Trend Macro™

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FED SHADOW

Time for Taper Tantrum Two?

Thursday, April 6, 2017
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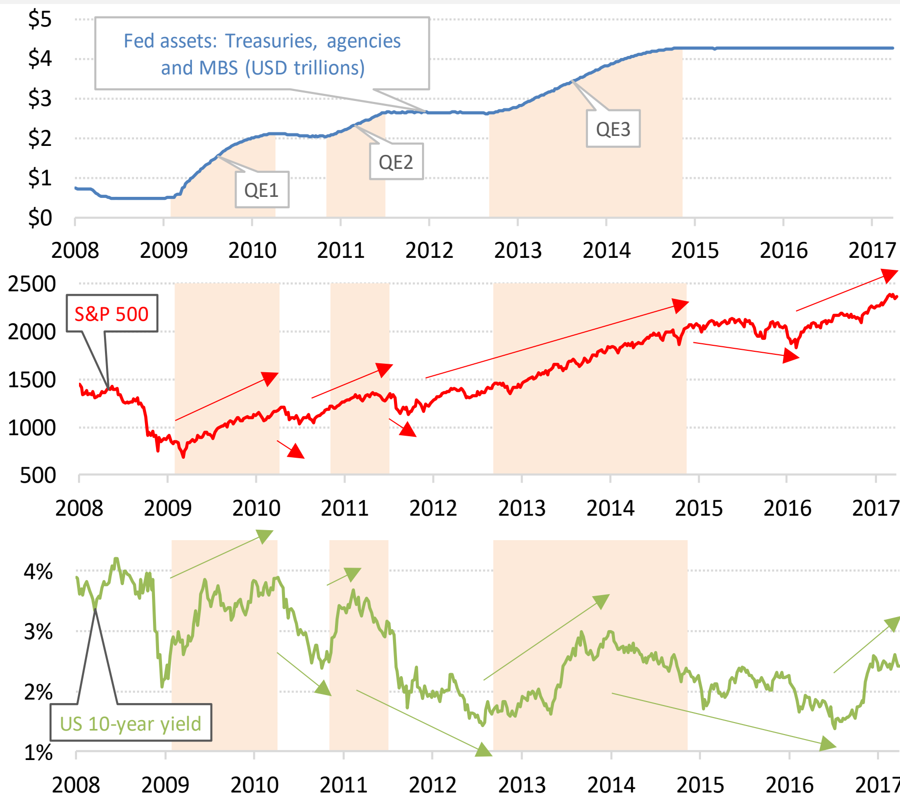
Get over it. After the 2008 panic, QE never did much anyway. We won't miss it.

The minutes of the March FOMC, released yesterday, contained a bombshell, a seemingly epochal policy shift not mentioned at all in the meeting's statement, and barely hinted at in Chair Janet Yellen's press conference – that "most participants…judged that a change to the Committee's reinvestment policy would likely be appropriate later this year." *In other words, the Fed's balance sheet is going to start shrinking. The age of quantitative easing is officially over.*

Here's what we know from the minutes – the points on which "most," "nearly all," or "many" participants agreed:

- "…reducing the size of the balance sheet should be conducted in a

How stocks and bond yields have reacted under three QE regimes



Source: FRB, Bloomberg, TrendMacro calculations

Update to strategic view

US FED, US STOCKS, US BONDS, US MACRO: Yesterday's March FOMC minutes dropped the bombshell that the Fed will stop reinvesting maturities and prepayments in its asset portfolio, running off its balance sheet and ending the age of QE. It is disturbing that there was no mention of this in the FOMC statement, and barely a hint in the press conference, but we think it is actually of little consequence. The empirical record of the effect of LSAPs on markets is spotty, and gives no intrinsic reason to fear that stocks will collapse or that long-term yields will surge higher. Theoretically, all they do is de-risk the market by putting maturity and duration risk on the Fed's balance sheet. This may have been key in the risk-averse era of "secular stagnation," but it is useless if we are in a "turning" toward greater risk-tolerance.

[Strategy dashboard]

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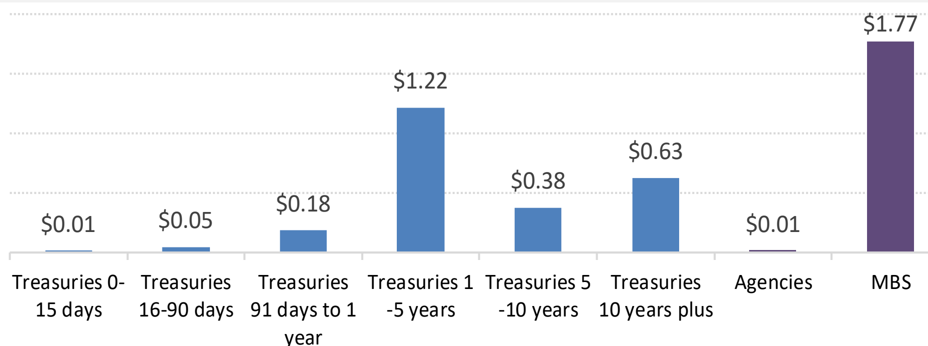
passive and predictable manner." *We think "passive" is code for just letting the positions run off naturally by not reinvesting maturities and pre-payments, without any outright sales. Based on the sector composition and maturity structure of the Fed's portfolio, that means the shrinking of the Fed's balance sheet will be a gradual multi-decade project* (please see the chart below).

Sector composition and maturity structure of Fed assets USD trillions



Source: FRB, TrendMacro calculations

- Timing of onset will "…depend on an assessment of economic and financial conditions." *If the markets throw a sufficient tantrum, it will be delayed.*
- The policy change will affect "both Treasury securities and agency MBS." *There is no intention to actively allocate credit, except to passively reverse the allocation that has already taken place.*
- "…policy should be communicated to the public well in advance of an actual change." *We'll do better next time, than the ham-handed handling of this policy announcement yesterday, buried in the minutes. Sorry about that.*

Here's one key element we do not know:

- *The minutes are silent as to the terminal point for the Fed's balance sheet – when the "passive" run-off is complete, we have no idea how big it will be.* All we know, from the Fed's Policy Normalization Principles and Plans, is that it "will, in the longer run, hold no more securities than necessary to implement monetary policy efficiently and effectively, and that it will hold primarily Treasury securities."

Does reducing the balance sheet matter to the markets or the economy?

- *We think not. This isn't really all that epochal.*
- To be sure, this is unexplored territory. In this near-decade of quantitative easing by large-scale asset purchases (LSAPs), we have no experience with shrinking the balance sheet – only three times in which we've stopped enlarging it.
- **For stocks,** there were sharp corrections immediately following the cessation of QE1 and QE2 (please see the charts on the first page). When QE 3 ended, stocks flat-lined.

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Mercatus Research
April 4, 2017

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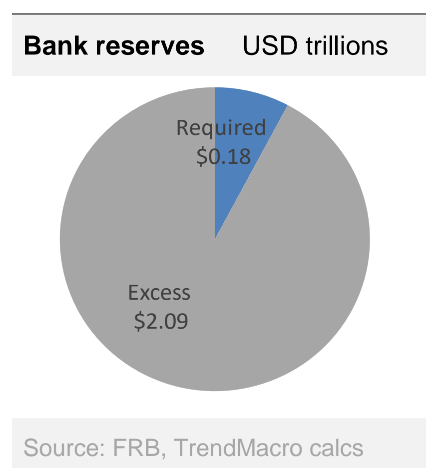
- Except for the first wave of recovery from the 2009 bottom, the onset of rallies (included the present one that began last July) has not been synchronized with the onset of LSAPs.
- **For bonds**, the onset of all three LSAPs coincided with a notable back-up in yields (again, please see the charts on the first page). And yields fell after all three LSAPs ended – but yields had started falling mid-way through both QE2 and QE3.
- *Notably, stocks have been rallying and bond yields have been rising since last July, in the aftermath of the Brexit panic and accelerated by the US election in November – without any Fed asset purchases going on. Perhaps this is what the Fed has been waiting for to halt reinvestments – evidence that markets can go it alone.*
- Such observations are merely empirical – they are entirely theory-free. Perhaps just as well, because as former Fed Chair Ben Bernanke has said, QE works in practice, but not in theory.
- *QE1 worked because it wasn't quantitative easing at all.* It was a classic prudential intervention, the central bank acting in its role as the lender of last resort – in this case, soaking up agency and mortgage-backed securities that were being dumped world-wide.
- *QE2 and QE3 worked because, well… did they actually work?* We don't think there's any particularly strong reason to think they did anything at all.
- *The LSAPs didn't "print money" or "drop money from helicopters" or "fund the deficit."* The Fed bought bonds that existing money had already paid for, paying for them with overnight deposits on its balance sheet. So when the Fed fails to reinvest maturities and pre-payments, *the need for new issuance to be financed by the market (rather than the Fed) will not tighten financial conditions – the money the market will need is sitting there on deposit with the Fed right now, all ready to go.*
- *We can't say LSAPs provided lendable reserves for the banking system.* The banking system has never been reserves-constrained. It has been risk-constrained, capital-constrained, and regulations-constrained. The reserves created by LSAPs are all "excess reserves" (please see the chart at right). *Running off that excess will not diminish actual lending capacity.*
- *We can't say they stimulated the economy by lowering long-term yields* during a period when short-term rates were pinned to the zero bound. As we have seen, long-term yields went *up*, not down, with the onset of all three LSAPs (again, please see the charts on the first page). *There is no reason, based on the track record, to fear that ceasing re-investment will cause yields to rise any more than they would have anyway as the economy pulls out of "secular stagnation."*

Bank reserves USD trillions



Source: FRB, TrendMacro calcs

- *Perhaps there was some "signaling" value.* Maybe LSAPs let the market know that the Fed was serious, that it would do "whatever it takes." Never mind that doing an otherwise ineffective thing shouldn't inspire confidence in the first place (but maybe it did).

Now it seems Fed wants to send an "all clear" signal – that it no longer takes "whatever it takes." For what it's worth, it seems that yesterday's bombshell didn't signal much about hawkish intentions – if anything, curve-implied expectations for future Fed rate hikes eased a bit.

- *The only theoretically solid argument for the LSAPs is that they de-risked the capital markets*. This is approximately what Bernanke meant when he spoke of the "portfolio balance channel." By replacing the markets' holdings of long-term Treasuries and MBS with overnight deposits on its own balance sheets the Fed took maturity and duration risk out of the market and into its own portfolio.
- We have argued that by taking these risks out of the market, the Fed may have indirectly supported stocks and other risky assets by freeing up limited risk-bearing capability (see "Is the Fed Moving the Stock Market?" March 11, 2013).
- Note that that this is not "monetary policy" in any sense, nor does it even require the existence of a central bank to have done it. The Treasury could have accomplished the same thing by ceasing to issue long-maturity bonds, and issuing only short-term bills.
- *But whoever does it, if risk-aversion has been the hallmark of the "new normal" and "secular stagnation"* (see, for example, "From Executive Orders to Spontaneous Order" February 17, 2017) *it would have been generally constructive to reduce the total quantum of risk the markets must bear.*
- And if we are right that we are entering a new generational period – a "turning" – marked by greater risk tolerance, then it is appropriate for the Fed to let the market bear more risk again.

With the Fed's "passive" approach of non-reinvestment, as opposed to outright sales, it will take many years to find out whether any of this will matter at all. Our best guess is that it won't.

Bottom line

Yesterday's March FOMC minutes dropped the bombshell that the Fed will stop reinvesting maturities and prepayments in its asset portfolio, running off its balance sheet and ending the age of QE. It is disturbing that there was no mention of this in the FOMC statement, and barely a hint in the press conference, but we think it is actually of little consequence. The empirical record of the effect of LSAPs on markets is spotty, and gives no intrinsic reason to fear that stocks will collapse or that long-term yields will surge higher. Theoretically, all they do is de-risk the market by putting maturity and duration risk on the Fed's balance sheet. This may have been key in the risk-averse era of "secular stagnation," but it is useless if we are in a "turning" toward greater risk-tolerance.