The Fed’s balance sheet plan

There’s a risk the Fed only hikes once more in 2017 before shrinking its balance sheet.

Source: iStock

"No hikes until balance sheet reduction begins"

Alongside his arguments for voting against a March rate hike, FOMC voter Neel Kashkari suggested in an interview yesterday (and in an article last week) that the Fed should outline its plans for balance sheet normalisation before hiking rates any further.

> *We think there is a risk that the Fed only hikes once more this year*

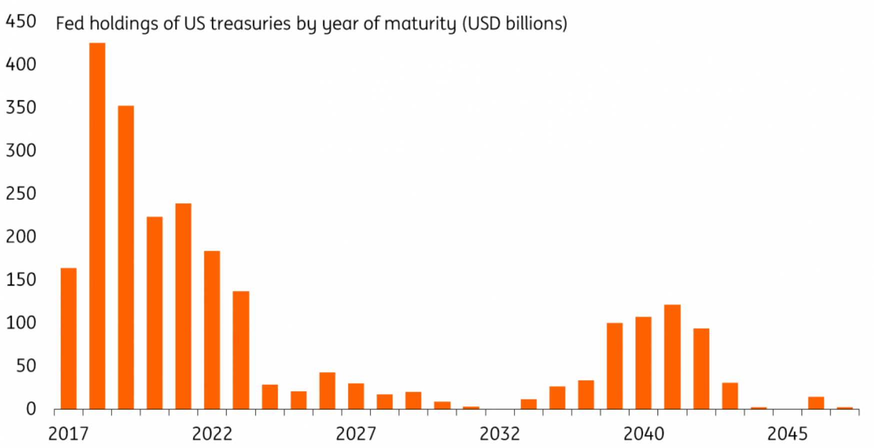
He said that this should happen “soon” and that the Fed should “publish a detailed plan of how exactly we will shrink the balance sheet and when that roll-off will begin”. His rationale is that the Fed cannot know for certain how the market will react and the announcement could trigger “somewhat tighter monetary conditions”.

The tricky questions the Fed needs to answer

Before the Fed announces its balance sheet strategy, it faces the tricky job of answering questions like “What is the optimal size of the balance sheet?” and “How quickly should it be unwound?”.

The former depends on a variety of factors, including the increased foreign demand for dollars. Whilst there appears to be no clear consensus here, most commentators agree that the balance sheet will end up larger than it was pre-crisis. On the latter question, we think the Fed will most likely gradually taper treasury portfolio reinvestment.

How the Fed's Treasury holdings mature



Source: Bloomberg

Watch this space!

Whatever the answers, it is fairly clear that this plan is still very much in the developmental stage. But given the increasing number of Fed speakers that are commenting on the topic, we think that an announcement might not be so far away.

Find out more about Friday's jobs report

This is a key reason why we think there is a risk that the Fed only hikes once more this year, rather than twice as the dots suggest. Normalisation of the balance sheet will remove a major buyer of US treasuries from the market and is likely to push up longer-dated yields to some degree, thereby reducing the need for rate hikes at the short end.

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