May 2017

We stand at the verge of warmer weather and summer activities. You may notice a larger number of runners, walkers and cyclists out and about, working off a little winter weight and getting ready for summer apparel. Recent comments from members of the Board of Governors of the Federal Reserve indicate they are thinking the same thing, sort of, reducing the size of the Fed's balance sheet.

Much of the market's attention has been focused on rising interest rates. This could occur as a result of three things or a combination of any or all of them. The Federal Reserve Open Market Committee (FOMC), the rate setting committee, has discussed normalizing interest rates (increasing) as economic activity and labor conditions have improved and inflation has moved closer to their target of 2%. The markets have assigned a greater probability that the FOMC will raise rates at their next meeting in June, then leaving rates where they are. The FOMC has indicated they think 2 or possibly 3 rate increases will be warranted before year end.

Another factor for rising interest rates is the fiscal policy coming out of Washington. This has two components. The first is the long-awaited tax plan being adopted. A recently released one page plan is short on detail and subject to much speculation as to specifics and the timing. The other part of the fiscal plan is spending, whether on increases in infrastructure funding or other administration priorities, which is being viewed as widening the current budget deficit.

The third part of this triad is reduction of the Fed's balance sheet. This stands at about $4.5 trillion. Prior to the financial crisis, this stood at about $900 billion. The expansion resulted from the purchase of primarily U.S. treasury and mortgage backed securities as part of the several quantitative easing (QE) programs implemented by the Federal Reserve to stimulate the economy. This is broad concern that shrinkage in the balance sheet could lead to a rise in interest rates and, when combined with the other two components, could slow economic growth. If the balance sheet is to be reduced, any effects may depend on how it is done and over what period of time.

The Fed could start to sell its current holdings on the market and bring its balance sheet back to pre-2008 levels. This would be very disruptive to the markets and likely lead to the Fed recognizing losses on many of its current holdings. This would appear to the least popular choice. Another method would be to change their investment policy and stop the reinvestment of maturities and pay downs (principal payments on mortgages for mortgaged backed securities). Total mortgage backed securities (MBS) held by the Fed is about $1.77 trillion. Estimates of monthly pay downs are $18-20 billion. Without reinvestment in similar securities, would result in an additional $230 billion of MBS supply in 2018. Total MBS issuance in 2016 was $225 billion and estimated for 2017 to be $180 billion. This may give you some idea of the size and potential effect on the MBS market. If this should be the action taken by the FOMC, the laws of supply and demand would take over, likely increasing rates and depressing prices in the MBS market.

In the area of Treasuries held on the Fed's balance sheet, there are $426 billion maturing in 2018 and another $357 billion in 2019. This is a larger market than MBS, but these represent a sizable

chunk. The markets would need to find a way to absorb this additional supply. If allowed to just roll off, the likely result would be higher rates and lower prices, similar to that discussed above for MBS.

The Federal Reserve has been very careful and moved with great care over the past year and previewed its intentions carefully. This is to avoid a repeat of the “Taper Tantrum” in the summer of 2013 when the Fed hinted at reductions in asset purchases. The market’s negative reaction at that time was in large part due to an unanticipated shift in the tone of the Fed’s policies. Comments from various Federal Reserve Governors may be part of a process of preparing the markets for a later action and policy shift. The Fed has made it clear it views the economy as nearing employment and inflation goals. After the last meeting of the FOMC, they yielded no guidance on the balance sheet other than they would continue to reinvest principal payments until normalization is well under way.

Another wild card in this mix is a potential change in the composition of the FOMC. The Chair’s position will expire in February 2018. It is uncertain whether the President will reappoint Janet Yellen. There will also be 3 board member nominations by that time and this could change both the composition and direction of the Fed and its policies.