Four Reasons Not To Worry About The Fed's Taper

By ALAN REYNOLDS – September 17, 2013

At Wednesday's Federal Reserve announcement, policymakers are widely expected to begin to scale back (taper) monthly purchases of Treasury and agency bonds from $85 billion to perhaps $70 billion or so.

Such a change would be minuscule compared to the huge stock of outstanding Treasury and agency bonds or to daily trading volume. Yet many analysts fear that even so trivial a change must be ominous for stockholders, even though the Fed pledges to keep short-term rates near zero.

As one financial columnist recently put it, "worries focus on what will happen to stocks as that stimulus begins to shrink."

Worries about the taper are hugely overblown for at least four reasons:

1. It's old news.

Traders have been discounting an end to the Fed's bond-buying spree for months, with 10-year Treasury yields rising from an unsustainably low 1.65% last November to nearly 3% lately.

This is not simply because Fed officials said they will slow the pace of bond buying, but because sensible global investors have long feared that holding U.S. bonds with a coupon below 2% was inherently hazardous.

The Fed ended two prior quantitative easing (QE) schemes, after all, with no memorable effect. If Wednesday presented a serious threat to stocks, the market would not have been rising so smartly just before that date.

2. A steeper yield curve is not a "tighter" policy.

The spread between interest rates on 10-year and three-month Treasuries is one of the most reliable indicators of future economic activity. When that spread virtually vanished in 2000 and again in 2006-2007, that signaled trouble ahead. Conversely, the economy recovered as the spread widened to 2.39 percentage points in 2009 and 3.08 points in 2010.

Banks make money by borrowing short and lending long. They naturally become more cautious and selective about lending when three QE experiments deliberately flattened the yield curve after late 2010.

Bank lending for real estate and consumers shrank in 2011, and nonfinancial credit rose just 3.7%. As the yield curve steepened in recent months, by contrast, financial stocks have outperformed because lending is becoming more attractive.

The indisputable fact that flatter yield curves are the opposite of "stimulus" may explain why valiant Fed economists have struggled in vain to prove the quantitative easing boosted economic growth. In fact, growth was faster in the four quarters before QE1 than it has been since.

3. Pushing yields down did not spur bond shift to stocks.

Until bond prices stopped rising, there was no compelling reason to sell bonds in order to buy stocks as apologists for quantitative easing often claimed. While it lasted, the Fed's effort to push bond yields down, and bond prices up, created capital gains for diehard bondholders, including China and Japan.

4. Stock multiples were virtually unaffected by QE.

The earnings/price ratio (the inverted P/E ratio based on 12-month trailing earnings) generally mirrored the ups and downs of 10-year Treasury yields from 1970 to 2008, but not when the Fed began meddling with the bond market.

The E/P ratio was about 12.7 in 1980 when the bond yield was 11.4%, which means low bond prices were linked to low stock prices. That E/P ratio fell to 6.1 by 1986 as yields dropped to 7.7%. And by 2008, the E/P ratio was 3.66 and the bond yield 3.54%.

Once QE began, by contrast, the E/P ratio rose to 6.2 by March 2012 even as bond yields dropped to 1.8%. The recent E/P ratio of 5.4 is still higher than the 1988-2008 norm of 4.9 and unusually high relative to bond yields.

Since a high E/P means a low P/E ratio, this makes it impossible to claim that the Fed inflated the P/E since 2010. If QE had any positive effect on stock prices it must be via higher earnings, not higher multiples. But there were winners and losers from low bond yields and the flatter yield curve, and any net benefit for economic growth remains elusive.

Stock prices have increased since 2009 because corporate earnings increased, not because stock multiples were inflated by U.S. or foreign central bank purchases of Treasury IOUs.

Stockholders must always remain wary of possible shocks to earnings, such as the doubling of oil prices between June 2007 and 2008. But gentle euthanasia of the Fed's quixotic efforts to flatten the yield curve is likely to prove the least of our concerns.