First Trust
Monday Morning OUTLOOK

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630-517-7756 • www.ftportfolios.com June 14, 2021

Taper Tantrum Two?

To drive home his commitment to easy monetary policy and low interest rates in mid-2020, Federal Reserve Chairman Jerome Powell declared the Fed was not even "thinking about thinking about raising rates."

The Fed meets again later this week and, very likely, is *still* not thinking about thinking about raising rates. But that's only part of the Fed's tool kit. Bond purchases are another, and have been running at a pace of $120 billion per month ($80 billion in Treasuries and $40 billion in mortgages). With inflation up, and the economy growing, the Fed is most certainly thinking about how to "taper" this bond buying.

As a result, some investors are worried about the impact on financial markets. Back in 2013, when Fed Chairman Ben Bernanke hinted that the Fed would slow the pace of quantitative easing, the 10-year Treasury yield jumped from roughly 1.7% to 3.0%, while the stock market hit an air-pocket. This rough patch for markets was famously dubbed the "Taper Tantrum."

That financial turbulence was enough to put Bernanke and the Fed back on its heels, and they ended up postponing actual tapering until the beginning of 2014.

So, what happens this time? It's true that monetary stimulus has been a key part of the current recovery from pandemic shutdowns. However, with so much liquidity in the financial system, we are skeptical that a policy shift toward tapering would create the same kind of market response for a few reasons.

First, the bond market has experience with tapering. When tapering finally ended in October 2014, bond yields were back down to about 2.3%. In other words, the tumult in markets was temporary. Eventually, the Fed didn't just taper, it shrunk its balance sheet, which bottomed in August 2019 when the 10-year yield was back down to about 1.6%. So, after all the fear about tapering, yields eventually fell back to where they were before Bernanke even talked about tapering in the first place.

Second, the US is awash in monetary liquidity, and will remain so through any tapering and well beyond. That's why the Fed is currently conducting massive reverse repo operations. There is so much cash that the financial system is perfectly willing to park it at the Fed…which, if you think about it, is a kind of self-tapering. The money is just not necessary for economic growth.

Third, the need for Fed bond buying to finance government spending is waning. President Biden originally asked for close to $4.3 trillion in extra spending for the next ten years, but Congress has balked. The White House might have to settle for as little as $1 trillion, maybe even less, depending on negotiations with Congress. Moreover, part of the spending package may come from money re-purposed from prior spending bills. No wonder bond yields fell last week even while consumer prices rose rapidly.

Last, it's important to keep in mind that back in 2013, many, many investors were worried about a double dip recession. As a result, when the Fed said growth was strong enough to taper, higher bond yields were a sensible response.

Today, investors see rising growth due to reopening and higher inflation because of easy money. This is not 2013, when consumer prices were up only 1.7% in June versus the prior year. Now, when a taper is announced it'll be the Fed signaling it's getting slightly more serious about inflation.

A taper at this point, is NOT tightening. As a result, yields should be higher a year from now, but a tantrum-like surge is unlikely.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
6-15 / 7:30 am	Retail Sales – May	-0.6%	**-0.8%**		0.0%
7:30 am	Retail Sales Ex-Auto – May	+0.4%	**+0.6%**		-0.8%
7:30 am	PPI – May	+0.5%	**+0.6%**		+0.6%
7:30 am	"Core" PPI – May	+0.5%	**+0.4%**		+0.7%
7:30 am	Empire State Mfg Survey – Jun	22.0	**21.5**		24.3
8:15 am	Industrial Production – May	+0.6%	**+0.6%**		+0.5%
8:15 am	Capacity Utilization – May	75.1%	**75.0%**		74.6%
9:00 am	Business Inventories – Apr	-0.1%	**-0.1%**		+0.3%
6-16 / 7:30 am	Housing Starts – May	1.640 Mil	**1.645 Mil**		1.569 Mil
7:30 am	Import Prices – May	+0.8%	**+0.3%**		+0.7%
7:30 am	Export Prices – May	+0.8%	**+0.2%**		+0.8%
6-17 / 7:30 am	Initial Claims – Jun 12	360K	**370K**		376K
7:30 am	Philly Fed Survey – Jun	31.0	**38.7**		31.5