

FED WATCH: A NEW NORMAL

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September has certainly been the month for central banks. Indeed, investors have already witnessed formal policy meetings from the Bank of Canada (BOC), the European Central Bank (ECB) and the Bank of England (BOE). In two out of these three convocations, the results have tilted more [hawkish](#) than consensus expectations. The BOC meeting was the first to take place this month, and the Canadian policy makers surprised the fixed income markets by implementing their second [rate hike](#) in as many meetings. The BOE did not raise rates at its gathering just last week, but intimated that an increase could very well be coming in the months ahead.

That brings us to today's outcome of the [Federal Open Market Committee \(FOMC\)](#) meeting. From a headline perspective, the results did not deviate from expectations. Specifically, the voting members decided to take a break from their rate hike cycle and instead announced their widely telegraphed decision to begin the [balance sheet](#) normalization process, beginning next month.

The details behind their plan to begin phasing out their reinvestments in [Treasuries](#) and mortgage-backed securities (MBS) were already provided following the June FOMC meeting, which we highlighted in a previous blog post "[Fixed Income: Finding the Right Balance](#)." To summarize, the initial phase will consist of a \$6.0 billion cap on reductions in Treasuries, and \$4.0 billion in MBS. Subject to certain 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 billion threshold is attained, the combined reduction in the balance sheet would amount to \$600 billion over a twelve-month period. To put this into some perspective, as of this writing, the Fed's holding of Treasuries, agency debt and MBS came in at \$4.25 trillion.

UST Maturity Distribution on Fed's Balance Sheet (in millions)

	< 1 year	Over 1 Year to 5 Years	Over 5 Years to 10 Years	> 10 Years	Total
Dollar Amount	\$361,937	\$1,144,904	\$325,435	\$633,193	\$2,465,468
% of Total	14.7%	46.4%	13.2%	25.7%	100.0%

Source: Federal Reserve, as of 9/14/2017. Details may not add up due to rounding. Past performance is not indicative of future results.

As this September gathering had been getting closer and closer, a question I heard on a number of occasions was: What is the UST maturity distribution of the [Federal Reserve's \(Fed\)](#) holdings? Before we answer that query, a couple of general notes. First, the Fed's total holdings consist of Treasuries, MBS and federal agency debt securities. The combined portion of MBS and agency makes up 42% of the Fed's total balance sheet holdings, essentially all of which in MBS. That leaves 58% of the overall amount for Treasuries. As the table above illustrates, nearly half of the Fed's UST holdings lie in the "Over 1 Year to 5 Years" sector, with the next largest share (nearly 26%) in maturities of greater than 10 years. Perhaps a better way of looking at it is that maturities 5 years and under make up 61%, while the tally above the 5-year threshold is 39%.

Conclusion

By making its balance sheet plan process very open and public, the Fed was trying to make the actual implementation of the plan go as seamlessly as possible. The goal would be to have the bond markets essentially be immune to any potential dislocations as the phase out of reinvestments would be viewed as just another background event. Keep in mind, though, that once the process begins, the bond market will be entering new territory, and it could very well be occurring simultaneously with additional rate hikes.

Unless otherwise noted, data source is Federal Reserve as of 9/14/2017.

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DEFINITIONS

Hawkish : Description used when worries about inflation are the primary concerns in setting monetary policy decisions.

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.

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.

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