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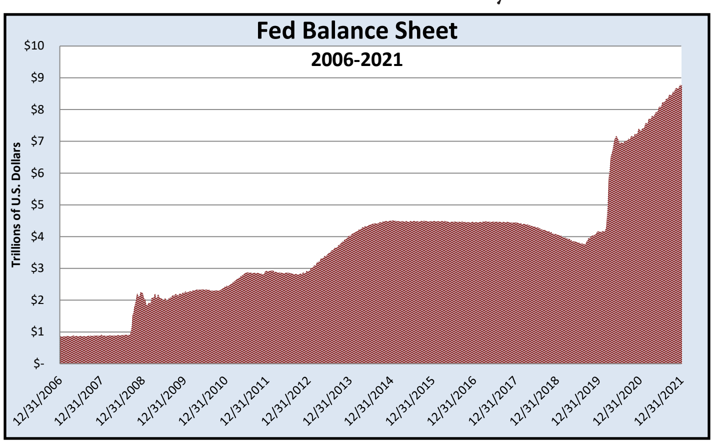
Will the Impact of Quantitative Tightening (QT) on the Economy be more than anticipated?

As most market participants know, the Federal Reserve is beginning the process of tightening monetary policy. For most observers, this means that they will raise interest rates in an effort to reduce the extraordinarily easy monetary conditions that were in place since since the Financial Crisis of 2008-2009. And, with regard to raising interest rates, the Federal Reserve has considerable experience in doing that since its founding in 1913, and therefore there is some reasonable experience to help predict the impact of doing so on the economy.

But this time is different. As part of its response to the Financial Crisis in 2008, the Federal Reserve began a series of bond-buying operations referred to as "Quantitative Easing" (QE) . The idea was that the Federal Reserve would step into the financial markets as a huge buyer of bonds in order to provide liquidity and ensure that the financial system would not seize up from panic selling. This worked. But as a result, the Fed's aggregate holdings have risen from less than $1T before the Financial Crisis to $9T today.



The Fed now prudently wants to shrink its bond holdings back down, and there are several good reasons for doing so, including:

1. To help slow the economy in accordance with its desire to reduce inflation.

2. To prevent the Fed from following in the footsteps of the Confederacy, the Weimar Republic and far too many other central banks which financed unsustainable government deficits and devalued their currencies.

3. It may spare the Fed the awkwardness of having to explain to Congress why it incurred sizeable losses on its huge bond holdings when interest rates rose.

The Mechanics of Quantitative Easing (QE) and Quantitative Tightening (QT)

Quantiative Easing (QE) - the Fed buys bonds and deposits the proceeds into savers' bank accounts, anticipating that the savers will spend some of that money on goods and services. This new spending stimulates the economy.

Quantitative Tightening (QT) - the Fed sells bonds and withdraws the funds from consumers' bank accounts, diminishing their ability to spend. The reduction in spending slows the economy.

But it is the first reason that is our main focus today: how Quantitative Tightening may help to slow the economy and curb inflation.

So how do we estimate the impact of QT?

With very little track record, the answer is hard for even the Fed's 400 PhDs to calculate and certainly more complicated than "watching paint dry" as former Fed Chair Janet Yellen described during their last attempt at policy normalization in 2017. The Fed isn't the only central bank with a nascent understanding of QT. Indeed, the Bank of England favors interest rate policy as its primary tool rather than engaging in QT, specifically citing the better-understood relationship between raising rates and the economy.

But for our purposes, perhaps a good place to start is the direct impact on the money supply – consumers will now have $1T per year less in their bank accounts, and available to spend. In turn, aggregate demand for goods and services will be reduced - slowing economic activity.

QT will also have an immediate influence on fixed income markets. When the Fed, the largest bondholder in the world, begins to unwind its assets, it is certainly enough to move the needle and drive interest rates higher, particularly on the longer end. Since many loans are often tied to the longer end, this will affect affordability. For example, if mortgage rates increase, the housing market will probably slow.

Another potential influence QT may have on the underlying economy is through the "wealth effect". Economists estimate that a $1.00 decrease in our wealth (from falling stock markets, for example) produces a $.02-$.04 decrease in spending.

If the Fed's continued selling pushes interest rates higher, that might pressure both the overall stock and bond markets lower – producing a negative wealth impact along the lines mentioned above. The stock and bond markets are off more than 10% so far this year, so perhaps that wealth effect is coming to the forefront already.

So this is what is at play. And our thinking is that the impact of QT is equivalent to a hike of roughly 50-100 basis points. However we tend to believe that there is a potential for underappreciated impacts as well as unanticipated risks, precisely because we are in unchartered territory, which is so hard to analyze.

Accordingly, we at Northeast are keeping an eye on the announcements out of the Fed – and from other central banks – regarding how they anticipate rolling out their monetary policy tools. And recently we have tended to keep the average durations of our bond portfolio relatively short.

Bruce H. Monrad is chairman and portfolio manager of Northeast Investors Trust (NTHEX), a no-load, high-yield fixed income fund whose primary objective is the production of income. Bruce is among the longest-tenured bond fund managers in the industry, having run Northeat Investors Trust for more than 30 years.

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