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Contact Information:

Media:
Madelyn McHugh
(212) 805-6039
mmchugh@leggmason.com

Do the Lessons from 2013's Taper Tantrum Apply to Today's Bond Markets?

Short-Term Mispricing of Fed's Intentions Unlikely to Be As Serious, This Time, Western Asset Predicts

PASADENA, AUGUST 9, 2017 – Bond prices were roiled by the Taper Tantrum of 2013. A signal from the U.S. Federal Reserve (Fed) regarding plans to "step down" asset purchases led to a sudden – and sharp – sell-off. Bonds, risk assets and especially emerging markets (EMs) all moved down in price simultaneously. This "taper tantrum" was caused by markets badly mispricing the Fed's intentions regarding short-term interest rates, despite Fed pronouncements.

Now the Fed has announced it will adjust its reinvestment program later this year, selling assets to eventually shrink its balance sheet by $1-2 trillion. This effort toward "normalization" would be yet another step in the Fed's slow and gradual exit from extraordinary monetary policy.

But Western Asset Management portfolio manager & research analyst John L. Bellows Ph.D., believes that market participants will heed lessons learned in 2013 and the possibility of another "taper tantrum" is unlikely.

"The lessons from the 2013 taper tantrum are relevant for bond investors today, but as circumstances are different, we do not expect a similar outcome," Mr. Bellows predicts.

Mr. Bellows details this message in a recently released white paper, "Four Lessons from the Taper Tantrum of 2013," available from Western Asset via this link.

Clarity of expectation and action are paramount. "Central banks have been very clear that adjustments to balance sheet policies do not signal a shift in the broader accommodative stance," Mr. Bellows writes, "and so far have been effective at communicating that message."

A close follower of the Fed and other central banks, Mr. Bellows is an economist who served in three senior positions at the U.S. Department of the Treasury from 2009 to 2011.

"The negative correlation across bonds and risk assets is likely to hold, much like it did over most of 2013," he writes. "The starting point matters for asset prices. EMs are notably at a better starting point than in 2013."

"Over the longer term, we believe markets will respond to inflation and growth, neither of which is likely to be impacted very much by upcoming adjustments to central bank balance sheets."

The lessons of the 2013 Taper Tantrum prove strong and stark because it was so unexpected.

According to Mr. Bellows, "In May 2013, then-Chairman Ben Bernanke said that the Fed could 'step down' the pace of asset purchases 'in the next few meetings.' There was no hint or suggestion in his comments that the Fed was also considering changes to the interest rate policy."

"In fact, at the beginning of the same testimony, Bernanke emphasized that the Fed's forward guidance in regard to interest rates 'underscore[d] the Committee's intention to maintain highly accommodative monetary policy as long as needed.'"

"Yet, market participants struggled to make the distinction between changes in asset purchases and the broader accommodative stance. In the immediate aftermath of Bernanke's comments, the market repriced its expectation for the future path of short-term interest rates from one hike to four full hikes by mid-2015. And this repricing was in spite of the fact that Fed officials were pushing back very hard and reasserting the forward guidance at every opportunity."

A common observation about the 2013 taper tantrum is that bonds and risk assets experienced a period of negative returns, thereby upending the negative correlation between the two that is the foundation of many portfolios. This was true, but only for a very limited time.

"When assessed in the proper perspective, such a combination of price moves is neither puzzling nor alarming," Mr. Bellows concludes.

"Now in 2017, central bank balance sheets are again top-of-mind for bond investors," he writes. The Fed plans to shrink its balance sheet, slowly, gradually. The European Central Bank (ECB) is a few years behind but nonetheless has signaled a desire to move in the same direction.

"Large central bank balance sheets have been a prominent feature of the post-crisis landscape, and it's understandable that bond investors are watching these developments warily," Mr. Bellows writes. "A few have even raised the concern that apparently small changes in balance sheet policy can have an outsized impact on markets, as was the case in 2013."

"Given this recent experience, some wariness about Fed moves – and the market's potential reaction – is understandable."

"But, is the taper tantrum really all that relevant for understanding the current landscape?"

Mr. Bellows believes its lessons remain important and relevant for bond investors.

"Encouragingly, this time around markets don't appear to be making the same mistake," he observes. "In the U.S. the market pricing of the path of short-term interest rates has actually moved lower this year, even as the change to reinvestment policy has moved closer. And in Europe recent communications about a potential taper of asset purchases has had limited impact, if any, on the pricing of the short-term rate path."

"This is a key difference from 2013; this time around, central banks have been more successful in maintaining expectations that broad accommodation will remain in place – and should that hold, it will be an important departure from the taper tantrum."

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