The Impact of QT on Financial Markets

May 2022

We have written extensively on our expectations for future rate hikes and the peak in US rates. In this paper, the first in a series of three on Quantitative Tightening (QT), we summarize our thinking on QT and its implications for markets.

Executive Summary

- Quantitative Tightening (QT) most likely leads to higher government bond yields and a flatter yield curve. But QT is not QE in reverse, and its impact on interest rates is more muted.
- QT means lower prices on risky assets, all else equal. We see further challenges to equities and credit (higher corporate bond yields and spreads). We expect commodity prices to remain volatile, as they remain caught between slowing global growth and struggling supply.
- We see income equities (i.e. equities of companies that return cash to shareholders either through dividends or share buybacks) outperforming non-income paying stocks as income provides a hedge for upside inflation surprises and implies a lower sensitivity to higher rates. On a relative basis, we also favor value-tilted and high-quality stocks.

Introduction

At the May 2022 meeting, the Federal Reserve raised interest rates by 50 basis points (the largest hike in 22 years) and announced that, beginning June 1st, they will start to reduce the size of their balance sheet (currently sitting at around $9tr). The balance sheet runoff will start at $17.5 billion for MBS holdings and $30B for Treasury holdings, respectively rising to $35B and to $60B after three months. At this pace, the Fed’s balance sheet will shrink by about $500 billion in 2022, and more than $1tr over the following years. Many expect the Fed’s balance sheet to fall to a terminal size of $6-6.5 trillion, implying an overall reduction from ~37% of GDP to ~25% in the next 2/3 years. Balance sheet will play “an important role” in firming the stance of monetary policy, but the precise impact remains uncertain. Powell suggested that its effect could be around one 25 bp rate hike.

US QE/QT and Federal reserve total assets

Source: BNY Mellon Investment Management, Macrobond. Data as of 16/05/2022.
For illustrative purposes only. Forecasts regarding future events, targets or expectations, are only current as of the date indicated. There is no assurance that such events or expectations will be achieved, and actual results may be significantly different from that shown here.
**Takeaway #1: QT Most Likely Leads to Higher Government Bond Yields and a Flatter Yield Curve**

We think that QT coupled with higher policy rates leads to higher long-term interest rates and a flatter yield curve as the market prices in expectations of a tighter policy stance (higher expected rates), but also leads to rising expectations for a slowdown in economic activity - offsetting some of the rise in the average policy rate embedded in longer term bonds in the form of expectations. The rising probability of an economic slowdown eventually also puts downward pressure on term premia (the risk premia embedded in government bonds), because it becomes more desirable to hold a safe fixed income security when the economy does poorly, and policy is eventually expected to loosen in response to a weaker outlook. Such a combination of factors tends to lead to a rise in yields initially but also a flattening of the yield curve.

Determining the impact of QT on bond yields, and the shape of the yield curve in particular, is not straightforward as it depends on which of the channels through which QT operates is prevalent. In our opinion this is the reason why there is so much disagreement in the investment community on the impact of QT on interest rates.

*We acknowledge there are some alternative scenarios where QT may lead to a steeper yield curve, but we see them as less likely and more temporary in nature. We will review these alternative scenarios in a separate note.*

**Historically QE has been followed by a steepening in the yield curve, and QT by a flattening in the yield curve**

![Graph showing historical yield curve changes](source: BNY Mellon Investment Management, MacroBond. Data as of 16/05/2022. For illustrative purposes only.)

**Takeaway #2: QT means Lower Prices on Risky Assets, All Else Equal**

The relationship between QE and risk assets like equities and credit spreads has been relatively clear: risky assets have tended to rally during periods of positive and accelerating growth in central bank balance sheets, and struggle during periods of negative or slowing growth in central bank balance sheets.
Such effect occurs whatever the QT mechanism (discussed in the third paper of this series) one believes in. **QT leads to a rise in risk premia on risky assets** - either i) because the risk of a slowdown in the economy increases as policy tightens or ii) because the rise in the supply of safe government bonds, paired with the fall in the quantity of assets held by the private sector (what is often referred to as the “money” printed by central banks), leads to investors allocating less to risky assets.

**QT also leads to higher rates and therefore a rise in the discount factor applied to expected cash flows generated by firms.** This effect takes place either i) because of tighter policy expectations or ii) because of the increase in compensation required by investors to hold more government bonds (term premia).

**In theory, despite the rise in risk premia and rates, risky asset prices could still rise if expectations for firm earnings were to improve. In practice though, positive earnings surprises in the US have been slowing, and estimates for the next few years have flatlined once the energy sector is excluded.** The level of equity earnings is also far above trend, making it hard to sustain elevated growth.
Takeaway #3: This Is a Challenging Environment for Investors, with Rates Rising, Equities Struggling and Credit Underperforming. In Equities, on a Relative Basis, We Favor Value-Tilted, High Quality, Dividend-Paying Stocks.

In the US, we expect policy tightening to continue as growth disappoints and inflation surprises to the upside. We see further rises in interest rates, and a flattening bias in the yield curve to continue. We expect interest rates and the yield curve to remain volatile over the coming quarters.

We see further challenges to equities and credit (higher corporate bond yields and spreads). We expect commodity prices to remain volatile, as they remain caught between slowing global growth and struggling supply.

Given our expectations for higher interest rates, on a relative basis, we continue to favor value-tilted sectors relative to growth-tilted ones. We expect that as slower economic/earnings growth is priced in, high quality companies - i.e. those that generate strong cash flows, with sound balance sheets – should outperform low quality companies. Also, given the likelihood of further supply disruptions emanating from China, we favor companies less susceptible to higher input costs and better able to protect margins through pricing power.

We see income equities (i.e. companies that return cash to shareholders either through dividends or share buybacks) to outperform non-income paying stocks as income provides a hedge for upside inflation surprises and implies a lower sensitivity to higher rates.

Finally, we expect mortgage-backed securities (MBS) to come under further direct pressure from QT, given the risk the Fed will have to start selling MBS outright.\(^1\) This is because the higher rates backdrop

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\(^1\) Although the Federal Open Market Committee (FOMC) agreed that QT should be done predictably by adjusting the amounts reinvested of principal payments, some FOMC members thought it may be appropriate to consider direct sales of agency MBS “to
may result in lower mortgage prepayments (as re-financing occurs when rates fall), which in turn means the MBS run-offs may struggle to hit the $35bn cap set out by the Fed. In order to maintain the overall composition of the balance sheet skewed towards Treasuries, some MBS selling may be warranted as early as Q4.

enable suitable progress toward a long-run System Open Market Account (SOMA) portfolio (Fed balance sheet) composed primarily of Treasury securities."
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