US FEDERAL RESERVE POLICY IN TRANSITION:

Key Impacts for Canadian Fixed Income Markets

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EXECUTIVE SUMMARY

As the US Federal Reserve (Fed) starts to taper its massive quantitative easing (QE) in late 2021, it faces difficult tasks and serious risks in unwinding QE and in managing the future lift-off from near-zero policy rates. This paper examines the Fed's policy transition challenges and risks, and explores several crucial impacts for Canadian fixed income markets.

Fed policy has an indirect but powerful influence upon the absolute level and shape of Canada's yield curve via interest and foreign exchange rates. The Fed's COVID-19 successes include massive support during the pandemic's crisis phase that was decisive in helping prevent an even worse economic contraction and in stabilizing financial markets. Its communication and QE approach contained US Treasury yields (and, indirectly non-US bond yields) through November 2021, despite the robust US economic rebound and rising US and global inflation.

Yet, the structural risks are increasing and new risks are appearing as the Fed's policy transition begins. Longstanding critics point to the negative effects of ultra-low yields and QE in fostering misallocations of investment and undue risk-taking activities. They stress that the over-reliance upon easing fosters excessive leverage for households, businesses and governments. These and other side effects of ultra-easy policy create greater instability over the medium and long term in financial markets. Concerns also surround the "Fed put" whereby the Fed responds to financial market declines more quickly and decisively while it is slower and less active in dealing with elevated market levels and robust conditions.

Crucial challenges for the Fed's exit strategy start with its timing and pace. Various leading economists and analysts contend that the Fed's "patient" approach to unwinding QE and, eventually, raising policy rates is both too slow and insufficient. They see the Fed's start to tapering as already late and inadequate given US inflation pressures, massive fiscal stimulus, large-scale pent-up demand, double-digit savings levels and excess liquidity.

At the heart of the debate about the Fed's policy in transition are fundamentally different views on the nature of the rise in US inflation in 2021 and its future path. The Fed consistently assessed the 2021 rise in inflation as transitory until November 30, and resulting from temporary factors. However, many of the factors pushing inflation higher by late 2021 have proven more durable and broad-based. The October US Consumer Price Index (CPI) and the core CPI increased by 6.2% and 4.6%, respectively, from a year ago, their largest rise in 30 years. Consumer expectations of inflation are at their highest levels since 2013. Unlike the 2007-2008 global financial crisis (GFC), the Fed's transition to ultra-loose policy in late 2021 will occur with a far stronger US economy, ongoing huge US fiscal stimulus, and inflation well above the Fed's target.

The contrast in the financial environment in late 2021 is stark versus the GFC and its aftermath. US inflation-adjusted yields turned sharply negative in mid and especially late 2021. The Fed needs to keep inflation fears at bay to avoid a market-driven large increase in longer-term Treasury yields and US$ pressures. Yet, its reversal of ultra-loose policy should not be so disruptive as to cause currently very low credit spreads to rise substantially and create distress in the indebted US household and corporate sectors. It should avoid prompting major disruptions in emerging market economies akin to what occurred in 2013. The Fed must also consider the risks and uncertainty from COVID-19's Delta and new variants (e.g., Omicron).

For Canada, the Fed's transition to tapering creates increased policy "room" for the Bank of Canada (BoC) to move more rapidly in its reinvestment and runoff phases. However, the risks in the Fed's approach include much higher Canadian yields and greater volatility. Combined with the BoC completing its QE tapering, the Fed's unwinding of its ultra-easy policy has repercussions for Canada bond yields and Canadian credit spreads. Its policy pivot adds further pressure upon the substantial negative real yields of Canada bonds from rising Canadian inflation. It reinforces the merits of re-assessing the optimal size of fixed income allocations in portfolios in late 2021 and beyond.

From a risk perspective, the potential for a less orderly adjustment in US Treasury yields and other major debt markets such as Canada's has grown significantly with the Fed starting to taper its pandemic QE. The Fed's asset purchases and ultra-low rate guidance have encouraged many investors to buy many assets at very expensive prices. Combined with increased potential rate volatility as Fed policy shifts, there is a greater risk of yields abruptly adjusting, further complicating the role of bonds in Canadian institutional and individual investors' portfolios.