TrendMacro

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TRENDMACRO LIVE!

On the September FOMC

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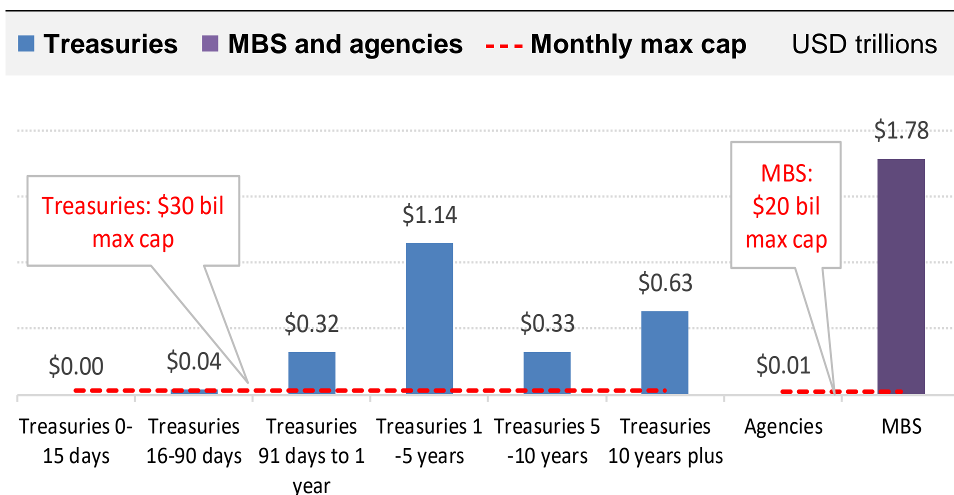
Hurricanes be damned. Balance sheet normalization begins in October. Don't fear it.

How the world has changed in just three weeks – enough, apparently, for the FOMC to announce the onset in October of the gradual normalization of its balance sheet. We had thought it would be deferred to the December meeting after a weak-ish jobs report (see "On the August Jobs Report" September 1, 2017), a hurricane that devastated Houston and another approaching Florida, and a looming debt-ceiling crisis (see "Debt! NoKo! Irma! DACA! Cohn! …and Other 4-letter Words" September 7, 2017).

Now, almost magically, all that has cleared (see "Donald and Chuck and Nancy and Tax Cuts" September 15, 2017). Stock markets world-wide are at new highs, the 10-year Treasury yield has backed up 20 bp, and oil prices are challenging their year-end highs. Apparently the "reflation trade" or the "Trump trade" – call it what you will – is back on. We don't think it was ever *off* (see "The Trump Trade is On, Not Ossoff" June 21, 2017). Whatever – it's enough for the FOMC to dare to take the first tentative step to normalization. *Following the guidelines promulgated in June, there will be no outright sales, only non-reinvestment of maturities. Initially that will be capped at $6 billion per month for Treasuries, and $4 billion for mortgage-backed securities and agency debt. Over a year, the caps will grow to $30 and $20 billion. We can't emphasize strongly enough how trivial even the maximum caps are in relation to the Fed's holdings, and the markets for these securities* (please see the chart below).

Treasuries **MBS and agencies** **Monthly max cap** USD trillions



Source: FRB, TrendMacro calculations

Update to strategic view

US FED, US MACRO: Normalization of the Fed's balance sheet will begin in October, with the FOMC brushing off any economic perturbations from the hurricanes. We strongly reiterate that the very gradual run-off of the balance sheet – the glacial pace of which Yellen promised was a permanent feature – does not represent policy tightening. All it does is require that a very risk-tolerant global market absorb, very gradually, small amounts of duration, pre-payment and credit risk. Chances of a December rate hike have risen somewhat with the FOMC's dismissal of hurricane effects. But the "dotplots" show falling anticipated policy rates at all tenors – including the "longer run," where one participant broke new ground with a 2-1/8% funds rate prescription.

[Strategy dashboard]

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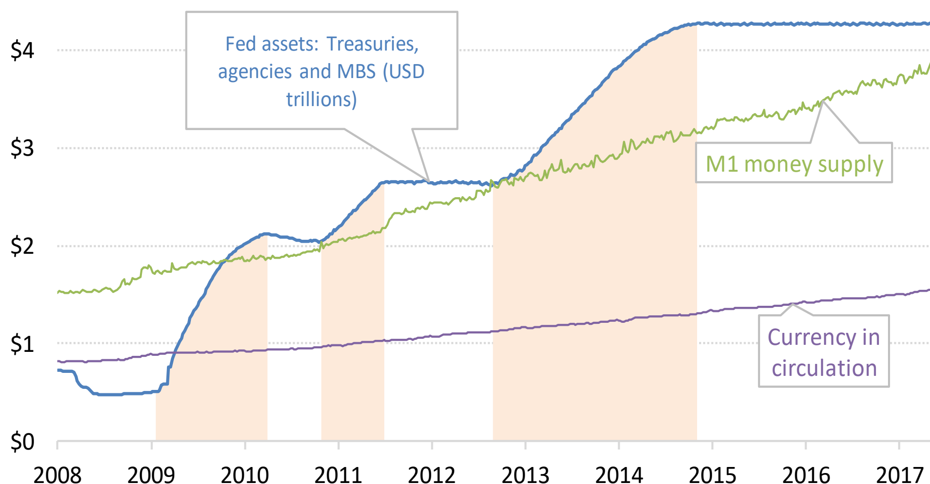
In her prepared statement at the post-meeting press conference, Chair Janet Yellen said that the normalization of the balance sheet would not be seen as a policy tool, and that "we do not plan on making adjustments to the normalization plan announced in June." *So markets need not worry that the glacial page of run-off might be accelerated.*

And there was no concrete guidance as to what the FOMC's ultimate target is for the size of its balance sheet. *The one thing we do know is that the FOMC understands that "normalization" doesn't mean a return to pre-crisis levels for the balance sheet. That means that its reduction from current levels may not end up being very significant.*

- The normalization statement released in June has said all along that it would be "a level appreciably below that seen in recent years but larger than before the financial crisis." That's not much help.
- We do take comfort from the assurance that "The Committee expects to learn more…during the process of balance sheet normalization." This is unknown territory, and learning-by-doing is inevitable. At least the Fed appreciates that.
- We note that, as the balance sheet expanded in the financial crisis, the critical moment was when its size exceeded the value of currency in circulation. That level is, informally, considered a limit on central bank asset holdings – a level justified by "seigniorage" – above which debt is being monetized. That Rubicon was crossed in early 2009 (please see the chart below), and to return to its shores would imply a very considerable asset reduction, to below $2 trillion (depending on when in the future it is achieved, considering that the amount of currency in circulation secularly rises).
- We note the striking coincidence that both QE2 and QE3 began precisely when the M-1 money supply had risen to meet the then-prevailing level of Treasury and MBS holdings (please see the

Fed Treasury, MBS and agency holdings USD trillions **Purchase periods**



Source: Federal Reserve, TrendMacro calculations

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September 14, 2017

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chart above). If that turns out to be a "rule" for the Fed, the balance sheet cannot even fall by a full $1 trillion.

We reiterate our longstanding analysis that normalization does not represent policy tightening, and is not to be feared (see "Time for Taper Tantrum Two?" April 6, 2017) – *especially given how gradually it will be done, and the FOMC's wait-and-see approach to terminal value*.

- As we bid farewell to at least some of the Fed's asset holdings, it's important to understand what their acquisition meant – and didn't mean – for policy.
- *The key insight is: the Fed's three rounds of quantitative easing, begun in 2008, were not "helicopter drops of money," so gradually withdrawing them now does not eliminate money from the banking system.* QE had the property of pulling risky securities from the market – that is, securities subject to duration risk, pre-payment risk and credit risk – and replacing them with riskless overnight deposits on the Fed's balance sheet, earning a floating rate equal to the top end of the funds rate target range. *It was never anything more than a big fixed-for-floating swap.*
- It was probably a smart thing to do when the global economy was seized by risk aversion. *But today the global economy is very risk-tolerant, so we don't anticipate any particular consequences to gradually unwinding that swap.*

As we and the consensus expected, there was no rate hike announced today. It was easy to anticipate that the FOMC would wish to observe the market's reaction to onset without the interference of a surprise rate-hike.

- Today's FOMC statement brushed off Hurricanes Harvey, Irma, and Maria, saying that "Storm-related disruptions and rebuilding will affect economic activity in the near term, but past experience suggests that the storms are unlikely to materially alter the course of the national economy over the medium term."
- *The obvious implication is that the hurricane won't dissuade the Fed from hiking the funds rate at the December FOMC.* The funds futures market went from implying a 48% probability of a hike before today's FOMC statement was released, and immediately afterward jumped to 60%.
- That said, the long-term outlook for the funds rate remains very flat. The curve is only pricing for two-and-a-half rate hikes over three years.
- *Indeed, the average value of the "dot plots" representing FOMC participants' estimates of the appropriate funds rate, in the Summary of Economic Projections, fell at all tenors* (see "Data Insights: Federal Reserve" September 20, 2017).
- *We think it is telling that the "dotplot" funds rate for the "longer term" – reflecting the estimate of the appropriate funds rate in a steady state equilibrium – fell too, from 2.92% at the June FOMC to 2.78% today. One participant even moved his or her "dot" down to*

2-1/8%, the lowest in the five-and-a-half year history of this exercise.

Bottom line

Normalization of the Fed's balance sheet will begin in October, with the FOMC brushing off any economic perturbations from the hurricanes. We strongly reiterate that the very gradual run-off of the balance sheet – the glacial pace of which Yellen promised was a permanent feature – does not represent policy tightening. All it does is require that a very risk-tolerant global market absorb, very gradually, small amounts of duration, pre-payment and credit risk. Chances of a December rate hike have risen somewhat with the FOMC's dismissal of hurricane effects. But the "dotplots" show falling anticipated policy rates at all tenors – including the "longer run," where one participant broke new ground with a 2-1/8% funds rate prescription.