August 04, 2015

Economics Group

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Case Study of the Taper Tantrum and Term Premiums

In the summer of 2013, longer-term Treasury securities rapidly sold off as a result of Fed Chair Bernanke's press conference. We investigate the lessons of the selloff and implications for the coming rate hike.

What Caused the Taper Tantrum?

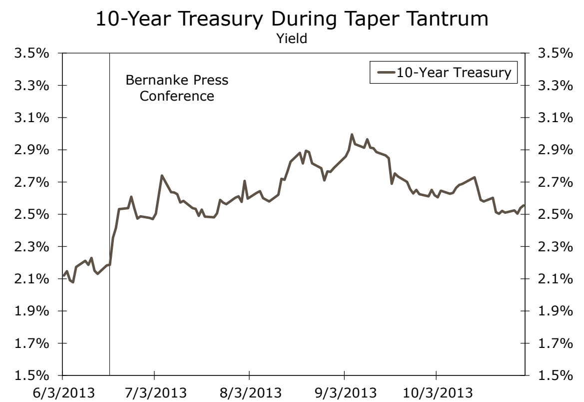
In the press conference following the June 2013 Federal Open Market Committee (FOMC) meeting, Chairman Bernanke suggested it would be appropriate to begin "tapering" the third round of quantitative easing (QE) later that year. This was news to financial markets, sparking a large selloff in fixed income assets (top graph). In this first report, we investigate the lessons learned and their implications for interest rates in the rest of 2015.

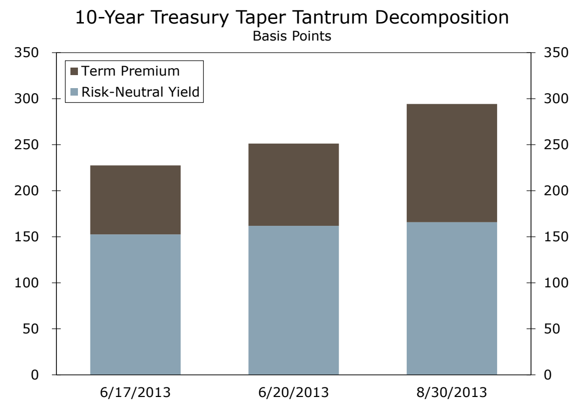
Looking at a decomposition of the yield curve into the risk-neutral yield (expected yield from rolling over short-term Treasury bills) and the term premium (compensation for risk that the short-term rate may not evolve as expected), we see that the majority of the increase in yields was driven by the term premium (middle chart). The risk-neutral yield rose to some extent, indicating Bernanke's comments pulled forward expectations regarding the path of rate hikes. That said, the majority of the increase was a result of the term premium, indicating investors required more compensation for the risk that short-term rates do not evolve as expected.

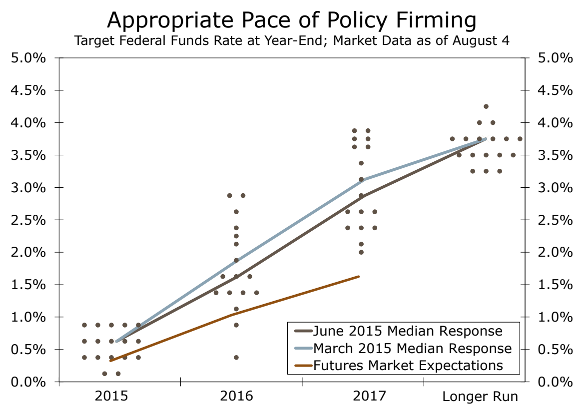
One of the goals of QE was to depress term premiums. Short- and long-term bonds are not perfect substitutes for one another and investors demand a term premium to hold longer-maturity bonds. Therefore, the term premium is determined by supply and demand for the longer-term bonds, and an earlier-than-anticipated ending of QE may have reduced expected demand for the securities, causing the term premium to increase.

Will Term Premiums Spike Again?

There is uncertainty about whether we will experience another "taper tantrum" scenario when the FOMC raises its policy rate for the first time this cycle. On one hand, yields have risen sharply since bottoming earlier this year, likely a result of the market discounting at least one rate hike this year. On the other hand, term premiums still remain at historically low levels. We feel the depressed term premiums are a result of supply and demand dynamics, however, and should not be largely affected by an increase in the policy rate. The Fed's balance sheet is still at an extraordinary level, contributing to the limited supply of longer-term bonds. Investors must, therefore, accept a lower premium to hold these bonds. In addition, higher capital requirements have increased demand for Treasuries by financial institutions. Thus, the term premium should remain depressed relative to historical norms when the Fed moves. Pending a large revision in expected short-term rates out into the future, which is a very real possibility if market expectations jump to the Fed's projections (bottom chart), we should not see a repeat of the "taper tantrum," although we still expect yields to rise. If the Fed unexpectedly begins selling assets, or if the reverse repo program is large enough, there could be a rapid selloff in rates as supply increases.







Source: Federal Reserve Board, Federal Reserve Bank of New York, Bloomberg LP and Wells Fargo Securities, LLC

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