What is Quantitative Tightening?

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Quantitative Tightening ("QT") is the opposite of Quantitative Easing ("QE"), a more commonly used term. QE was used during the global financial crisis of 2008 and again during the pandemic, when the U.S. Federal Reserve purchased large quantities of bonds to accomplish two goals: reduce interest rates and increase money supply. You've also likely heard of central banks "printing money". QE and printing money are related since central banks use QE to inject capital into the economy when they decide to increase the money supply or "print money". QE is effective because it increases the supply of money and lowers interest rates, which helps encourage economic activity (borrowing, spending, hiring, etc.).

How does QE lower interest rates? Bond prices and interest rates are inversely related, as prices increase, yields (interest rates) decrease. As is the case with most assets, increasing the number of buyers increases the price of the asset if all other factors are held equal. Central banks have endless buying power because of their ability to "print money", which means they can be a very large buyer of bonds. Adding a significant buyer of bonds to the market forces the price of bonds higher, thereby lowering interest rates and supporting economic growth.

What happens when central banks not only stop buying but start selling bonds (Quantitative Tightening)? QT creates additional bond supply which forces prices lower and interest rates higher. The U.S. Federal Reserve first announced principals for QT in January and official plans in May of this year. More details can be found on the Federal Reserve's website (federalreserve.gov). In summary, the Fed will reinvest fewer principal payments than those received from their current bond holdings which will substantially decrease the amount of bonds they own. This process started in June and will accelerate into 2023. The Bank of Canada is following a similar process and timeline for QT which will increase longer-term rates in Canada in a similar fashion to those in the US.

In our next column, we will discuss the impact of higher long-term rates on the stock market and your portfolio.

Contact us to discuss this issue and how it impacts your portfolio.

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