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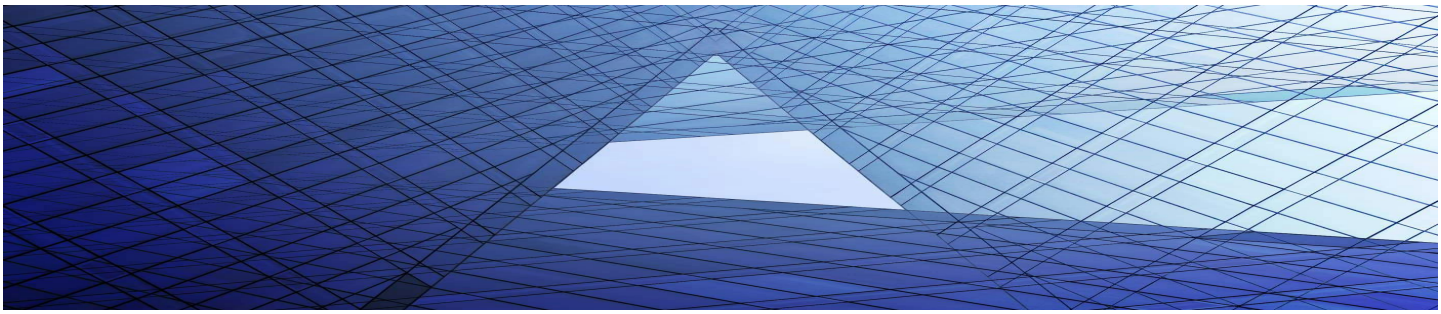

"Bond anniversaire": Taper Tantrum 10 years on

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In late May 2013, financial markets experienced a period of turbulence known as the "Taper Tantrum." It was a time of significant volatility and uncertainty as the Federal Reserve (the Fed) signalled its intention to reduce its bond-buying (i.e. "Quantitative Easing") Program. As we mark its 10-year anniversary, ***Kevin Thozet, a member of the investment committee at Carmignac*** *reflects on its impact, and the implications for financial markets.*

Origins of a Crisis

The Taper Tantrum was triggered by then-Fed Chairman Ben Bernanke's remarks in May 2013, indicating that the central bank was intending to reduce its bond purchases. This surprised financial markets, which had ignored earlier hints and had become reliant on the Fed's unprecedented stimulus measures to support economic recovery in the aftermath of the global financial crisis. The prospect of reduced liquidity, potential interest rate hikes and more generally, further tightening, led to a sharp sell-off in bond markets and a surge in volatility across various asset classes.

Global Market Turmoil

The impact of the Taper Tantrum was felt globally, with emerging markets bearing the brunt of the hit. As investors withdrew capital from riskier assets, currencies and bonds of emerging economies experienced significant depreciation and rising yields. Countries with large current account deficits and high external debt levels were particularly vulnerable to the sudden capital outflows. This episode underscored the importance of strong fundamentals and prudent macroeconomic policies in navigating global financial shocks.

Lessons Learned and Policy Adjustments

The Taper Tantrum served as a valuable lesson for central banks and policymakers around the world. It highlighted the need for improved communication and clearer forward guidance to manage market expectations. Central bankers became more mindful of the potential spillover effects of their policy decisions on global financial markets and sought to adopt a more cautious and transparent approach.

Echoes and Differences with Today

The case of EM

Today, emerging markets (EM) face a much more abrupt external shock. This time, it is not only the Fed but all G10 (ex-Japan) central banks tightening policy. Central banks are not merely 'tapering' their bond purchases, they are actually reducing their holdings through passive roll off of existing bonds, a policy known as "Quantitative Tightening". They are also hiking interest rates at a pace not seen since the early 1980s. The shock was so unprecedented and unanticipated that it has even triggered a crisis among US regional banks.

In spite of this, we have had very few accidents in emerging markets. Financial stress has been concentrated in the weakest links of the "frontier markets" universe, such as Ghana, Sri Lanka or Tunisia. The largest victims of the 2013 taper tantrum, the "Fragile Five" (Brazil, India, Indonesia, Turkey, South Africa) have proved resilient thanks to much better fundamentals than 10 years ago. De facto, most of the heavyweights of the EM world spent much of 2015-2019 deleveraging their private and public sectors. Moreover, their central banks did not make the same mistakes as their G10 counterparts in 2020-2021: they started their hiking cycle much earlier. This brought inflation under control earlier than in the G10, albeit at the cost of subdued aggregate demand growth. When the Fed hikes hit, their current accounts had already adjusted towards equilibrium; their inflation was already on a clear deceleration path and interest rate curves were adequately pricing some upcoming monetary loosening. Capital outflows were minimal as EM assets were largely under-owned by foreign investors that had preferred US assets for the past 2 years.

Mind the gap between market expectations and the Fed's actions

Another parallel with 2013 is the apparent gap between the Fed's forward guidance and market expectations in terms of future monetary policy. 10 years ago, markets were ignoring the message the Fed had been sending since January and, as its intention became unequivocal on 22 May, the tantrum unfolded. Analogously, today the Fed is signalling that it is intending to maintain its current policy rates while markets are expecting those

rates to be cut by 2.5% over the coming two years.

And one can ponder on what would happen should markets shift from factoring in 250 basis points cuts over the coming 24 months to mere 150 basis points cuts. Treasury yields could indeed grind higher but emerging markets rates would sell off and we would also likely see a big washout in most expensive growth stocks.

Yet some mechanisms have since been put in place to prevent a potentially dire outcome associated with such a chasm between the Fed's intentions and markets expectations. The first is the now famous dot plot providing some guidance on the FOMC's intention two years down the line – albeit it was introduced prior to the Taper Tantrum in 2012. The second is the enhancement of surveys conducted ahead of FOMC meetings which were added in the aftermath of the Taper Tantrum. In 2014, the Survey of Primary Dealers (which looks at gaining insight into rate expectations of Primary Dealers) was complemented with a Survey of Market Participants. (which aims at gathering investors' expectations as well). They aim to allow the better monitoring of potential stability-threatening discrepancies and if need be, better adjust the Fed messaging around future path of monetary policy - and hence to lower the risk of miscommunication.

What Could Go Wrong?

While the lessons from the past suggest that the prospects of a major monetary policy mistake, and hence a renewed rates tantrum, is very much unlikely, the central scenario remains the Fed dialling back on its tightening path should a new tantrum materialize. However, it is still too early to ponder the full international ramifications of this monetary policy shock.

One ongoing development is the potential resonance of liquidity tensions with the debt ceiling drama. So far this year, the suspension of debt issuance by the Treasury has helped stabilize the bond market. And, despite banks being large holders of Treasuries, the run on regional bank deposits had a muted impact on the Treasury market. This happened thanks to a complex alchemy of financial flows. The mechanism is the following: depositors withdrew money from banks and placed them in money market funds; banks were in turn forced to sell Treasury bonds (their most liquid assets) to face these deposit redemptions. These bonds were bought back by primary dealers, who refinanced them on the repo market. The other side of these repos were money market funds that had to invest the money they received from bank depositors. The repo market is thus the bridge that enabled to re-route private savings towards the bond market despite the deposit exodus. Once the debt ceiling is raised, the Treasury will have to issue 2.2tr$ by year-end, of which 1.4tr of T-bills. The question is how can the market absorb all this duration risk without sending shockwaves through the repo market and the entire US money market? Money market funds could choose to stick with their reverse repos with the Fed (currently 2.2tr$) instead of buying T-bills or funding the repo market, particularly if the bond market continues to price early rate cuts. This would set the scene for a replay of the repo market crisis of September 2019. The dislocation in the short-term dollar funding market would send shockwaves through the offshore dollar market and create a harmful dollar spike against EM currencies.

Conclusion – a balancing act

As we reflect on the 10-year anniversary of the Taper Tantrum, we recognize the significant impact it had on global financial markets and the subsequent adjustments made by policymakers.

The Taper Tantrum shock guided some major improvements in the communication and forward guidance of central banks. But even the most transparent communication framework cannot shield markets from volatility when central banks commit a major policy error and need to correct course in short order. Such is our current predicament after central banks fooled themselves and the markets with their 'transitory' inflation theory in 2021. In this abrupt policy U-turn, we should remain vigilant that another pocket of vulnerability could come to the surface, as the unexpected US banking tensions illustrated this Spring.

As we move forward, Central banks and policymakers continue to navigate a complex and evolving economic landscape and the goal remains to foster sustainable economic growth while maintaining financial stability. An ever-complex balancing act.

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