Has the Fed Turned Hawkish by Allowing Bond Yields to Surge?

It seems happy to let financial market conditions tighten.

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Nikolaj Schmidt
Chief International Economist

Surging yields on U.S. government debt are tightening financial market conditions, but the response to this from Federal Reserve Chairman Jerome Powell and his colleagues on the Federal Open Market Committee (FOMC) has been calm to the point of insouciance. Just last week, Powell triggered a sudden sell-off in long-term U.S. Treasury debt and equities when, in comments to a *Wall Street Journal* jobs summit, he expressed no concern about the sell-off in bonds and provided no indication of policy changes ahead.

What has happened? Has Powell turned hawkish?

I don't think so, but neither do I expect the FOMC to step in to calm the bond market with words or actions anytime soon. There are four reasons why I think this.

First, vaccine rollout and the significant fiscal support have led to a substantial improvement in the growth outlook. Given the past nine months' surge in demand for durable goods, the FOMC likely regards a marginal tightening of financial conditions as appropriate.

Second, to finance its substantial fiscal stimulus program, the U.S. Treasury has started to draw down its exceedingly large cash balance held at the Fed. Over the coming months, this will have much the same impact as around USD 1 trillion worth of quantitative easing. Combined with the stronger outlook for growth, we think that this leaves a high bar for the FOMC to become concerned about the tightening of financial conditions.

Third, the 2013 taper tantrum left a deep scar on the members of the FOMC, and the committee remains extremely sensitive about triggering another tantrum when it—eventually—decides to adjust its policy. If the FOMC steps in to keep bond yields from reflecting the improvement in the growth outlook, it could create a valuation bubble in the bond market—sharply increasing the risk of a Fed-induced taper tantrum later. Surely it seems better to let the bond market adjust early.

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Fourth, until now, the Fed has managed the coronavirus crisis in much the same way as it did the global financial crisis. However, there are fundamental differences between the two situations. The global financial crisis was a banking crisis that kicked off a decadelong deleveraging process for U.S. households and required monetary policy support to be maintained for an extraordinarily long period. The shock from the coronavirus pandemic has been deep, but it is likely to be much shorter-lived because the U.S. economy went into it without major imbalances in need of a recessionary purge. As we roll out vaccines, the Fed is beginning to adjust to this reality.

One final thought: Given that growth is accelerating and the U.S. Treasury is about to inject an enormous amount of money into the economy via its stimulus plan, maybe this is actually quite a good time for the Fed to let bond yields adjust higher. Financial conditions and risk markets should remain well supported by these factors, making a disorderly sell-off less likely. Of course, should the adjustment turn disorderly, Powell and company stand ready with soothing words and—most likely—policy action, should it be required.

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