Manager Perspective

C. Angus Schaal, CFP®

TANDEM
WEALTH ADVISORS

AUGUST 2013

Everything you ever wanted to know about Quantitative Easing, Tapering and Tightening

C. Angus Schaal, CFP®
Managing Director

Fixed income investors have enjoyed a 32-year bull market for bonds. We can trace its birth back to the inflationary days of 1981 when the benchmark 10-year US Treasury note yielded 15.32%. As inflationary pressures were squeezed out of the US economy, rates began to decline; quickly at first, but in a steady and almost unbroken pattern until earlier in 2013.

During the past six years, since the financial crisis erupted, there have been 520 rate cuts worldwide and a whopping $33 trillion in fiscal and monetary stimulus. Unwinding this stimulus will be neither easy nor quick.

Beginning in the depths of the 2008 financial crisis, the Federal Reserve began to buy US Treasury notes and bonds as a way of injecting more liquidity into the monetary system. They have consistently purchased these securities and for the past year have been buying them at the rate of $85 billion per month. In May, Federal Reserve Chairman Bernanke commented that the Federal Reserve would look to taper their bond purchases before ending them at some time probably in 2014.

What does the eventual end of quantitative easing (QE) mean? If we are to judge by the knee-jerk reaction in both the Equity and Fixed Income markets during May and June, ending QE would be very problematic. However, we need to further analyze why and how QE would be ended. The Federal Reserve has stated that the decision to taper their bond buying would be based on further improvement in the US Economy. Thus, stronger economic data would signal an economy that needs less assistance to continue its growth. If we believe the Fed will not raise interest rates until growth picks up, the positive economic strength should outweigh any tailwinds being provided by the bond buying. When economic growth improves, demand will pick up which would tend to push inflation higher. This means interest rates *should* rise because of the strengthening economy.

Thus, if the economy continues to show steady improvement, the Federal Reserve will begin to reduce the amount of bonds it purchases each month before completely stopping at some point in the next

Tandem Wealth Advisors LLC
www.tandemwealth.com

1850 N Central Avenue, Suite 330
Phoenix, AZ 85004
Tel 602-297-8600
Fax 602-297-8601

12 months or so. While investors may fear the removal of this significant buyer in the market, we would point out that budget deficits have been cut nearly in half during the past two years meaning the amount of new issuance by the US Treasury has decreased significantly. Therefore, the Federal Reserve has been buying a steadily increasing portion of the net new issuance during the past 12-18 months. We believe the Federal Reserve may begin reducing the amount of bonds purchased each month as early as mid-September 2013 after their next meeting. A prudent strategy of tapering would see the monthly $85 billion in purchases decline by approximately $20-25 billion.

There is a distinction to be made between short-term rates and long-term rates. While the Federal Reserve actively controls short-term rates via the Federal Funds rate, it can only indirectly control long-term interest rates via its purchases of bonds. We do not believe the Federal Reserve has any intention of increasing short-term rates for at least another 12-18 months, and possibly even beyond that. By tapering and eventually ending the purchase of longer-term bonds, the Federal Reserve will cause longer-term rates to rise, leading to a more normally shaped yield curve. This should encourage more lending by banks which would be another positive for the US Economy.

We are particularly concerned about the risk in long-term bonds. The past five years of QE has artificially depressed interest rates, resulting in the current lack of intrinsic value in longer-term bonds. As an example, the current 10-year US Treasury note with a yield of approximately 2.75% provides a return of 1.65% at the top federal tax rate. This is below the Fed's target rate of inflation of 2% resulting in an *annual loss of 0.35% in purchasing power* to bondholders.

At Tandem, we have kept fixed income maturities short for the past several years to protect against principal loss when rates eventually rise. We consciously accepted a lower current yield to protect principal as much as reasonably possible. With the ending of QE on the horizon we will be taking additional steps over the next few months to protect portfolios against rising interest rates by shortening maturities even further where prudent. In doing so, we carefully weigh current yield versus the inherent principal risk in the securities we hold in client portfolios.

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