Fed Plans To Trim Its Massive $4.5 Trillion Balance Sheet
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Fed to Reduce Massive $4.5 Trillion Balance Sheet – Implications

Most investors understand the implications of the Fed raising (or lowering) interest rates. After lowering short-term interest rates to near zero in late 2008, and keeping them there for eight years, the Fed is now committed to “normalizing” short-term rates by raising the key Fed Funds rate multiple times over the next couple of years.

Starting back in March, and more specifically at the May meeting, the Fed also began to talk about reducing the size of its “balance sheet” which today consists of apprx. $4.5 trillion in US Treasury bonds and mortgage-backed securities. My impression is that many investors don’t fully understand what reducing the balance sheet entails, but it is very important. I’ll try to explain it and the market implications as we go along today.

Let’s begin by going back to 2007 before the financial crisis and the Great Recession unfolded. In late 2007, the Fed Funds rate was above 5% – before the Fed embarked on its Zero Interest Rate Policy (ZIRP). Within about a year, the Fed slashed its key short-term rate to near zero and kept it there until late 2016 when it began increasing it.

Federal Funds Rate

In addition to raising and lowering short-term interest rates, the Fed can also increase or decrease its balance sheet of assets and liabilities. Since the Fed has the ability to “create money,” it can increase its balance sheet by virtually unlimited amounts.

To increase its balance sheet, the Fed has in recent years ballooned its purchases of US Treasury bonds and mortgage-backed securities. These purchases were intended to keep longer-term interest rates low and hopefully boost the economy.

In 2007, the Fed’s balance sheet consisted of apprx. $800 billion of mostly Treasury bonds and to a much lesser extent mortgage-backed securities. Sounds huge, right? Yet since then, the Fed’s balance sheet has exploded to apprx. $4.5 trillion, which is nothing short of mind-boggling! Now the Fed says it wants to begin reducing this mountain of debt.

As I will explain below, I fear that this unwinding of the Fed’s balance sheet has much more serious implications for the US economy than the planned increases in the Fed Funds rate.

If the Fed gets this so-called “unwind” wrong, the fallout could be dramatic, including a sharp rise in interest rates, tumult in the stock and bond markets and maybe the next recession.

This is why ALL serious investors need to understand what the Fed is about to undertake.

How the Fed Got to $4.5 Trillion & Is There a Way Out?

I like the way CNBC columnist Jeff Cox introduced this topic to his audience recently:

“Consider the Federal Reserve the Starship Enterprise of monetary policy: It went where no central bank had gone before, and now must plot the journey home.”

As noted above, the Fed had less than $1 trillion ($800 billion) in reserves back in 2007 before the Great Recession and
the financial crisis unfolded. Then in a series of three massive bond buys – known as “quantitative easing” (QE) – the Fed exploded its balance sheet by an incredible $3.7 trillion by 2009, thus bringing today’s total to $4.52 trillion.

Of the $3.7 trillion, just over 60% was US Treasuries with the rest in mortgage-backed securities (home loans packaged together as bonds). Both classes of bonds have various maturity dates. In the current policy, whenever bonds mature, the proceeds are reinvested (rolled over) in new bonds. This constant buying helps hold interest rates low.

This is where it gets tricky. Starting sometime later this year, the Fed says it will cease rolling over some of its maturing bonds each month, letting them disappear if you will. What this means is that the Fed will be reducing its monthly bond purchases, thereby reducing overall demand for these securities – which could cause bond yields to rise.

It’s a balancing act for the Fed to know how much less buying the bond markets can handle, without seeing yields rise significantly. The trouble is, Fed officials admit they have little clue how their actions will impact financial markets and, in turn, borrowing costs. Uncharted territory indeed!

Fed Announces Controversial Plan to Reduce Its Balance Sheet

At its May policy meeting, the Fed Open Market Committee (FOMC) discussed a detailed plan for reducing its monster balance sheet. The minutes of that May 2-3 meeting, and the details of the plan to reduce the balance sheet, were made public on May 24.

The so-called “unwind” plan is controversial and includes some significant potential risks that I do not believe are “priced-in” to the stock and bond markets yet. I’ll explain those risks below.

At the May meeting, the FOMC discussed a plan to begin unwinding part of its balance sheet later this year by initially letting $6 billion a month in maturing Treasuries run off – meaning they will not be reinvested – which will slowly increase over the coming months. Here’s what they said:

“For payments of principal that the Federal Reserve receives from maturing Treasury securities, the Committee anticipates that 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.”

With regards to mortgage-backed securities (MBS), the Fed discussed a similar plan where it will begin tapering $4 billion a month and slowly increase that amount each quarter until it reaches $20 billion/month.

In total, the Fed will reduce bond purchases by $10 billion per month initially later this year, increasing to $50 billion per month by early 2019.

Additionally, the Fed said the long-run plan is to keep the balance sheet “appreciably below that seen in recent years but larger than before the financial crisis.” Interesting. As noted earlier, the Fed’s balance sheet was around $800 billion before the financial crisis. Now at $4.52 trillion, the Fed says it wants to reduce it ‘appreciably’ but keep it above where it was in 2007.

Understandably, this has led to a great deal of speculation among Fed-watchers. Does this mean the Fed wants to keep a balance sheet of at least $2 trillion on a permanent basis? Or $1.5 trillion? Or $2.5 trillion? We just don’t know.

What we do know is that by starting at $6 billion a month for Treasuries and $4 billion a month for mortgage-backed securities, it will take several years and maybe more for the Fed to reduce its bloated balance sheet to whatever level it is targeting.

Unwind Timeline & Implications For the Markets & Economy

I’m devoting a lot of space today to this discussion of the Fed’s upcoming plan to reduce its balance sheet for several reasons. First, of course, is the sheer size of the balance sheet at $4.5 trillion. No central bank in history has had a balance sheet remotely this large.

Second, obviously, is no central bank has ever tried to unwind a balance sheet this large. And third, it is impossible to know what the effects on the financial markets and the economy will be. They could be very negative, even if the Fed somehow gets the unwind about right – whatever that may be.

Some argue it won’t be that big of a deal since the Fed isn’t going to be selling the assets outright in the market, but rather
will simply let a measured amount mature each month. And that is a point. However, if the unwind reaches the Fed’s targets of $30 billion/mo. in Treasuries and $20 billion/mo. in MBS, that’s $50 billion/mo. of buying which simply won’t be there.

Even though the phase-out will ramp up to that level over time (assuming it actually gets there), it’s not like no one will notice. $50 billion/month in reduced purchases over 12 months is $600 billion a year! Or 15% of the US economy. No one, including the Fed, can know today what effect that will have on the markets and the economy.

Reducing the Fed’s balance sheet at the same time the central bank is raising interest rates adds an unnecessary element of complexity to the monetary tightening process. Fed officials themselves acknowledge that they are less sure about the impact of a reduction in asset holdings on financial conditions than they are with the more familiar tool of an interest rate increase.

There is growing speculation among Fed-watchers that the FOMC will not try to do both at the same time, at least not initially. The current thinking is that the Committee will hike the Fed Funds rate another 0.25% to 1.25-1.50% on September 20, which is the next meeting with a Janet Yellen press conference afterward.

The current thinking is also that Chair Yellen will announce in the September press conference that the Fed is done hiking rates for this year and probably won’t resume until March or later next year.

In the meantime, the Fed will start to unwind its balance sheet perhaps in October beginning with $10 billion per month in purchase reduction.

Let me pause here and emphasize that the three previous paragraphs are speculation – the Fed has not suggested such a timeline, at least not publicly. This is merely a timeline suggested by some on CNBC and elsewhere in the financial media. What is clear is that Yellen & Company are serious about launching balance sheet reduction this year.

Conclusions: Markets Don’t Like Uncertainty

Let’s wrap this discussion up by talking about market implications of the Fed’s decision to significantly unwind its $4.5 trillion balance sheet beginning before the end of this year. There are more unknowns than knowns. This is never good when trying to predict market outcomes.

What we know is that the stock market is at all-time record highs. US stocks have only been this overvalued twice before in history – once before the Great Depression and a second time in the late 1990s just before the dot.com bubble burst. So it won’t take much of a negative surprise to end this eight-plus year bull market, yet nearly everyone is bullish and long.

Treasury bond yields are at or near record lows. Despite just about everyone thinking that bond yields would rise this year, as the Fed hikes short rates, bond yields have gone lower and lower. The speculative shorts have been run out of this market this year. Here, too, just about everyone is bullish and long at this point.

While it may be that the Fed can pull off this unprecedented unwinding successfully over the next few years, there is so much that could go wrong. Questions and uncertainty abound and will only intensify as we get closer to the actual bond and MBS purchase reductions.

While stocks and bonds have held up remarkably well since the news of the Fed’s bond purchase reductions starting later this year were made public on May 24, I believe that the financial markets have not fully priced-in this key information just yet.

As a result, we could be looking at a serious downside correction in stocks and bonds before year-end. And if the Fed doesn’t get this massive unwind just right (or even if it does), interest rates could shoot higher, and we could be looking at a new bear market in stocks and bonds later this year – and possibly even a new recession.

We are in uncharted waters. Remember you heard it here first.

Hoping the Fed gets it right,
Gary D. Halbert

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