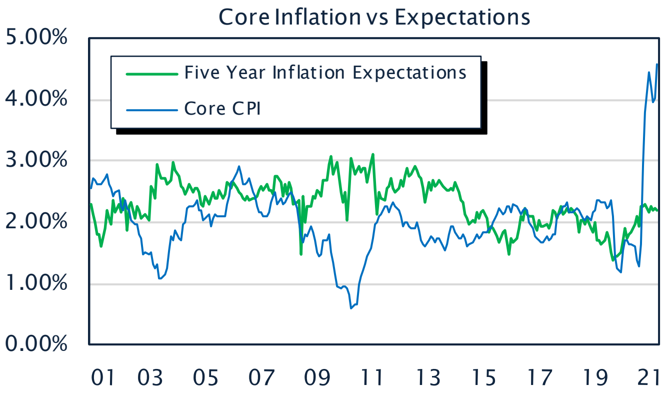
In doing so, the Fed dramatically expanded its day to day impact on the bond market. By definition, the program had to be huge—in the trillions of dollars—in order to have the desired effect. And, looking at the chart on this page, the QE program following the financial crisis did bring longer term rates down, as 10-year Treasury yields dropped from 4.0% to 1.5% from late 2008 to 2012 as the size of the Fed's balance sheet tripled.

One thing we learned from this period of QE is that the communication that accompanies the implementation of the policy is nearly as important as the policy itself. The "taper tantrum" of 2013, in particular, was a painful lesson for then-Chair Ben Bernanke. He announced, without prior warning to investors, in June of 2013 that the Fed would begin to taper its asset purchases, causing a big jump in yields during a period when the QE buying program was at its peak, and should have been exerting maximum downward pressure on yields. The lesson was clear: to be effective, policy must progress hand-in-hand with clear communication, relayed well in advance, about how and when future changes in policy will be implemented.

The Fed maintained its balance sheet in a "steady state" for three years beginning in 2015, as rates stabilized and the economy grew at a modest pace. It's important to point out (in today's context) that the Fed didn't begin to actually shrink its balance sheet for four full years once the tapering of purchases began. Of even more importance to our current situation, the Fed began hiking the Fed funds rate in December of 2015, eventually moving overnight lending rates nine times, by 225 basis points, from 2015 to 2018. As expected, longer term rates moved generally higher throughout this period, reflecting solid economic growth, along with a historically low unemployment rate and rising inflation concerns.

How effective was the 2008-2018 QE program? That depends on what measuring stick one cares to use. Clearly, in the initial months following the near-collapse of the financial markets in late 2008, the emergency liquidity programs the Fed put in place helped calm the markets and provided new sources of funds and lines of credit to financial institutions, without which many would have failed. The QE purchases that replaced (and outpaced) the emergency programs served the same function while also injecting funds directly into the US economy. But as time wore on, each successive round of asset purchases appears to have been less effective than the previous one, as long term rates failed to establish any clear correlation with the size of the QE program.

Nevertheless, the onset of COVID in early 2020 forced the Fed to once again implement emergency measures—including lowering the Fed funds rate back to zero and reinstating large-scale asset purchases—in order to calm markets and provide liquidity for a crippled economy. As the chart on the first page shows, the size of the COVID QE program has already surpassed the previous one, purchasing more than $3 trillion in new bonds during 2020 and an additional $1.3 trillion so far in 2021. Today, the Fed's government bond holdings are more than double the pre-COVID level, and that increase occurred in roughly 18 months, while the financial crisis program took more than five years to top out.



The Fed's recent tapering announcement is only the first step in what is likely to be a multi-year process of policy normalization. The current asset purchases are scheduled to continue to grow, albeit at a declining rate, for another nine months or so. Fed Chair Jay Powell has reiterated that lift-off of the Fed funds rate will come only after the US economy has met its "full employment" target, consistent with the revised inflation targeting approach the Fed adopted a little over a year ago.

But the Fed's more patient approach, which will allow the US economy to "run hot" well into an economic recovery, is bumping up against the worst supply disruptions the global economy has witnessed since the energy crisis of the 1970s. There is growing concern among many investors that the Fed is playing a dangerous game, and that supply chain problems are already lifting inflation expectations. They fear the new "keep rates lower for longer" policy never envisioned this level of noncyclical inflationary pressures, which could combine with labor market disruptions and lead to a sustained period of higher inflation. The remedy, critics believe, is the immediate suspension of new QE purchases and clear guidance that the Fed funds rate will be lifted sooner than later.

The US central bank is under unusual scrutiny right now. Core CPI is 4.6% higher than a year ago, the fastest rate of inflation since 1991 (when 10-year Treasury yields were more than 6% higher than today). Payroll growth has been disappointing over recent months, leading some economists to point to evidence of growing leverage on the part of employees as they demand higher wages and benefits—a real threat to stable inflation. As the chart on this page shows, inflation expectations are holding steady, but are vulnerable to any slippage in the Fed's credibility.

There's reason for concern, but there's no need for panic. As mentioned, the supply disruptions are unprecedented, and are distorting the incoming data, making it nearly impossible to get a grip on the underlying pace of price increases. There is early evidence that some of the worst disruptions are beginning to ease, but normalization in how goods are produced and transported around the world is already taking much longer than imagined a few months ago. This is a critical issue, since the longer this process drags out, the more embedded inflation expectations become. Fed Chair Powell has used the term "transitory" to describe the effects, but at some point things are no longer transitory.

We mention the mental aspect of inflation because, while we think of inflation as a monetary phenomenon—too much money chasing limited goods, and driving up prices—it is equally important to understand the psychological aspect of inflation. We've learned over the decades that inflationary fears grow and ebb over longer periods of time. Some of our readers will recall the bad old days of the 1970s and early 80s, when inflation eventually became an aspect of normal life, and one that was expected to continue indefinitely. Even after years of steady declines in consumer prices in the 80s, bond yields remained stubbornly high, as investors feared a return of higher inflation. In retrospect, real, inflation-adjusted yields were excessively high for more than a decade, as inflation expectations proved difficult to tamp down.

Could we be at the other end of a similar turning point, where we will need to adjust—both mentally and through the mechanism of higher interest rates—to a period of higher, stickier inflation? The Fed has the tools to suppress those concerns; we're waiting for Powell and Co. to use them.