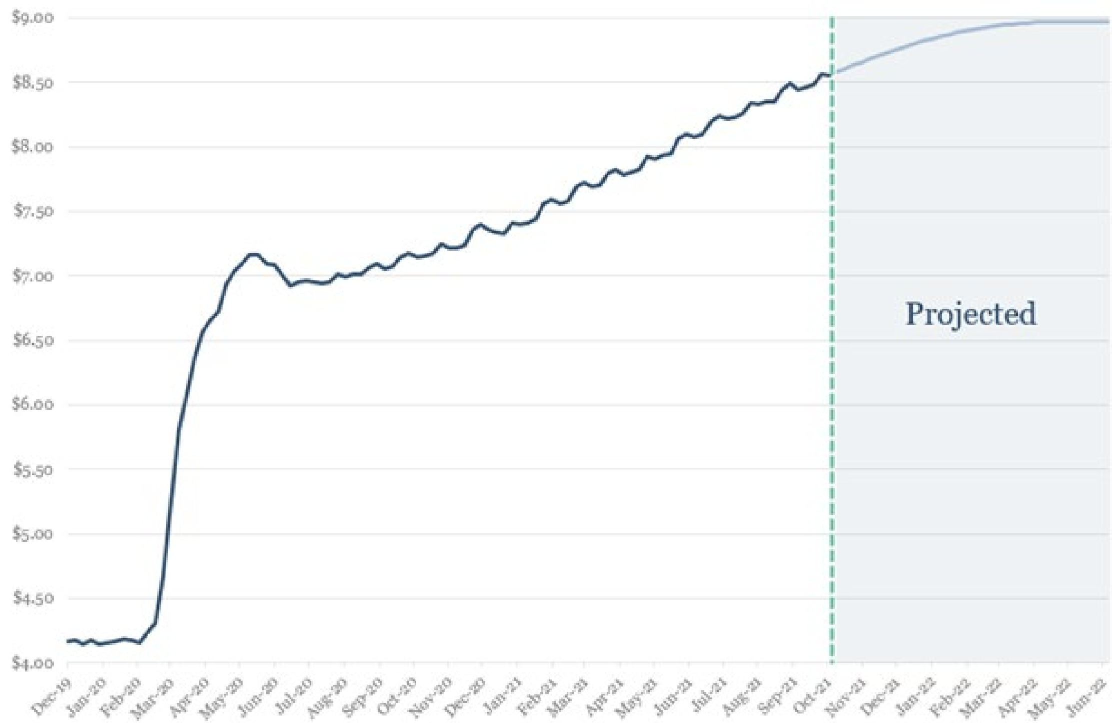
MARKET COMMENTARY

FIG. 1 Federal Reserve Assets ($ Trillions)



Sources: St. Louis Fed, Mill Creek.

The onset of COVID triggered the implementation of several monetary policy tools aimed at keeping the economy afloat.[1] In the US, the Federal Reserve relies on several main tools to achieve its dual mandates from Congress of maximum employment and stable prices. Prior to the Great Recession, the primary mechanism used by the Fed to impact economic conditions was adjusting the federal funds rate, which directly affects the cost of borrowing across markets more broadly. Decreasing the federal funds rate stimulates the economy because it lowers the cost of borrowing and encourages companies and individuals to spend more quickly. Increasing the rate slows lending and incentivizes saving due to the higher cost of borrowing.

The sheer magnitude of the economic collapse associated with the Great Recession, however, led the Fed to experiment with ‘unconventional’ monetary policies to provide additional support to the market’s recovery. One such program is known as quantitative easing (QE). It allows the Federal Reserve to make large scale asset purchases of longer-term securities from the secondary market, primarily US Treasuries and agency mortgage-backed securities. QE effectively adds a large, price insensitive buyer to the equation, placing upward pressure on bond prices, lowering interest rates, and creating more accommodative financial conditions.

The Fed launched its first quantitative easing (QE1) program in November 2008, purchasing approximately $300 billion of bonds every quarter through March 2010. QE1 was followed by QE2 (2013) and QE3 (2014), growing the Fed's balance sheet to $4.5 trillion by the end of 2014. However, as economic conditions improved, these extraordinary measures were scaled back and a return to more normalized policy prevailed. Tapering – or the gradual reduction of asset purchases – is part of the normalization process and a sign of growing economic strength. The Fed began tapering six years after the start of the Great Recession when it decreased its monthly purchases of Treasuries and MBS by $10 billion. Today, the shortest recession on record and solid economic indicators have compelled the Fed to reduce its asset purchases less than two years after the onset of the COVID recession. It is expected that monthly buying will be decreased by $15 billion in November and conclude mid next year. The move has been widely broadcasted to the public, so we don't anticipate large disruption in the bond or equity markets as the transition occurs. However, it does mark the beginning of the end of ultra-accommodative monetary policies and the likelihood for more normalized growth and returns as we head into 2022.

[1] Monetary policy and fiscal policy are the two main levers used to influence a country's economic wellbeing. Monetary policy is controlled by a country's central bank and directly impacts interest rates and the money supply. Fiscal policy decisions, on the other hand, are made by the government and set spending and tax rates. Programs such as the Paycheck Protection Program and CARES Act, for example, were fiscal stimulus measures used to provide COVID-19 relief.

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