Federal Reserve keen to get the ball rolling

While acknowledging there are still uncertainties, the minutes to the December FOMC meeting have the Fed admiting that there is plenty to justify tighter monetary policy. Rate hikes will remain the primary tool and that could start in May, but this is likely to be complemented by a move to shrink the Fed's bloated balance sheet before the end of the year

Federal Reserve

Source: Shutterstock

Tighter monetary policy is coming despite Omicron

The December FOMC meeting saw an important shift in the Fed thinking with an earlier end to QE (by mid-March) with the dot plot signaling three rate hikes in 2022 and three more in 2023. To be fair the Fed have been shifting for some time. Last March they were still saying it would be 2024 before hiking. In June they went to 2023 and in September they had the first hike coming in 2022 (but just one). The minutes to the December FOMC meeting show that inflation readings had caught them off guard and they have had to play rapid catch-up.

In this regard they acknowledged “that supply chain bottlenecks and labor shortages continued to limit businesses' ability to meet strong demand. They judged that these challenges would likely last longer and be more widespread than previously thought". While acknowledging uncertainty caused by Omicron, "several remarked that they did not yet see the new variant as fundamentally altering the path of economic recovery in the United States" while "most agreed that risks to inflation were weighted to the upside".

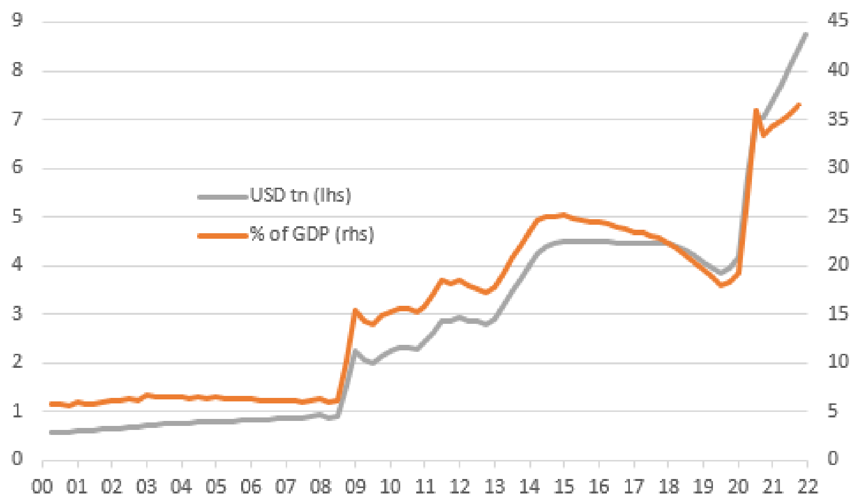
It also appears that the labour market situation has prompted a rethink within the FOMC. "Many participants saw the U.S. economy making rapid progress toward the Committee's maximum-employment goal. Several participants viewed labor market conditions as already largely consistent with maximum employment".

So with both the inflation and the employment goals of the Fed pretty much met we are very close to the point of rate hikes, which will remain the "primary means for adjusting the stance of monetary policy". We suspect March is too early for a rate hike given the lack of visibility caused by Omicron, but May is clearly on the cards.

Balance sheet shrinking to complement rate hikes

The next part, which the Fed addressed heavily in the minutes, is what to do about the balance sheet. It appears that the Fed are looking to shrink the balance sheet down more swiftly than they did last time around. The chart below shows that the Fed maintained the size of the balance sheet for 3 years after ending asset purchases in 2014 and how little they actually managed to roll off between 2017 and 2019 – around $500bn. This meant that as a proportion of GDP the assets on the Fed's balance sheet dropped from the equivalent of 25% of GDP to 18% of GDP. Today we are double that at 36%!

Assets on the the Federal Reserve balance sheet



Source: Macrobond, ING

"Participants judged that the appropriate timing of balance sheet runoff would likely be closer to that of policy rate liftoff than in the Committee's previous experience. They noted that current conditions included a stronger economic outlook, higher inflation, and a larger balance sheet and thus could warrant a potentially faster pace of policy rate normalization". Officials acknowledge that the current weighted average maturity of the Fed's holdings are shorter than five years ago so the balance sheet could shrink more quickly "if the Committee followed its previous approach in phasing out the reinvestment of maturing Treasury securities and principal payments on agency MBS".

Last month Christopher Waller from the Fed's Board of Governors suggested he would like to see the balance sheet brought down to around 20% of GDP. Assuming average nominal GDP growth of 5% over the next three years this would imply a balance sheet of roughly $5.4tn in 2025, which would mean the Fed offloading $3.4tn of assets. A longer drawn-out reduction would obviously require a less aggressive run down, but those are still going to be big numbers. Either way it looks as though it will start at some point in 2H 2022.

By raising rates and allowing some maturing assets to drop off the Fed's balance sheet the combined policy thrust perhaps argues for a lower peak in the fed funds that also has the advantage of encouraging the yield curve to remain positively sloping.

The Fed won't want an inverted yield curve, which has historically been the best guide for a recession and the Fed in today's minutes also hinted at this fear. "Some participants commented that removing policy accommodation by relying more on balance sheet reduction and less on increases in the policy rate could help limit yield curve flattening during policy normalization. A few of these participants raised concerns that a relatively flat yield curve could adversely affect interest margins for some financial intermediaries, which may raise financial stability risks".

Market rates take the minutes as a cue to keep motoring higher

Both ends of the curve have ratcheted higher in response to the minutes. A flatter curve has also been a notable outcome; rate hikes are coming. Policy tightening acceleration has acted to push the 2yr yield well north of 80bp, and the 10yr has hit 1.7%. The latter has been driven by a rise in real yields. The 10yr real yield remains deeply negative (at -90bp), as nominal rates remain well below inflation expectations, but it is up 20bp since the beginning of the year, and just today up by almost 10bp. This is important, as rises in the real yield go hand in hand with an improved macro outlook. Inflation expectations have fallen, which is what would be expected from a more hawkish Fed that is increasingly prepared to act.

The minutes also went into the thought process when it comes to balance sheet reduction, which is code for a tightening in liquidity conditions. Currently there is some USD 1.5tn going back to the Fed on the reverse repo facility, essentially this is the market handing cash back to the Fed that is swashing around the system. Crudely this could be taken out of the system, through balance sheet reduction over time. The minutes note the importance of the standing repo facility, which is a means to adding liquidity to the system as the Fed reduces its balance sheet, where market participants can lend collateral to the Fed to get access to liquidity. This is a buffer that allows the market to be in part self-regulating in liquidity management.

The latter is important, as the last time the Fed reduced their balance sheet, the system began to creak at a certain point as liquidity conditions tightened faster than had been expected. The standing repo facility offers a route out of any potential liquidity crunch, making it possible to get access to liquidity when required in a seamless fashion. This is all good preparation for a period where the Fed is either allowing bonds to roll off the front end (soft quantitative tightening) or outright selling bonds back (much heavier liquidity tightening which we have not seen before). We are not there yet as the taper needs to happen first, followed by hikes. But then these are the items on the Fed's menu where the tightening can be amplified as required.

Author

James Knightley
Chief International Economist, US
james.knightley@ing.com

Padhraic Garvey, CFA
Regional Head of Research, Americas
padhraic.garvey@ing.com

Disclaimer