FIXED INCOME: FINDING THE RIGHT BALANCE

Kevin Flanagan — Head of Fixed Income Strategy
06/21/2017

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 mortgage 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.

Important Risks Related to this Article

Fixed income investments are subject to interest rate risk; their value will normally decline as interest rates rise. In addition, when interest rates fall, income may decline. Fixed income investments are also subject to credit risk, the risk that the issuer of a bond will fail to pay interest and principal in a timely manner or that negative perceptions of the issuer's ability to make such payments will cause the price of that bond to decline.

For standardized performance and the most recent month-end performance click here NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

For more investing insights, check out our Economic & Market Outlook

View the online version of this article here.

IMPORTANT INFORMATION

U.S. investors only: Click here to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an "as is" basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the "MSCI Parties") expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages (www.msci.com)

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Kara Marciscano, Jianing Wu and Brian Manby are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only.

You cannot invest directly in an index.

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.