FRANKLIN STREET PARTNERS

Balance Sheet Normalization

Craig Sullivan, CFA, CAIA®
Director of Fixed Income
September 2017

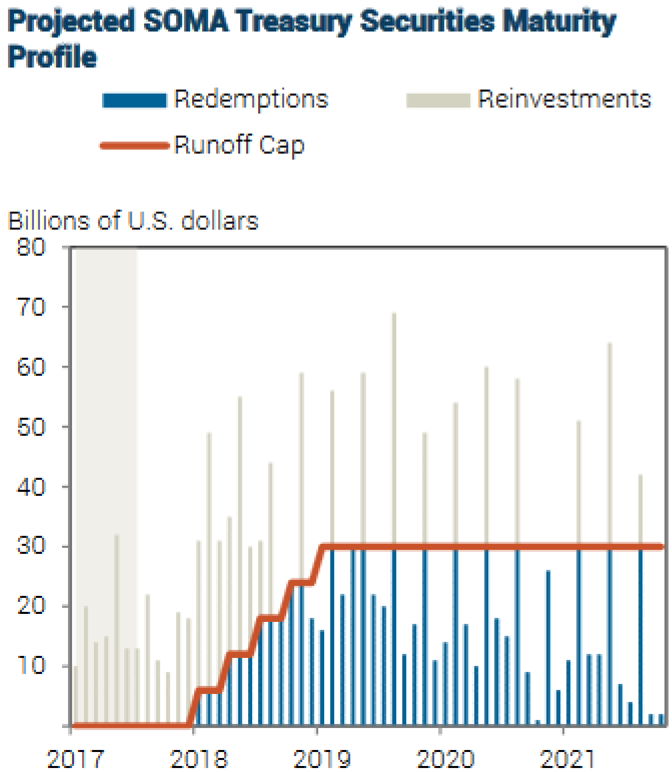
On Wednesday, The Federal Reserve (Fed) announced that, starting in October, it will begin the process of 'normalizing' its balance sheet from its current level of ~$4.5 trillion. This announcement was widely expected by the market, and the plan to reduce the balance sheet had already been announced at the June meeting.

For treasuries, the cap will be $6 billion per month, initially, and will increase in steps of $6 billion at three-month intervals over 12 months, until it reaches $30 billion per month.

For Agency Mortgage Backed Securities (MBS), the cap will be $4 billion per month, initially, and will increase in steps of $4 billion at three-month intervals over 12 months, until it reaches $20 billion per month.

It is important to note that the Fed **will not be selling securities**, rather it is simply no longer reinvesting proceeds unless they exceed the respective cap. In other words, in certain months the Fed will still be buying U.S. Treasuries (UST) and/or mortgages in the amount that exceeds the cap.

The chart below shows the amount of maturing USTs each month, along with the evolution of the cap on reinvestment. The khaki line above the orange line indicates months where the Fed will still be purchasing USTs.



Source: Federal Reserve Bank of New York

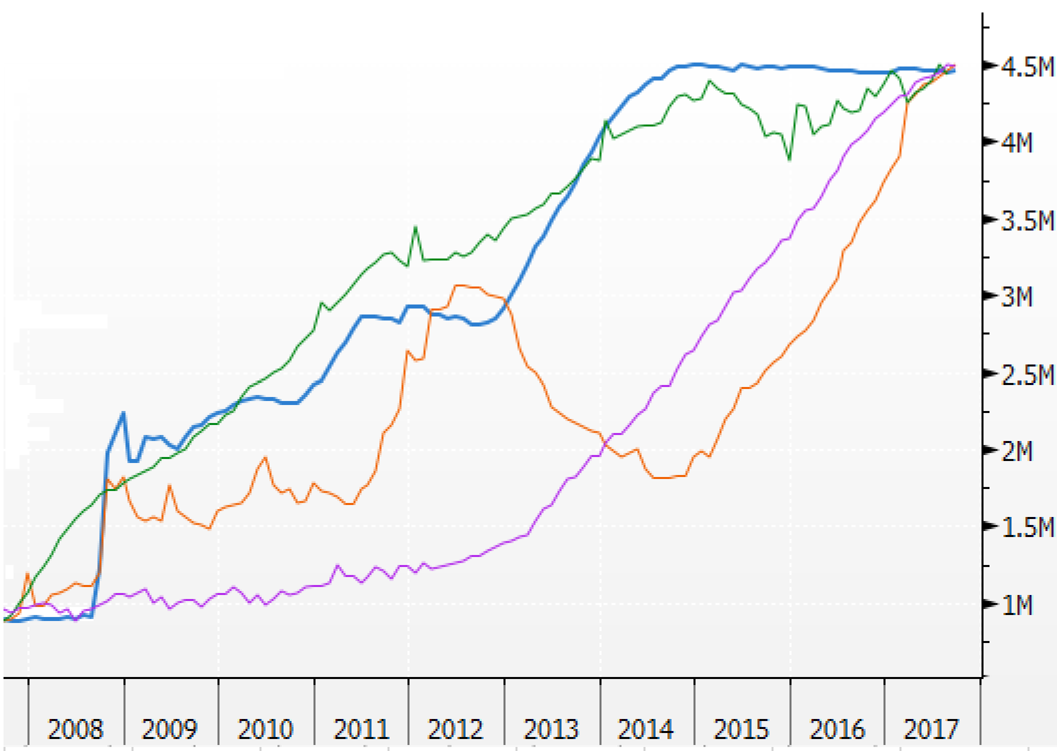
Estimating the reinvestment of agency MBS is more complex due to mortgage prepayments, which will vary with the level of interest rates, as well as the pace of home sales. As long as interest rates don't fall sharply, reinvestment of MBS proceeds would end in late 2018, as prepayments fall below the cap. A sharp drop in interest rates would cause prepayments to rise as people refinance. This would result in larger amounts being reinvested by the Fed in the earlier months of the process.

The final size of the balance sheet has yet to be determined; however, the Fed has estimated that normalization will occur sometime in 2021-2022.

The Fed also update their 'dots', which represent each Federal Open Market Committee (FOMC) participant's forecasts for the Fed Funds rate, at a point in the future. The updated plot shows that the median FOMC participant (blue line and yellow dots) is inclined to hike the fed funds rate again before year-end. The median longer-run dot was revised lower to 2.75% from 3% on the previous dot plot (gray line and red dots) released at the June meeting. The indication of another rate hike in 2017, given the recent inflation readings, was seen as slightly hawkish (more tightening than expected) by the market.

Source: Bloomberg. 09.22.2017

The great unknown is when other central banks will join in normalizing their balance sheets. The chart below looks at the size of the big 4 central bank balance sheets (Fed (blue), European Central Bank (ECB) (orange), People's Bank of China (PBOC) (green) and the Bank of Japan (BOJ) (purple)).



Source: Bloomberg. 09.22.2017

The Eurozone's recent economic data would suggest a much lower balance sheet over the course of the next three years. Meanwhile, the BOJ's balance sheet will likely continue to increase; however, overall global liquidity will be neutralized by the reduction of the Fed's balance sheet. Therefore, what Draghi decides for the ECB is likely most important for yields going forward.

Investors seem to expect and understand that the process of 'normalization' of balance sheets for global central banks will be a long one, especially if the global economy experiences a recession in the coming 3-5 years.

The one thing that could change this and force the central banks to speed up their process would be . . . inflation.