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Taper Tantrum on Steroids

Yesterday (Jan 24th, 2022) the stock market (Dow) suffered an inter-day loss of over 1,100 points only to end the day up nearly 100 points. This kind of market volatility is highly unusual and very scary. I believe we are now experiencing our second "Taper Tantrum". The first Taper Tantrum started in May'13, when Fed Chairman Ben Bernanke told Congress he was considering a reduction in the amount of bonds the Fed was currently buying and putting on its balance sheet. His testimony coincided with a 5% drop in the market and higher bond yields. The 10-year-Treasury yield was 2% when Bernanke testified and spiked to 3% in Jan'14 when the tapering actually started. Tapering ended in Oct'14 and by Jan'15 the 10-year-Treasury yield was down to 1.72%.

It wasn't until 2016 that the Fed Funds rate started to increase. Between 2016 and 2018 the rate rose from .25% to 2.50%. During this time, the 10-year-Treasury rate rose from 2% to 3.24%, where it peaked. The Fed Balance Sheet reduction started in 2017 and ended in 2019 ($4.45 trillion to $3.76 trillion). In the 3rd quarter of 2019, the Fed stopped reducing its balance sheet and the 10-Year-Treasury hit 1.50%.

What Happened?

The first Taper Tantrum from announcement to completion was spread over 5 years, and despite some short tern volatility, it was basically a non-event. The Fed's balance sheet dropped 15.50%, the fed funds rate increased from .25% to 2.50% (a 900% increase) and the 10-Year-Treasury rate dropped from 2% to 1.5% (a 25% reduction). From May'13 to Sept'19, the Dow rose over 60%.

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What's different this time? Inflation is soaring and the Fed is panicking. We don't know for sure but the forward guidance suggests tapering will end in 2 months and interest rate increases will start when tapering ends (March'22). The reduction of the balance sheet could start as soon as July and be much more aggressive than last time.

The entire progress made during the 2014-to-2019 tightening cycle was reversed in less than one year. By the 2nd quarter of 2020 the Fed balance sheet more than doubled to $7.1 trillion and the 10-Year-Treasury yield dropped below 1%.

If the measured and slow 5-year process went too far and had to be quickly reversed, what could happen if this time we do it "on steroids"? Looking forward to Powell's speech on Wednesday.

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