Quant insight

25.01.2024

# Qi Scenario Spotlight
# - what happens to stocks if the Fed taper QT?

**The market remains fixated on the debate surrounding Fed rate cuts - is the first cut as soon as March? Will there be three or five reductions in 2024?**

**But interest rates are only one weapon in the Fed's monetary policy toolbox.**

**Quantitative Tightening is their other big weapon to restrict demand and fight inflation. And recent comments in the FOMC Minutes & from various Fed Governors have floated the idea that the Fed's stance on QT could soon shift.**

Money markets can be geeky but without getting too deep into the weeds, the bottom line is the prospect of falling reserves and/or the expiry of the Bank Term Funding Programme have the potential to be **significant drains on overall market liquidity.**

The quid pro quo would be the Fed start to **taper the pace of Quantitative Tightening** which would go some way to providing an offset.

This is important. While the initial heavy lifting of the Fed's tightening cycle was done by real yields marching higher in 2022, Qi shows that in 2023 it was higher bond volatility (plus wider credit spreads) that were the main transmission mechanism that tightened financial conditions and weighed on equities.

The chart below shows the MOVE index which is the widely watched measure of volatility in the US Treasury market. It experienced two sharp spikes last year.

During the March regional banking crisis; and again after the August Quarterly Refunding Announcement focused market attention on deficit concerns and Powell followed up with a hawkish press conference at the September FOMC.

And it was the Q4 QRA's pivot to funding the deficit via increased bill issuance rather than coupons which injected liquidity, reduced rate volatility and kick-started this "risk on" rally markets are currently enjoying.

This means **equity investors need to be on high alert for any change in QT and subsequent state of overall market liquidity.**

Qi is ideally placed to help. We employ swaption volatility rather than the MOVE index as our proxy for market expectations around QE versus QT. Qi portal users can track shifts in the factor (in z-score terms) to get a sense of context.


Qi's suite of macro factor sensitivity data is available across thousands of assets from its API as an excel add-in. We extracted sensitivity data for all S&P 500 stocks to Fed QT expectations. We define sensitivity as the % change in a stock for a 1sd move in the macro driver, all else equal. From this data, we ran the following filters:

- Removed stocks where Qi's model RSq was less than 65% i.e. where macro is not providing a high degree of explanatory power for a stock's price action

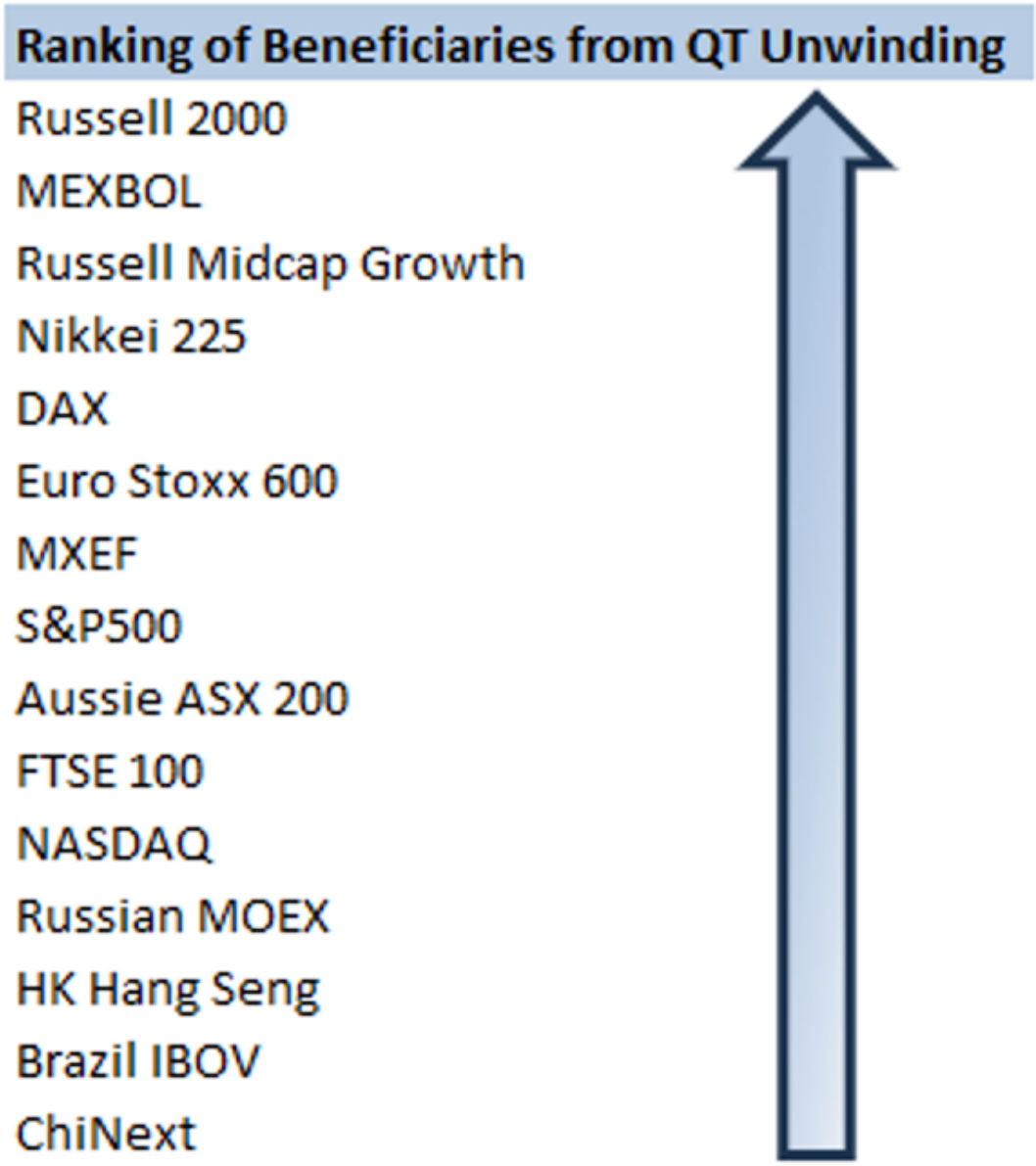
- For the remaining ~400 stocks, we identified the average exposure to Fed QT expectations for all stocks within an industry group. In other words, ranking which industries would benefit the most from an unwinding in Fed QT.

- **23 of the 25 US Industry Groups would benefit from QT unwinding i.e. it would benefit across the board**. However, the range of sensitivity is large. The ranking is shown below, led by **Consumer Durables, Banks, Staples, BioTech and Real Estate Investment**. At the other end of the spectrum are Insurance, Energy, Telecoms and Software. A screen down to the individual stock level is available upon request.

| Ranking of Beneficiaries from QT Unwinding |
| --- |
| Consumer Durables & Apparel |
| Banks |
| Consumer Staples Distribution |
| Pharmaceuticals, Biotechnology |
| Equity Real Estate Investment |
| Health Care Equipment |
| Financial Services |
| Consumer Discretionary Distrib |
| Real Estate Management |
| Household & Personal Products |
| Utilities |
| Food, Beverage & Tobacco |
| Materials |
| Semiconductors |
| Transportation |
| Consumer Services |
| Capital Goods |
| Automobiles & Components |
| Technology Hardware & Equipmen |
| Media & Entertainment |
| Commercial & Professional Serv |
| Software & Services |
| Telecommunication Services |
| Energy |
| Insurance |

- In addition, we rank the same exposure screen across global equity indices (subject to macro explanatory power of at least 65% RSq)

- **The Russell 2000 would the primary beneficiary of QT unwinding. Notably, Technology is more sensitive to inflation expectations than QT expectations**. In effect, QT unwinding would help broaden equity market breadth




- Repeating the same screen across our ETF universe, reveals a similar flavour to the above screens. The top 12 most exposed are shown below. **Biotech, small caps and real estate ETFs** feature highly

**Ranking of Beneficiaries from QT Unwinding**

SPDR S&P BIOTECH ETF
ARK GENOMIC REVOLUTION ETF
ISHARE BIOTECHNOLOGY
ISHARES MICRO-CAP ETF
INVESCO S&P 500 HIGH BETA ET
REAL ESTATE SELECT SECT SPDR
ISHARES U.S. HOME CONSTRUCTI
ISHARES CORE US REIT ETF
ISHARES MSCI MEXICO ETF
ISHARES US REAL ESTATE ETF
ISHARES RUSSELL 2000 ETF
ISHARES CORE S&P SMALL-CAP E

Read the PDF

Quant Insight Limited
Dawson House
5 Jewry St
London
EC3N 2EX
UK