The Major bond letter

#16. QT teaser

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Fixed Income - Rates

Global

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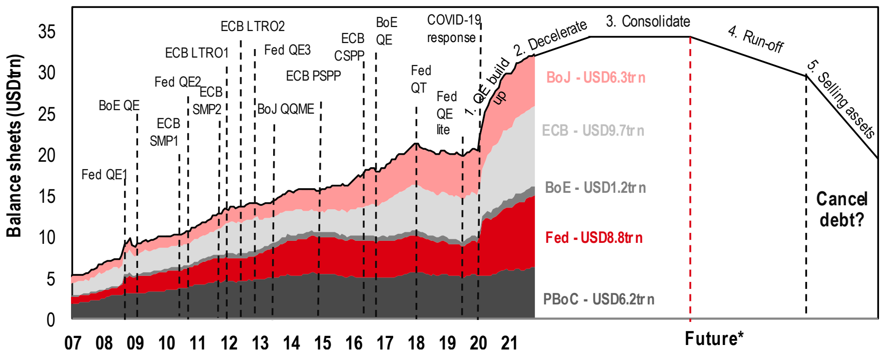
Bond investors have come to terms with the swing towards rate hikes in the US and elsewhere, a conventional tightening of monetary policy. Now they have the teaser that comes with shrinking balance sheets, also known as QT (quantitative tightening), the reverse of QE (quantitative easing). The conventional wisdom is that changing patterns of central bank bond buying mean yields will go up. We beg to differ.

All eyes are on the Bank of England and Federal Reserve for news on when, and by how much, reinvestments will be reduced. These details won't tell us what it means for markets, however, and whilst we have some experience of QT from 2018-19, the context was different. Three years later, the Fed is tapering QE, has not yet started to hike rates, and markets are already obsessing about QT.

Once upon a time QE was controversial. It was referred to as "unconventional" to differentiate it from interest rate policy, an emergency measure deployed in 2008 that supposedly would not be used again. Before QE we wouldn't have been talking about central bank balance sheets because the main tool was rates, but having fallen to zero, central banks had to find something else. Balance sheets are very much larger today, as a proportion of GDP, because they have been used to provide additional policy stimulus (see Figure 1).

Figure 1. More than USD30trn of central bank balance sheet



Source: HSBC, Bloomberg. *Note: Future is not to scale

To see why this might matter, just look at the growth of the major central bank balance sheets since the 2008 global financial crisis (GFC), and particularly the steep pandemic-related increase in recent years. Tempting as it is to focus on the Fed, markets are global and policy effects spill from one region to another, so we have combined balance sheets to get a more complete picture.

The chart shows five general stages: 1) QE, 2) tapering, 3) consolidation with reinvestment, 4) QT or non-reinvestment, and 5) selling of bonds. Markets are now debating what happens when we get to stage 4, and, in the case of the UK, even stage 5. Today the aggregate position is between stages 2 and 3.

QE is business as usual to market participants; it's no longer unconventional. Markets have learnt how to respond, with just about all financial assets benefiting in some way, and one reason for this is that continued QE means rate hikes are off the table. What's less certain, however, is what happens with QT. We argue that the "what goes up, must come down" narrative misses how QE works.

We are often asked: "If QE drove government yields down, then surely its reversal (QT) means they will go up?". Here are four reasons to take a more considered view.

First, a fundamental explanation as to why government bond yields need not rise is that they have already moved ahead of both the asset purchases and the run-off. Intuitive thinking might be that reduced demand for bonds, along with an increase in available supply, means higher yields, but a more reasoned view suggests otherwise. Demand for bonds will depend on the economic conditions, at home and abroad, and relative valuations to other asset classes. Meanwhile, the supply of US Treasuries should decline by around 35%, something that is less well reported. This follows a sharp projected fall in the budget deficit, and because the US Treasury is likely to replace the Fed's maturing bonds with bills, as in the last QT in 2018/19.

Second, the previous decisions to start QE, taken in extraordinary times of crises and threat of economic depression, were an unambiguous message to markets that it was OK to take risks. In central bank language these are the signaling and portfolio rebalancing channels. The latter is known as "risk-on" to market participants. Low real rates of interest – after adjusting for inflation – went into deep negative territory, making other assets look relatively more attractive. During QE, *equities outperformed bonds*, so maybe with QT the valuation challenge is more with equities.

Third, when expectations for the level of real yields fall it can be due to a combination of reasons. If the QE is a confirmatory signal that nominal rates are on hold for a long time, then rising inflation expectations mean the real yields can only go down. We believe that today's level of bond yield is best explained by the expected path of the policy rates, and the trend of the longer-run equilibrium. The latter is linked to the real neutral rate, that rate consistent with full employment and inflation at target, which has been falling for decades, irrespective of big events like the pandemic and GFC.

Fourth, the bonds bought by the central banks in QE were not sucked up into a vortex without implications. The original central bank purchases had to be financed, so that for each USD1bn of bonds bought, reserves of USD1bn were issued to the banking system. How QT plays out will depend on the complex interactions between banks, money market funds and the central banks.

There is a lot we won't know for some time yet, but tempting as it is to think QT means bond yields will go higher, our more considered view is that it is already being factored in. In any case, investors should consider the balance of both supply and demand. The QT teaser is not solved by just looking at one side.

Previous editions of 'The Major bond letter'

#1. *Eurozone common issuance*
#2. *How to spice it up in a dull market*
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#5. *The bond market sell-off*
#6. *Treasuries and trees*
#7. *Inflation rationality*
#8. *Lucky number*
#9. *Stuck in the middle*
#10. *Taper and the Hole*
#11. *Every basis point counts*
#12. *Push back*
#13. *Game of chicken*
#14. *Across the pond*
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