CAN WE EXPECT ANOTHER SURPRISE FROM THE FED?

Wisdomtree EU
08 Jul 2020

The Federal Reserve (the Fed), has taken unprecedented measures during the current Covid-19 crisis, but many market participants are currently asking, 'could it go one step further and engage in yield curve management?'.

The released minutes from the most recent[1] Federal Open Market Committee[2] (FOMC) meeting has indicated that FOMC members are generally supportive of data-based forward guidance methods but continue to question the feasibility of yield curve control (YCC).

While there are benefits to YCC, one cannot ignore the significant cost implications. It is likely that the Fed, along with other central banks are studying the implications very carefully before deciding whether to use such a tool.

The Bank of Japan (BoJ) forged the path to YCC as a policy tool back in 2016 and participated in this methodology to circumvent significant rate declines. After moving policy rates into negative territory in January 2016, the Japanese government bond (JGBs) yield curve exhibited a downward shift across the full curve with 10-year JGBs offering -0.12% and 30-year JGBs offering 0.32% on June 2016. This eventually led to the BoJ introducing YCC as a policy tool incorporating a 0% target yield for 10-year government bonds and -0.1% in the short end of the yield curve.

As a policy tool, YCC helped lower the yields at which corporates could borrow given that JGB yields were esstentially anchored at lower levels. While the BoJ has somewhat managed to apply YCC to meet its target, the size of the Japanese government bond market is significantly smaller than the size of the U.S. Treasury market making YCC a more challenging tool for the Fed to undertake over an extended period of time.

Anchoring government bond yields to lower yield levels could lead investors to seek higher yield elsewhere. There is a risk and reward trade off in fixed income whereby higher yields compensate investors for the greater risks associated with a given investment. Therefore, one of the unintended consequences of YCC, or other policy tools aimed at keeping government bond yields lower, could be that investors may allocate a larger portion of their portfolios to riskier assets in order to meet certain return targets.

Higher demand for credit risk has in the past resulted in credit spreads moving lower and corporations being able to borrow in the primary markets at lower rates. In 2019, investors demonstrated strong demand for corporate bond exposures driving the credit spreads for investment grade bonds and high yield bonds lower which lead to both asset classes providing double digit total returns[3].

One of the key consequences that the Fed will likely consider as it navigates discussions around YCC, is that a cap on yields will impact the valuable information that investors obtain from a free trading bond market. There has already been strong criticism from investors on the impact that quantitative easing has had on government bond yields and the shape of the yield curve. While other policy tools currently in use do influence government bond yields, the bond market is still able to function in a manner that allows the Fed and investors to obtain useful information about financial conditions. Therefore, any new policy tool introduced by the Fed will likely at least consider ways to maintain that independence.

Given the already utilised forward guidance tool, the need to use front-end YCC is very much a topic of debate. While the debate amongst FOMC members is still on the cards, the tone seems to be leaning towards the possibility that YCC may not be the most desirable policy tool in the near term.

Data obtained from Bloomberg unless otherwise stated.

[1] Meeting took place on 10 June 2020.

[2] Source: Federal Reserve Gov website: https://www.federalreserve.gov/newsevents/pressreleases/monetary20200701a.htm

[3] Using the iBoxx USD liquid investment grade index and the iBoxx USD liquid US high yield index as a reference for the asset class.

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