That shrinking feeling

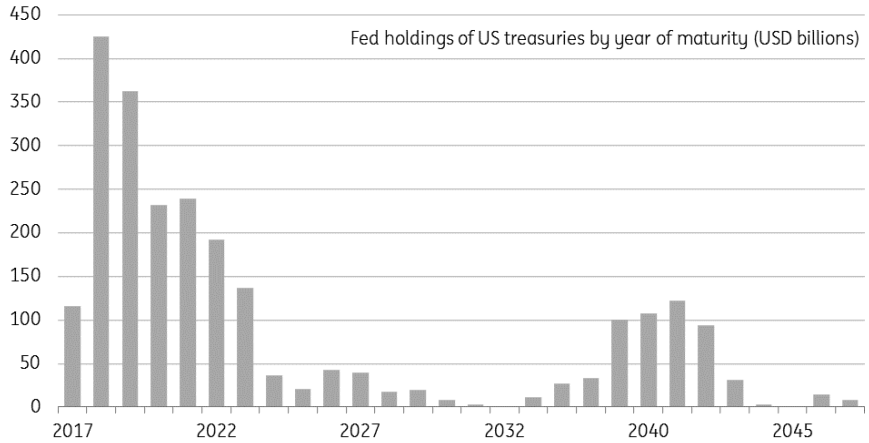
Shrinking the Fed's bloated balance sheet is a key issue for markets. Expect more details from the Fed over coming weeks

Source: iStock

The Fed's balance sheet has swelled

A key issue relating to policy normalisation is the process of shrinking the Fed's balance sheet. Because of the Fed's quantitative easing programme, implemented when interest rates were near zero to stabilise the financial system and additionally stimulate the economy, it has ballooned to US$4.5tr. The Fed's System Open Market Account (SOMA) is now holding US$2.465tr of Treasury securities and US$1.78tr of MBS securities. Pre financial crisis (December 2007), SOMA totalled just US$0.75tr.

When the Fed's Treasury holdings mature



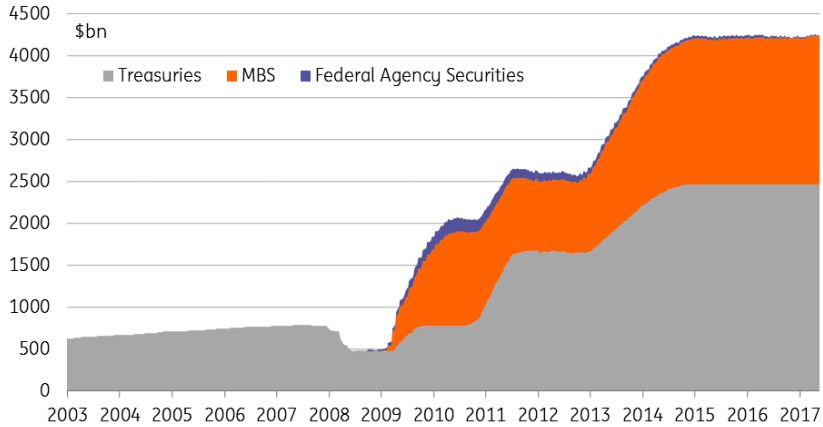
Source: Bloomberg

Unwinding could start later this year

The Fed stopped buying assets in October 2014 and since then the Federal Reserve has been reinvesting the proceeds of any maturing securities, which has kept the balance sheet stable. However, given the relative strength of the economy and rising inflation pressures, the case for keeping the balance sheet so large has weakened.

Currently, the Fed's position is that it will not seek to shrink it until "normalization of the level of the federal funds rate is well under way". A June rate hike and a further rate hike in the second half of the year would leave the Fed funds rate at 1.25-1.5%. We think this would be consistent with the Fed's guidance on balance sheet adjustment. Note the minutes to the March FOMC meeting stated that "most participants... judged that a change to the Committee's reinvestment policy would likely be appropriate later this year".

Composition of the Fed's balance sheet



Source: Macrobond

In the Fed's survey of primary dealers (released in March), the median response for the level of the Fed funds rate at which point balance sheet reduction would be announced is 1.63%, which would

mean that they expect three more Fed rate hikes before the announcement. However, we suspect this will edge lower in the next survey.

As for the process, former Fed Chair, Ben Bernanke, has argued that the experience of the "taper tantrum", when the Fed announced a slowing in its asset buying plans in 2013, suggests caution is warranted. The signalling, in terms of what it meant for short-term interest rates, was not as clear as it could have been and led to a sharp increase in volatility and higher bond yields. Consequently, he concludes that the process needs to be "passive and predictable". This was recognised in the minutes to the March FOMC meeting, which acknowledged it needs to be "gradual and predictable, and accomplished primarily by phasing out reinvestments of principal received from those holdings".

50% Potential proportion of bonds the Fed will let mature initially

A phased approach is most likely

The question here is whether it should be a phasing out or a ceasing of reinvestment of both Treasury securities and agency MBS securities. Ceasing reinvestments altogether was viewed as being "easier to communicate while allowing for somewhat swifter normalization". However, a phased approach, such as reinvesting 50% of maturing proceeds, "was seen as reducing the risks of triggering financial market volatility or of potentially sending misleading signals... while only modestly slowing reductions in the Committee's security holdings".

We favour a phased reduction, at least to start with given the key concerns about market implications. This is the general view of the market too with the Fed's primary dealer survey showing 68% of respondents expect a phased reduction of Treasury reinvestments with 73% responding the same for MBS holdings. The general assumption amongst respondents was that this phased period would last between nine and fourteen months.

Expect the Fed's balance sheet to stay fairly large

The next key question is how big the Fed's balance sheet should be over the longer term. The Fed has not made its views clear on this as yet and maybe we will hear more within today's FOMC minutes.

Former Fed Chair Bernanke has been more explicit, stating "growing holdings of currency and changes in the Fed's methods of implementing monetary policy alone may imply that only moderate reductions in the balance sheet will ultimately be required – another reason that it's unnecessary to move quickly". In a Brookings Institute paper published earlier this year, it was his view that "taking currency demand into account as well, it's not unreasonable to argue that the optimal size of the Fed's balance is currently greater than US$2.5tr and may reach US$4tr or more over the next decade. In a sense, the US economy is 'growing into' the Fed's US$4.5tr balance sheet, reducing the need for rapid shrinkage over the next few years".

What this means for markets

Given the emphasis on "gradual and predictable" it seems likely that the Fed will soon offer guidance on the long run optimal size of the balance sheet. Given Bernanke's comments we suspect that it may be higher than the US$2-2.5tr many analysts have suggested. Moreover, under a scenario where the Fed reinvests 50% of the maturing bonds, the scaling back of the Fed's balance sheet is clearly going to be slower than when the Fed was expanding its balance sheet.

A slower and less aggressive reduction in the balance sheet will limit the upside pressure on longer dated Treasury yields and MBS and allow the Fed funds rate to become a more important influencer of market rates. Even if balance sheet adjustment did lead to an undesirable increase in longer dated yields, a signalling of a more dovish path of Fed rate hikes could help offset this.

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