

The Major bond letter

#10. Taper and the Hole

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Global

Markets will look to this year's meetings in Jackson Hole for any chatter about the start of the US Federal Reserve's taper, that already much anticipated slowdown in its bond buying program. It would be a shame if this is the only focus because the annual get-together of central bankers is potentially a much bigger deal. We recall numerous occasions when the Economic Policy Symposium has taken a deep dive into the key drivers of lower-for-longer rates, for example. This year may be no exception.

For all the market talk of taper, the official theme of this year's Jackson Hole (26-28 August) is "Economic Policy in an Uneven Economy", which suggests there will be a focus on inequality, both within and between countries.

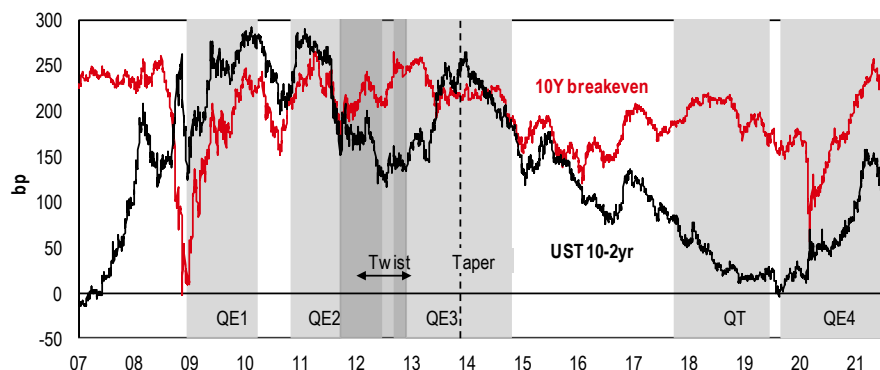
Rising economic inequality matters to bonds because it is one of the longer-run structural drivers that has contributed to rates being so low; in a nutshell, the better off are more likely to save their marginal dollar than spend it. More savings is consistent with lower yields, especially when it goes into bonds. Other factors behind low rates include ageing populations, debt overhangs, and low productivity.

What does the taper even mean for bonds?

Many in the bond market are anticipating a possible announcement on the decision to reduce the pace at which the Fed will buy bonds. We think the taper is largely in the price for US Treasuries, but the picture is not so clear for asset classes that tend to have higher risk, including credit, emerging markets (EM) and equities.

Prices in the Treasury market usually move in advance of key announcements, and this is consistent with what central bankers would call 'signaling'. In our view, the last time the taper was a market event – in 2013 – the conditions were very different to those we have now. Many participants are wary of a repeat of the 'taper tantrum' from eight years ago but that happened because of stretched valuations – forward yields were excessively low – and poor communication from the Fed. Lessons learnt. Valuations are not so stretched at this point in 2021 and Fed signalling has been much more considered.

US inflation breakevens and yield curve suggest tapering is in the price



Source: HSBC, Bloomberg

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Steven Major, CFA
 Global Head of Fixed Income Research
 The Hongkong and Shanghai Banking Corporation Limited

Our chart shows a repeating pattern, with the curve and inflation expectations or “breakevens” – calculated as the difference between the yield on Treasuries and inflation-protected securities – peaking towards the end of each iteration of quantitative easing (QE). This is what we mean by the Treasury market pricing-in the taper. What about everything else?

When ‘risk-free’ government yields are lowered, the prices of other assets are given a boost. This has been the playbook for bonds since QE started with the financial crisis of 2008. In search of additional return, bond investors are encouraged to take more risk by switching into credit, investment grade and high yield, and other riskier assets.

QE contributed to the better performance of risky assets by lowering the risk-free rate along the yield curve. Meanwhile, lower real yields made equities look more attractive, by boosting the equity risk premium, and leverage increased as carry trades – borrowing money to buy something that yields more – became appealing.

This process can also work in reverse. EM, credit and equity investors have been conditioned by memories of what happened in 2013, when a rapid surge in yields had knock-on effects, and thus await news on the taper with bated breath.

What could happen if measures were taken to address inequality?

From the discussion above there could follow a view that links lower rates and quantitative easing (QE) to inequality. If those who own assets – including houses, equities, bonds, etc – become even wealthier whilst everyone else stays the same or gets poorer, there might be greater inequality gaps.

At the company level the big and strong could become even more powerful than the small. Capital might win at the expense of labour. Looking at these trends in terms of risk premium, the owners of capital effectively benefit from a decline in the ‘equality risk premium’, the equivalent of an increase in the inequality risk premium.

Let’s imagine what might happen if rates were hiked and QE was rapidly unwound in an effort to reduce inequality. Asset prices would fall, there might be a recession and, all else equal, the dollar could go up. This could result in those at the top-end becoming a bit less wealthy but could wreak havoc amongst the less fortunate, those with big mortgages, and low savings. Importantly, it might not impact overall equality trends.

This is not just about the US, of course. Like it or not, the US Fed sets rates for much of the global economy, and its decisions have wide-reaching repercussions. Some EM countries are vulnerable to higher debt servicing costs, for example. The impact here is on inequality between countries rather than within them.

Jackson Hole’s participants may well argue that it is not for central banks to deal with inequality – governments and their fiscal policies are better suited to the task. Tightening policies through regulation of certain sectors and companies could be the way to generate more inclusive growth, and improving levels of equality.

In theory, by driving a redistribution from capital to labour, there could be a reversal of the trend in the inequality risk premium. This could negatively impact some companies, adversely affecting their performance in credit and equity markets. Government policies may be better suited to dealing with inequality but they could also be disruptive, sparking a flight to quality and flows towards safer assets, such as government bonds.

Investors should make sure it is not just chatter about the taper that they pay attention to at this year’s Jackson Hole.

Previous editions of ‘The Major bond letter’

- #1. [*Eurozone common issuance – a long time coming*](#)
- #2. [*How to spice it up in a dull market*](#)
- #3. [*New year, old narrative*](#)
- #4. [*Beneath the surface*](#)
- #5. [*The bond market sell-off*](#)
- #6. [*Treasuries and trees*](#)
- #7. [*Inflation rationality*](#)
- #8. [*Lucky number*](#)
- #9. [*Stuck in the middle*](#)

Disclosure appendix

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Source: HSBC

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Source: HSBC

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The Hongkong and Shanghai Banking Corporation Limited
 Level 19, 1 Queen's Road Central
 Hong Kong SAR
 Telephone: +852 2843 9111
 Fax: +852 2801 4138
 Website: www.research.hsbc.com

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