What is the Federal Reserve going to do? Where are interest rates going? How does the political landscape affect it all? Strategas Head of Fixed Income Research Tom Tzitzouris answers a few questions about some of the most timely issues facing markets.

**TAPERING TELEGRAPHED | POLITICAL RISK HIGH | LONG-TERM YIELDS CAPPED**

**ROSS MAYFIELD:** The Fed has telegraphed a winding down of their bond-buying program in the coming months. Do you expect volatility a la the 2013 taper tantrum?

**TOM TZITZOURIS:** It’s not our base case that we’ll see 2013-style volatility. And that’s partly because the reason we saw so much volatility then was that Fed Chair Bernanke announced the idea at perhaps the worst possible place and time: Congressional testimony. This time around it’s been so well telegraphed that for the most part the market is saying, “let’s get on with this.” We think a surge of geopolitical risk, domestic and foreign, is what’s holding the Fed up.

**ROSS:** We’ve certainly felt it this week. Does it affect your own outlook for interest rates and inflation?

**TOM:** It does. Let’s focus on the domestic political issues and those are debt ceiling, 2022 fiscal budget, and tax increases. All will impact not just longer-term Treasury yields, but also Fed policy. As it stands, we have a fiscal drag ahead as stimulus measures are reduced. Until that gets watered down (e.g. smaller tax hikes), we expect long-term bond yields to remain suppressed. The Fed has to be cautious in their communication here because if the market prices-in rate hikes just as the impact of the fiscal drag hits, 2022 could be another lost year where economic growth underperforms potential and inflation expectations deflate in a way the Fed does not want.

**ROSS:** It’s a lot of moving parts—stimulus, taxes, debt ceiling, tapering. And one other piece is the looming supply crunch that we might see in the Treasury market (e.g. less issuance of government debt). How do you expect that will influence rates?

**TOM:** The Treasury is almost certainly going to reduce the size of its 5-yr, 7-yr, and 10-yr note auctions, and probably as soon as the fourth quarter of 2021. You could see substantial reductions there. That should serve to do two things:

1) Encourage foreign demand for US Treasurys by easing fears that supply is going to run severely high for a long time.
2) Scare away short sellers (investors betting against US Treasurys) who might’ve viewed the supply explosion in Q1 as an opportunity to short Treasurys.

All in all, it probably puts a ceiling on how high the 5-yr, 7-yr, and 10-yr Treasury yields can rise in the near-term. And then eventually (say, late-2022 or 2023), the Treasury will pick up issuance again. But this is another reason you’re seeing a ceiling on the 10-yr yield around 2.0% for the foreseeable future, at least until we can get past the fiscal uncertainty ahead.
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