FIXED INCOME: FINDING THE RIGHT BALANCE

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In the post-Federal Reserve (Fed)-meeting world of the money and bond markets, there seems to be a disconnect between what market participants are thinking and the Fed policy decisions that are actually being made. It is a case of the market not buying what the Fed is selling. In other words, the term "policy mistake" has begun to enter the discussion, as the U.S. Treasury (UST) arena appears to be operating under the assumption that the Fed should perhaps ease up on its tightening campaign because (a) inflation has been slowing in recent months, and (b) economic growth has been lackluster. This line of reasoning concludes that the policy makers will go too far with their rate hike and balance sheet normalization plans, to the detriment of the economic setting.

Based on the Fed's actions at last week's June FOMC meeting, the policy makers do not seem to be deterred in their "full steam ahead" outlook, as they envision yet another rate hike this year and expect "to begin implementing a balance sheet normalization program this year" as well. So, let's assume economic and financial conditions do live up to the Fed's expectations, what then will their plan look like for phasing out their reinvestment program?

Fed's Balance Sheet Normalization Guidelines (in billions)

	Initial Cap per MO.	3-MO. Interval Increase	12-MO. Maximum Cap per mo.
U.S. Treasuries	$6.0	$6.0	$30.0
Agency Debt & MBS	$4.0	$4.0	$20.0
Total	$10.0	$10.0	$50.0

Source: Federal Reserve, as of 6/14/2007.

Going into this year, we anticipated the Fed taking the next step in its policy normalization process, addressing the reinvestment of Treasury holdings, agency debt and MBS. However, much like the policy makers moved up the timing of the first rate hike in 2017, the timetable for the balance sheet part of the equation has also been expedited. Although the voting members did not specifically lay out a date for the announcement and implementation of phasing out these reinvestments, if the Fed holds to the script it has followed thus far, an announcement at the September FOMC meeting is certainly a distinct possibility. In fact, at the June FOMC presser, Chair Yellen mentioned how the balance sheet plan could be put into effect "relatively soon."

Along these same lines, the Fed has now provided specific dollar amounts and a timetable of sorts. As you can see in the enclosed table, the initial phase will consist of a $6.0 billion cap on reductions in Treasuries and $4.0 billion on the mortg age backed securities front. Subject to conditions, the plan would then be to increase the amount of paydowns by $6.0 billion in Treasuries and by $4.0 billion in MBS every three months until a peak of $30.0 billion is reached for UST and $20.0 billion for MBS. This translates into a combined drawdown of $10.0 billion to start and potentially $50.0 billion a year later. In theory, if the $50.0 threshold is attained, the combined reduction in the balance sheet would amount to $600 billion over a 12-month period. To put this into some perspective: as of this writing, the Fed's holdings of Treasuries, agency debt and MBS came in at $4.26 trillion.

Conclusion

By making its balance sheet plan process public this quickly, the Fed is trying to make the actual implementation of the plan go as seamlessly as possible. The goal would be to have the bond markets essentially immune to any potential dislocations as the phase-out of reinvestments would be viewed as just another background type of event. Keep in mind that once the process begins, the bond market will be entering new territory, though.

Unless otherwise noted, data source is Federal Reserve, as of 6/14/2017.

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DEFINITIONS

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Treasury : Debt obligation issued by the U.S. government with payments of principal and interest backed by the full faith and credit of the U.S. government.

Fed tightening : Refers to the Federal Reserve enacting monetary policies that have the overall impact of reducing the availability of credit, which is widely thought to have the potential to slow economic growth.

Inflation : Characterized by rising price levels.

Rate Hike : refers to an increase in the policy rate set by a central bank. In the U.S., this generally refers to the Federal Funds Target Rate.

Federal Open Market Committee (FOMC) : The branch of the Federal Reserve Board that determines the direction of monetary policy.

Balance sheet : refers to the cash and cash equivalents part of the Current Assets on a firms balance sheet and cash available for purchasing new position.