hfma south texas chapter
healthcare financial management association
Chili Pepper Express
stxhfma.org

Preparing for the Taper

How Changes to Fed Stimulus May Impact Nonprofit Portfolios

After more than five years, the Federal Reserve Board (the Fed) announced on Dec. 18, 2013, that the quantitative easing program currently in place, the monthly open-market purchase of $85 billion of mortgage-backed securities and treasury securities, would begin to slow. The announcement described a $10 billion reduction of monthly securities purchases beginning in January.

While stock markets soared—the S&P 500 rose 1.66%—treasury yields responded more gently as bond market participants had anticipated this move for many months. The announcement came six months after Fed Chairman Ben Bernanke first referenced the "tapering" of bond purchases.

On June 19, 2013, Bernanke, who also is chairman of the Federal Open Market Committee (FOMC), addressed the media at the conclusion of the committee's two-day meeting. In this press conference, he stated that the Federal Reserve could begin to taper the amount of monthly asset purchases later in 2013. This announcement preceded a sharp sell-off in the bond and equity markets and led many investors and economists to believe a decrease in the rate of asset purchases would be announced at the conclusion of the FOMC's September meeting.

Contrary to popular consensus, the committee voted 9-1 to continue the pace of asset purchases at its September meeting. Bernanke cited a slow recovery in the labor market and the fiscal uncertainty in Washington as the primary drivers behind the decision to delay tapering. The bond markets rallied at the announcement, with the 10-year yield falling to 2.7% from 2.85% the previous day. As the December meeting approached, bond markets anticipated a tapering announcement as the yield on the 10-year treasury note rose to 2.92%.

The Fed also chose to alleviate concerns of a complete reversal of its easy money policy by communicating its intentions in a post-meeting press conference to keep interest rates low "well past the time" that the unemployment rate falls below 6.5%. While Chairman Bernanke stated that Fed actions will remain "accommodative," he noted that the labor markets had witnessed "substantial improvement."

How We Got Here

The Federal Reserve Reform Act of 1977 established the Federal Reserve's monetary policy objectives to be to "promote…maximum employment, stable prices and moderate long-term interest rates."[1] The Fed has been given several tools to achieve these objectives, including setting the discount rate, setting reserve requirements for banks and conducting open market operations. While its board of governors is responsible for setting the discount rate and reserve requirements, the FOMC, comprised of the seven members of the board and five of the Federal Reserve Bank presidents, is responsible for conducting open market operations, including purchasing assets in the open market as a tool for manipulating interest rates. By manipulating interest rates, the Fed is able to provide cheap financing to companies in periods of economic downturn as well as to raise borrowing rates when the economy begins to overheat, a situation where production is unable to keep pace with growing demand often resulting in high inflation.

In response to the financial crisis of 2008, the FOMC implemented unprecedented open market activities, in the form of asset purchases, to prevent large institutions from failing while also aiding in broad economic recovery. The committee began purchasing short-term securities in the open market at an accelerated pace in September 2008, pushing short-term interest rates to extremely low levels and providing easier access to liquidity for struggling financial institutions. Two months later, it initiated an $800 billion asset purchase program or "quantitative easing," later referred to as QE1, that significantly lowered long-term interest rates, allowing corporations and consumers to secure long-term capital at historically low rates. Since then, additional quantitative easing actions have been taken with the goals of increasing economic expansion and lowering unemployment by increasing consumer spending via reducing borrowing costs. As a result of over five years of quantitative easing, the assets on the balance sheet of the Fed have increased by nearly $3 trillion.

Easing Off the Accelerator

At the conclusion of the June 2013 FOMC meeting, Bernanke

discussed potential tapering of the current $85 billion in monthly asset purchases, firmly stating that the Fed would not abruptly end the easy monetary policy. He likened a tapering to "easing off the accelerator" as opposed to "slamming on the brake." Despite his cautious words, markets reacted sharply, with the S&P falling 3.4% within three days of the announcement, while the yield on 10-year U.S. Treasuries rose from 2.18% on the day before the announcement to 2.48% by the end of the following week. The market reaction was a clear indication that a reduction in stimulus would not be well received by the markets.

The FOMC has repeatedly stated that tapering will not begin until economic conditions have improved and growth can continue naturally. A tapering of asset purchases, therefore, should be interpreted as a positive by the markets, as strong economic growth and low unemployment are catalysts for asset prices. Despite this logic, markets typically have reacted poorly to the mention of tapering or stricter monetary policy and this has led some to believe that quantitative easing from the Fed may be artificially inflating asset prices.

What to Expect

On Jan. 31, 2014, Chairman Bernanke will be replaced by current Fed Vice Chair Janet Yellen, who has expressed the opinion that the current direction of Fed policy will remain in place. While the Fed will continue to maintain an easy monetary policy, further reductions to the current stimulus are inevitable as economic conditions continue to improve, however. In Yellen's nomination hearing in November 2013, the soon-to-be chairwoman dismissed the thought that the FOMC would consider the impact of tapering on asset prices by stating, "I don't think that the Fed ever can be, or should be, a prisoner of the markets."

Impact on Nonprofit Portfolios

As observed at the end of every Fed meeting over the past six months, news of tapering results in short-term volatility. The long-term impact is likely to be less meaningful, however. After all, tapering is a sign that economic conditions are improving and a strong economy leads to strong performance across the markets. However, there are a few steps investors can take to strengthen their portfolios against a reduction in stimulus that will likely lead to higher interest rates.

As the Fed begins to decrease asset purchases, long-term interest rates are expected to rise. Fixed-income securities typically perform poorly in rising interest rate environments, so the prices of bonds will fall as interest rates rise. When interest rates are rising, it is prudent to maintain a shorter duration in the fixed-income portfolio to mitigate expected price declines. Shorter duration can be attained in a number of ways, including allocating to short-term bonds, fixed-income securities with higher coupons and/or assets that have variable interest payments.

In addition to allocating assets within the fixed-income portfolio, there are opportunities to allocate among asset classes. Some assets have historically performed well in periods of rising interest rates. For example, over the 20-year period prior to the beginning of quantitative easing in 2008, commodities produced an average annual return of 21.04% in years in which the 10-year yield rose compared to a return of only 7.89% in years when the 10-year yield was falling.[2] This compares to a return for investment-grade fixed income of 3.54% when the 10-year yield is rising and 9.53% when the yield is falling.[3]

In addition to commodities, several other equity asset classes as well as asset classes with equity-like characteristics have traditionally performed well in periods of rising rates. These include emerging markets equities (27.3% in years the 10-year yield rose versus 16.31% in years the yield fell) and developed markets equities (15.55% versus 4.67%).[4] While these broad observations are encouraging, many other factors outside of historical performance should be considered before making allocation decisions, such as current valuations, portfolio risk tolerance, economic outlook, etc.

Given improving economic conditions and statements by the FOMC, tapering will begin in January 2014. A decrease in demand by the FOMC is expected to drive interest rates higher, both increasing borrowing costs and leading to falling prices for fixed-income investments. Investors can combat rising interest rates by both shortening the duration of the fixed-income allocation and considering asset classes that have performed well in periods of rising rates.

[1] *"The Federal Reserve's Dual Mandate." Federal Reserve Bank of Chicago. Last updated Nov. 13, 2013.*

[2] *As measured by the S&P GSCI.*

[3] *As measured by the Barclays Intermediate Government/Credit Index.*

[4] *As measured by the MSCI Emerging Markets Index and MSCI EAFE Index respectively.*

William M. Courson is the president of Lancaster Pollard Investment Advisory Group in Columbus. He may be reached at wcourson@lancasterpollard.com.