Global Asset Management

U.S. Federal Reserve: Focus shifts to the balance sheet

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In what marks the next leg of unwinding the extraordinary stimulus implemented during the financial crisis, the U.S. Federal Reserve (Fed) has announced plans to begin reducing the size of its balance sheet, by allowing bonds to mature at a pace of US$10 billion per month, and then gradually increasing to a pace of US$50 billion each month. This gradual tightening of the money supply is expected the same impact as hiking rates one or two times per year. In the following article we discuss the Fed's role, details on how and why the balance sheet grew to its current size, exactly how the Fed plans to reduce it, and the impact this may have on the broader economy.

The role of the Fed

While it is common for the economy to experience natural ebbs and flows in activity, longer-term cyclical and secular forces are more meaningful for growth. The Fed was introduced in the early 1900s to sustain the supply of money and credit during economic contractions, acting as the lender of last resort. Today, the Fed controls the money supply to ensure stable growth and targeted inflation levels. Increasing this supply is stimulative for the economy because banks are incented to lend more, while decreasing it is restrictive to growth. The Fed makes adjustments to the money supply in three ways: (1) through changing reserve requirements (the amount of capital banks must have against deposits – this is rarely used in the modern era); (2) adjusting the prevailing interest rate; and (3) engaging in open market operations, including the purchase and sale of bonds, which is the method through which the Fed will reduce the size of its balance sheet.

Digging into the balance sheet

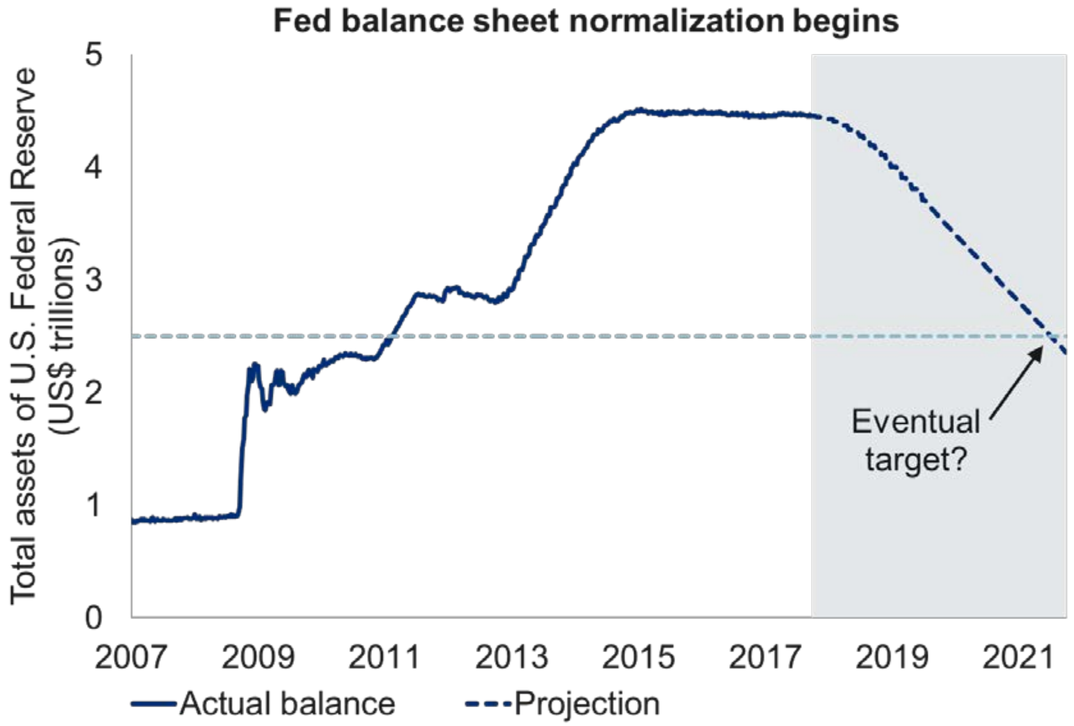
The Fed operates a balance sheet similar to any business or household. On the asset side sits any government bonds as well as the balance of loans the Fed may have made to member banks. During and after the financial crisis, the Fed began injecting liquidity into the economy, purchasing U.S. Treasuries and government-supported mortgage-backed securities. Under normal circumstances, raising or lowering interest rates would have been sufficient, but with interest rates near zero, increasing the money supply by purchasing bonds (known as quantitative easing) was a palatable and successful option.

A refresher on quantitative easing

The basic mechanics of quantitative easing are simple. A central bank prints money (or, more delicately, "expands the monetary base") and uses that money to buy financial assets, often government bonds. By purchasing financial assets, the central bank raises the price of those investments, improving returns to investors and creating a virtuous circle for investor confidence. Large-scale purchases of fixed-income investments also lower yields, reducing the overall cost of borrowing and greasing the gears of commerce. The potential inflationary consequences of this policy drive inflation expectations higher which, in an environment where the nominal interest rate is fixed, lowers the policy rate in inflation-adjusted terms, and amounts to additional stimulus. The threat of currency debasement results in a weaker U.S. dollar, which boosts exports and domestic manufacturing jobs. The impacts are self-reinforcing.

Enter the next stage of the process

As quantitative easing programs continued, the Fed's balance sheet expanded from a base of around $800 billion to nearly $4.5 trillion. In 2014, after the economy had shown sufficient strength, the Fed began to taper the pace of its bond purchasing program – and, eventually, its purchases altogether – with the knowledge that the U.S. economy was safely on its way towards normalization. This was then followed by the recent series of four rate hikes. Although the Fed's balance sheet was no longer growing, it was still much larger than usual. In June 2017, the Fed laid out the basis of its plans to unwind the swelling of assets on its balance sheet. In September 2017, the Fed confirmed that the process will begin in October.



Note: Projection based on assumption of implementation of balance sheet normalization program in October 2017 with an initial reinvestment cap of US$10 billion/month and that the cap would remain at US$50 billion/month after gradual increase over time. Source: FRB, Haver Analytics, RBC GAM

Prior to this September announcement, the Fed had reinvested any maturing bonds into new bonds, rolling over the program and maintaining the money supply at its current level. Going forward, the Fed will allow US$10 billion of principal to expire each month, ramping up the monthly pace by US$10 billion each quarter until it caps out at US$50 billion per month, likely toward the end of 2018, barring any economic disruption to the plan. Any bonds that mature in excess of the permitted amount will be actively reinvested in the portfolio to control the size and composition of the balance sheet.

The Fed likely doesn't need to reverse the size of its balance sheet all the way to the pre-crisis norm for the following reasons:

- the economy is bigger and prices are higher,
- the velocity of money now seems to be lower,
- bank capital holding requirements are higher, resulting in a lower money multiplier, and
- even at US$50 billion per month and a potential end goal of US$2.5 trillion, it will still take several years for the balance sheet to normalize.

Impact on markets

Loosely speaking, US$50 billion of bond selling should increase the U.S. 10-year yield by about 1 to 2 basis points (bps). As a result, the full speed of withdrawal equates to around 12 to 24bps per year of upward pressure on the 10-year yield. This is similar to the effect that one to two rate hikes have on the long end of the bond market. Thus, the effect is palpable and argues for higher yields, but is not overwhelming.

At this juncture, 12 out of 16 Fed participants expect another rate hike by the end of 2017 with three more planned for 2018. This points to a combination of traditional rate increases and non-traditional bond selling tightening the U.S. money supply. In our view, this tightening is entirely appropriate, if not inconsequential for fixed-income investors given the strength of the U.S. economy.

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