On May 22, 2013, then Federal Reserve (Fed) Chairman Ben Bernanke surprised investors during testimony to Congress by announcing the Fed was considering tapering its monthly asset purchases and normalizing interest rates in the coming months. Within a month of Chairman Bernanke’s announcement, the S&P 500® declined 4.4% and the 10-year U.S. Treasury jumped more than 50 basis points (bps). Clearly markets were caught off guard by the Chairman’s comments; that moment has been known as the “taper tantrum” ever since.

As a result of the tantrum, investors have come to view “taper talk” with a negative connotation. A common narrative is that unconventional monetary policy accommodation, also known as quantitative easing (QE), drives asset prices higher and interest rates lower, so investors tend to be cautious about scaling back monetary stimulus. As such, the phrase “tapering is tightening” also emerged from this period, reflecting concerns that the removal of QE would lead to tightening financial conditions.

But what happened during the actual 2013-2014 tapering period? Markets did not careen into a massive selloff, and the economy did not double-dip into a recession, so why is there still a sense of foreboding? While investing is driven by a mosaic of events, we believe the historical narrative typically gets condensed into one or two bite-sized messages, and the taper tantrum is no exception. The facts left out of this narrative are that equity markets soon recovered from the knee-jerk reaction and bond markets were mixed.

Today, we face a similar scenario, as the Fed has hinted at plans to taper its latest QE program “soon,” which was swiftly enacted during the COVID-19-induced market selloff. Given the taper tantrum soundbite is still somewhat fresh in many investors’ minds, our aim with this publication is to dispel the notion that tapering is equivalent to a market pullback. We believe markets are far too dynamic to be wholly influenced by any one participant, even the Fed! We tackle the topic several ways, looking at a comparison of financial conditions, as well as fixed income and equity markets. If there is one message we want to make clear, it is this: Don’t fear the taper.

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Investors should remember tapering is a sign of forward progress for markets. Thus, as the Fed begins to ring the proverbial cowbell and wind down its emergency QE measures, we remain confident investors should not fear the taper.

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U.S. investors have been living in a “QE world” since late 2008; however, it would be remiss to have a discussion on tapering QE without a high-level review of the Fed’s monetary policy toolkit. We believe it is important to understand at least the basics to see that from our perspective, investors shouldn’t fear the taper.

Historically, the Fed has used conventional monetary policy tools to promote sustainable economic growth through its dual mandate of price stability and maximum employment. However, since the Global Financial Crisis, the Fed has turned to unconventional monetary policy tools to support and stimulate the economy.

Unconventional monetary policy accommodation, also known as QE, is the act by a central bank to purchase longer-term investments, typically government bonds and other securities, to increase financial liquidity, bank lending and private investment (Figure 1). These purchases increase the money supply with the aim of reducing interest rates and stimulating growth.

QE is not a phenomenon specific to the United States and the Fed. Central banks around the globe have supported markets with unconventional monetary tools going back to the early 1990s. In fact, one of the most underappreciated aspects of the post-financial crisis era, in our view, is that nearly every major central bank, including the Bank of England (BOE), Bank of Japan (BOJ), European Central Bank (ECB) and Swiss National Bank, has deployed QE programs of their own to varying degrees. For example, the BOJ has been relying on monetary stimulus to such an extent that its balance sheet is now approximately 130% of Japan’s GDP through the end of August 2021. In contrast, the Fed’s balance sheet is approximately 38% of U.S. GDP; however, it was less than 10% prior to 2008. Let’s recap where four major global central banks stand today.
Federal Reserve

The Fed has embarked on QE programs over two distinct periods. The first round occurred at the start of the Global Financial Crisis in late 2008 through October 2014 when the U.S. economy finally began to show signs of economic stability. During that time, the Fed’s balance sheet increased from less than $1 trillion in 2008 to $4.5 trillion by the end of 2014. It was not until 2017 that the Fed began to shrink its balance sheet. The program ended in September 2019. In our view, the Fed’s balance sheet reduction became a significant driver of tightening financial conditions, not simply tapering QE. It was during the balance sheet reduction of tightening policy that equity markets experienced a 20% correction in December 2018, the first drop of that magnitude in more than 10 years – four years after tapering ended!

Fast forward to the onset of the pandemic: In March 2020, the Fed issued an emergency 150 bp interest rate cut, which effectively lowered the Fed’s policy rate to 0%, and announced a $700 billion QE program aimed at swiftly and aggressively stabilizing the U.S. economy. Since then, the Fed has been buying a massive $120 billion of securities (approximately $80 billion of U.S. Treasuries and $40 billion of mortgage-backed securities or MBS) monthly. Prior to the pandemic, the Fed grew its balance sheet approximately 15% annualized over 10 years to $4.2 trillion. Following the onset of the pandemic, the Fed’s balance sheet doubled in just 17 months (Figure 2).

Figure 2. Fed Balance Sheet Composition Since 2008

As of 8/31/21. Source: Bloomberg, L.P.
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Bank of England

The BOE has engaged in expansionary monetary policy for more than a decade. Currently, interest rates are being held at 0.1% (in place since March 2020) with asset purchases set at an annual rate of 10% of GDP; the bank’s balance sheet stands at $1.24 trillion. The BOE’s Monetary Policy Committee recently offered a detailed plan for tightening monetary policy, suggesting asset purchases would be tapered once significant progress had been made toward sustainable economic growth and maintaining inflation at its 2% target level. This is currently forecast for year-end 2021. However, the combined effect of Brexit and the pandemic have complicated the withdrawal of stimulus as together they have reduced the U.K.’s potential labor force. New immigration restrictions may slow labor growth further. As slower-growing economies tend to have lower inflation and real interest rates, we believe rates in the United Kingdom are likely to remain lower on a relative basis.

European Central Bank

After upping its monthly asset purchases to $90 billion from $73 billion as a surge in COVID variants pushed the region into a double-dip recession in first quarter 2021, the ECB recently made dovish adjustments to its monetary policy framework during its 2021 strategic review in July. These adjustments raised its inflation target to 2% and adjusted the preferred inflation measure to include owner-occupied housing costs. The ECB’s balance sheet currently stands at $2.18 trillion. Fiscal support is expected to be withdrawn once European economies have recovered from the pandemic, which is currently forecasted to be in early 2022.

Bank of Japan

Since 2001, the BOJ has employed QE to stimulate economic growth, spur inflation and support asset values. Unfortunately, the bank’s expansive monetary stimulus has not resulted in the desired outcome. We think the BOJ’s policy actions to effect control over the yield curve have resulted in interest rate volatility and excessive levels of government debt without any significant positive impact to the Japanese economy. In first quarter 2021, the BOJ modified its asset purchase program targets, which include the purchase of stock and bond exchange-traded funds (ETFs), with the aim to recapitalize businesses and bolster asset prices. The rate of purchases will now be flexible to accommodate more asset purchases in times of market instability and less in times of market strength given the unsustainability of prior purchase levels.
Investors have equated tapering monetary stimulus with tightening financial conditions. However, it is imperative to understand these are two distinct actions. Tapering is simply the deceleration of monetary stimulus, but not an end to it. On the flip side, tightening financial conditions include increasing a central bank’s policy rate (e.g., the federal funds rate) and reducing the central bank’s balance sheet. Even as the Fed begins tapering its asset purchases, its balance sheet will increase at a decelerating rate until the tapering process is complete. Importantly, the Fed will continue to maintain its balance sheet at that size; therefore it will provide a significant level of market liquidity. In other words, tapering is not tightening financial conditions.

What are “financial conditions,” exactly? It is a term often used but rarely defined, that describes a compilation of variables that characterize the relationship between the economy and financial markets. Indices that capture these conditions comprise data from four main categories: Treasury yields, corporate credit spreads, U.S. dollar trends and asset valuations. Financial conditions are considered to “loosen” when these measures move together in a way that reinforces stronger economic and financial market activity and “tighten” when that momentum slows or even reverses (Figure 3). It is perhaps no surprise that financial conditions are currently near their most favorable level on record. Thanks to widespread global policy accommodation, this effect has been felt worldwide. But now as the Fed looks to slow its monetary policy support to avoid an overheating economy, the question becomes what lies ahead.

How might tapering impact U.S. financial conditions?

Dialing back monetary policy accommodation is likely appropriate once the Fed has stabilized the economy to a point where monetary stimulus is no longer necessary to sustain economic growth. In practice, however, this can be quite a balancing act. As Fed Chairman Jerome Powell stated at the Jackson Hole Economic Symposium in August, an “ill-timed policy move unnecessarily slows hiring and other economic activity,” and that “such a mistake could be particularly harmful.” Combined with financial markets’ heightened sensitivity to changes in liquidity over the past decade, the pressure to thread the needle with clear communication and expert timing is even greater. We believe the Fed understands this conundrum well. Given the Fed’s intention to deliver explicit guidance about its decisions and the factors that go into them, we believe the Fed is trying hard to learn from its mistakes.
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Looking ahead, we believe the mechanics of tapering, the context of history and the abundantly careful guidance from the Fed serve as useful guideposts. Despite the market’s tantrum in 2013, the intent is to help the economy in the long run by avoiding excesses in the short run. In our view, the Fed was correct to taper QE when it did; the U.S. economy was firmly on the road to recovery as it was shifting into an accelerating expansion phase of the cycle in mid-2013 (Figure 4).

What about financial conditions in the rest of the world?

As the Fed goes, oftentimes so goes other major central banks. We believe this time will be no different. Gauging just how much a breakup with QE in the United States may affect the financial conditions in other countries is in large part a conversation about the global business cycle and the current economic environment that continues to be impacted by the pandemic. Despite its own challenges, the U.S. economy has been recovering from the COVID-19 pandemic relatively quickly compared to Europe and Japan.

Global investors may be weary of the upcoming round of Fed tapering because the global economy began to weaken around the same time the last Fed tapering program was ending. However, we believe this was purely coincidence. During the tapering period of 2013–2014, China, the second largest economy in the world, was beginning to show a significant deceleration in growth (Figure 5). Reverberations from China’s slowdown were felt across developed markets, including the United States, and financial conditions began to tighten (Figure 6). Given China’s outsized role in driving tightening financial conditions during this period, we do not expect developed market central banks to increase monetary support due to Fed tapering alone.

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Given the Fed’s sizable $120 billion in bond purchases, it is a significant participant in U.S. bond markets. We believe QE directly impacts fixed income markets for a number of reasons, including: (1) the Fed has been expanding its balance sheet through the purchase of U.S. Treasuries and MBS since March 2020, and (2) proceeds from prior QE programs continue to be reinvested. As investors anticipate a new round of tapering, we believe it is helpful to examine what happened during the last tapering period.

During the 2013 taper tantrum, bond investors had a knee-jerk reaction to Chairman Bernanke’s surprise announcement, which led to spiking yields and declining bond prices. However, during the following 11-month period, bond markets largely returned to pre-tantrum levels (Figure 7). And yet investors typically only remember the immediate aftermath of the taper tantrum and forget fixed income markets delivered positive returns during the tapering process.

Global fixed income results were similar (Figure 8). However, conditions have changed since 2013, most significantly with the use of negative interest rate policies across much of the developed markets.

The fate of U.S. Treasuries during this period tells a somewhat different story. They too followed a similar spike during the taper tantrum, but Treasury rates generally did not move lower thereafter; thus, long-duration Treasuries did not perform well over the subsequent 11-month period (Figure 9).

![Figure 7. U.S. Bond Indices](image1)

**U.S. bond markets should not fear the taper.**

<table>
<thead>
<tr>
<th></th>
<th>TAPER TANTRUM (5/22/13 - 6/22/13)</th>
<th></th>
<th>POST-TANTRUM (6/22/13 - 10/31/14)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Change in Yield (bps)</td>
<td>Return</td>
<td>Change in Yield (bps)</td>
</tr>
<tr>
<td>Bloomberg Aggregate</td>
<td>43</td>
<td>-2.5%</td>
<td>-2</td>
</tr>
<tr>
<td>Bloomberg MBS</td>
<td>51</td>
<td>-2.0%</td>
<td>-5</td>
</tr>
<tr>
<td>Bloomberg Corporate Bond</td>
<td>58</td>
<td>-4.0%</td>
<td>-3</td>
</tr>
<tr>
<td>Bloomberg High Yield</td>
<td>142</td>
<td>-3.7%</td>
<td>-8</td>
</tr>
<tr>
<td>Markit Credit Default Swap</td>
<td>110</td>
<td>N/A</td>
<td>-7</td>
</tr>
<tr>
<td>North American High Yield</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

![Figure 8. Global Bond Indices](image2)

**Global fixed income also performed well.**

<table>
<thead>
<tr>
<th></th>
<th>TAPER TANTRUM (5/22/13 - 6/22/13)</th>
<th></th>
<th>POST-TANTRUM (6/22/13 - 10/31/14)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Change in Yield (bps)</td>
<td>Return</td>
<td>Change in Yield (bps)</td>
</tr>
<tr>
<td>Bloomberg Global Aggregate ex-U.S.</td>
<td>29</td>
<td>0.8%</td>
<td>-6</td>
</tr>
<tr>
<td>Bloomberg EM Aggregate</td>
<td>119</td>
<td>-6.6%</td>
<td>-5</td>
</tr>
</tbody>
</table>

Source: Bloomberg, L.P.

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We believe the experience of the taper tantrum highlights the Fed’s possibly most overlooked but powerful tool: forward guidance. In a similar but opposite way, we saw a dramatic demonstration of the power of Fed guidance in March 2020 when the Fed announced its intention to buy individual corporate bonds and ETFs. This signaling was enough to quickly calm highly stressed fixed income markets.

While the initial reaction to the tapering announcement was clearly negative across nearly every fixed income asset class, once the initial shock wore off, fixed income markets were surprisingly positive during the tapering process. So how were fixed income markets able to absorb the Fed’s tapering? In short, we believe there was plenty of market liquidity to compensate for the Fed’s withdrawal. Consider the size of the bond market relative to the Fed’s purchases. According to Bloomberg data, the U.S. bond market grew an average $208 billion per month for the first eight months of 2021 compared to the $120 billion per month of purchases by the Fed. Additionally, the Fed’s participation could be crowding out other market participants, thereby forcing those buyers further out the efficient frontier (Figure 10).

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**Figure 9. U.S. Treasury Market**

*Treasuries took much longer to recover from the taper tantrum.*

<table>
<thead>
<tr>
<th></th>
<th>TAPER TANTRUM (5/22/13 - 6/22/13)</th>
<th>POST-TANTRUM (6/22/13 - 10/31/14)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Change in Yield (bps)</td>
<td>Return</td>
</tr>
<tr>
<td>Bloomberg U.S. Treasury Index</td>
<td>29</td>
<td>-1.8%</td>
</tr>
<tr>
<td>10Y</td>
<td>49</td>
<td>N/A</td>
</tr>
<tr>
<td>Bloomberg U.S. Treasury Inflation-Linked Bond Index</td>
<td>53</td>
<td>-5.9%</td>
</tr>
<tr>
<td>2s10s</td>
<td>37</td>
<td>N/A</td>
</tr>
</tbody>
</table>

Source: Bloomberg, L.P.

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**Figure 10. Asset Class Comparison: Return vs. Risk**

*Low global yields are pushing investors further out the curve.*

As of 8/31/21. Source: Morningstar, PNC

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From a credit cycle perspective, we appear to be in an analogous position as markets were in 2013. Similar to how current credit markets are recovering from last year’s pandemic-induced recession, in 2013, markets were finally experiencing a recovery in credit upgrades following the Global Financial Crisis. However, there are two important differences:

1. Today’s valuations are much more stretched relative to 2013. For example, the option-adjusted spread for investment grade corporate bonds was 130 bps in May 2013; today it is less than 90 bps.
2. The composition of interest rates is different, namely due to a significant decline in the term premium for long-dated bonds.

The term premium is a theoretical estimate of the opportunity cost for owning long-dated bonds over shorter-term ones. In May 2013, the term premium was approximately 100 bps, whereas it is negative today. Essentially the market is implying there is no difference between owning long- or short-dated Treasuries, a phenomenon most investors had never experienced until the term premium dipped negative in 2018. This contrasts sharply with the 40-year average term premium of 174 bps (Figure 11). In our view, the negative term premium should contain any adverse reaction in fixed income markets as the tapering process is underway.

An important final takeaway from fixed income markets is that we believe the main reason markets reacted as violently as they did to the last tapering was due to concern that not only would the Fed taper QE, but it would also seek to normalize interest rates. Considering the Fed’s policy rate is directly linked to many other short-term funding rates that cascade across fixed income markets, we believe the future path of interest rate policy is of far greater importance. That being said, the current Fed regime appears to have learned the lessons of the financial crisis, the taper-tantrum era and the tightening of financial conditions in late 2018. Therefore, we believe the Fed has been very deliberate and transparent in its approach to rolling back QE, which is why investors should not fear the taper when the time eventually arrives.

Figure 11. Adrian Crump & Moench 10Y Treasury Term Premium

A Negative Term “Premium”?!
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TAPERING IMPACT ON U.S. EQUITIES

Some investors equate the taper tantrum and the idea of tapering QE as a negative event for equities. However, we believe it is the focus on raising interest rates — and thus tightening financial conditions — that is the concern. However, tapering is the deceleration or lifting of monetary stimulus; it is not an overt act to tighten financial conditions or increase interest rates, nor is it aimed at reducing the Fed’s balance sheet. As such, we believe interest rates will remain well below historical levels, which should benefit equities. As the U.S. economy continues to recover and strengthen from the 2020 recession, we believe the overall long-term outlook for U.S. equities should be positive.

Given the current expensive absolute valuations of U.S. equities, investors may wonder if these valuations can be sustained once monetary stimulus is reduced and eventually withdrawn. U.S. equities have benefited from low interest rates and lower long-dated bond yields. The Fed’s QE policy has reduced interest rates and loosened credit, allowing companies to issue and refinance their debt at historically low rates, thus improving cash flows and profit margins. Companies have also seen their valuation boosted as investors placed a higher value on future profits given the low interest rate environment. But as the Fed signals the slowing of its unconventional monetary policy accommodation, we would expect equity valuations to come under pressure in the near term as investors adjust the discount rate used for valuation.

Large Cap

In the month following the start of the taper tantrum, the S&P 500 declined 4.4%. The S&P 500 Value index fared modestly better, declining 4.0% versus the S&P 500 Growth index which fell 4.8% as expectations for higher interest rates pressured growth company valuations. However, by the time Chairman Bernanke confirmed the Fed would indeed begin tapering on Dec. 18, 2013, the S&P 500 had recovered all of its losses and advanced 9.8%, with the Growth index gaining 11.3%, outpacing the Value index gain of 8.2%. By the time the Fed ceased its asset purchases on Oct. 30, 2014, the S&P 500 index had gained 23.1%, while the Growth index advanced 26.4%, again outpacing the Value index gain of 19.5%. Notably, the Nasdaq-100® Index gained 38.0% during the same period.

After it was revealed in April 2021 that the Fed was “talking about talking about” tapering, the S&P 500 rose 1.1% over the following month, while the Value index declined 2.9%, led lower by the Financials sector. Over the
same period, the Growth index advanced 4.9% and the Nasdaq-100 gained 6.4% as interest rates have largely been moderating since their recent peak on March 31, 2021. Notably, the 10-year U.S. Treasury note fell below its 50-day moving average in the days following the Fed’s tapering hint. We interpreted this as a signal the rise in interest rates was likely tied to initial expectations for additional fiscal stimulus and not the withdrawal of monetary stimulus.

The valuation and sector composition of the S&P 500 was vastly different in 2013 than where it stands today (Figure 12). In 2013, the S&P 500 traded at a 14.3 times (x) forward price-to-earnings (P/E) multiple, with the Information Technology, Financials, Health Care and Energy sectors comprising 60% of the index. Today, the S&P 500 trades at a forward P/E multiple of 21.2x with the Information Technology, Health Care, Consumer Discretionary and Financials sectors comprising 63.6% of the index. The shift in the economy towards less business-sensitive sectors and the prolonged low interest rate environment has driven up U.S. equity valuations.

We believe the impact of COVID-19 on companies sped up an economic transition that was already underway, which has positioned large-cap and growth-oriented asset classes as prime beneficiaries in a post-pandemic world given their scale and reach. Large caps are dominated by the largest technology and internet-based industries that have strong secular revenue growth drivers, solid profitability and consistent free cash flow. In our view, these companies have superior return on invested capital and return on equity metrics over multiple cycles with the strongest earnings growth prospects across the globe, even in a protracted economic slowdown scenario. As such, even with a withdrawal of monetary policy accommodation, we believe large-cap and growth companies will be positioned to sustain their growth trajectory, which in turn should support their valuations.

**Mid Cap, Small Cap & U.S. Real Estate Investment Trusts**

During the month following the first hints about tapering in 2013, the S&P MidCap 400® declined 6.0% due to its outsized exposure to the interest-rate sensitive Real Estate sector and to the economically sensitive Energy, Industrials and Consumer Discretionary sectors. The Russell 2000® Index lost 3.3%, faring modestly better than mid-caps, as its larger exposure to the Information Technology and Health Care sectors benefited returns. The interest rate-sensitive FTSE Nareit All Equity REITs Index slid 12.5%. However, by the end of the tapering, the S&P MidCap 400 and the Russell 2000 had reversed course and gained 17.8% and 17.9%, respectively, while the FTSE Nareit All Equity REITs Index managed to recover its losses and post a 5.6% gain over the period.

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Source: FactSet®. FactSet® is a registered trademark of FactSet Research Systems, Inc. and its affiliates.
Notably, the valuation of the S&P MidCap 400 has only modestly increased since the 2013 tapering, trading at a forward P/E of 16.6x versus 16.9x today. Interest rate-sensitive sectors including Financials, Industrials and Real Estate comprise 45% of the index. The valuation of the Russell 2000 has increased more significantly from a forward P/E of 21.4x versus 26.1x today driven by the Information Technology and Health Care sectors.

Emerging Markets

Emerging market (EM) equities also reacted negatively to the initial tapering news in 2013. In the few days after the announcement, EM equities suffered the largest relative declines, down 13.6%. Many emerging market countries were impacted by expectations for higher U.S. interest rates and a stronger U.S. dollar, which would pressure EM companies’ dollar-denominated debt and EM currencies. However, by the end of the Fed’s tapering in late 2014, the MSCI EM Index had recovered most of its losses, posting a modest loss of 0.1%. Currently, when compared to the month since Chairman Powell indicated tapering was up for consideration, the index has gained 2.4%. We believe a shift in country and sector exposures in the index accounts for the performance differentials between 2013’s tapering announcement and today.

For example, the combined weight of China, Taiwan and South Korea in the index has increased dramatically from 45.0% to 61.4%, with mainland China accounting for more than one-third. Notably, the Chinese economy has transitioned from a manufacturing and export-led nation to a consumer-led, services-driven economy which provides better insulation from shifts in global central bank policies.

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Consequently, the declining exposure to the commodity-exporting countries of Brazil, South Africa and Russia has lessened the impact of a strengthening U.S. dollar. Additionally, we do not expect Fed tapering to have a lasting effect on the U.S. dollar as expectations for tapering action and interest rate increases are more imminent at other central banks.

TAPERING TAKEAWAYS

U.S. monetary stimulus is not ending, it is tapering — this is an important distinction. Whether other central banks increase stimulus or end up following the Fed’s lead, either way we believe there is still significant monetary support in financial markets.

It is also important to recognize the context around why the Fed is tapering; U.S. economic growth appears to be on solid footing following the recession of 2020! While we expect the low interest rate environment to persist for some time, fixed income markets may be challenged to provide meaningful returns. Equity markets continue to display a strong fundamental outlook as global markets reopen from the pandemic and economic growth recovers. Thus, as the Fed begins to ring the proverbial cowbell and wind down its emergency QE measures, we remain confident investors should not fear the taper.