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Around THE Curve

The Uncharted Territory of Balance Sheet Reduction

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Investors should be concerned. We believe there is significant information risk in the Federal Reserve's (Fed) recently announced intention to begin unwinding its balance sheet later this year or in early 2018.

More Questions than Answers

First, there has never been a policy of balance sheet reduction in the Fed's history, so the central bank has no domestic experience to draw on for guidance. Second, there is no basis for believing the Fed can accurately anticipate the consequences of this new policy. Quantitative easing (QE) has been controversial from the start, and there is great disagreement—including among Federal Open Market Committee (FOMC) members—over what it was supposed to accomplish or how it was supposed to work. Instead of resolving the uncertainty, reversing QE will only add more. Lastly, Fed Chair Janet Yellen has expressly stated that she does not want to use balance sheet reduction to tighten monetary policy. The statement begs for clarity where there is not any. What will she look at to determine if reversing QE amounts to a policy tightening? What kinds of data will the central bank use to make this evaluation? Why has the Fed decided to do this now instead of later, after the normalization of the federal funds rate is farther along, which was the original plan? What framework will the Fed use to discriminate the effects of changes to the balance sheet?

Unintended Consequences of Unwinding QE

In my view the risk is just what Yellen fears: Balance sheet reduction could turn out to be a particularly potent form of monetary tightening. Instead of the much anticipated increase in bond yields as the central bank sells securities back to the market, the nominal gross domestic product (GDP) implications could flatten the yield curve and carry yields lower. Unfortunately, capital markets will be the first sign of any dollar scarcity developing.

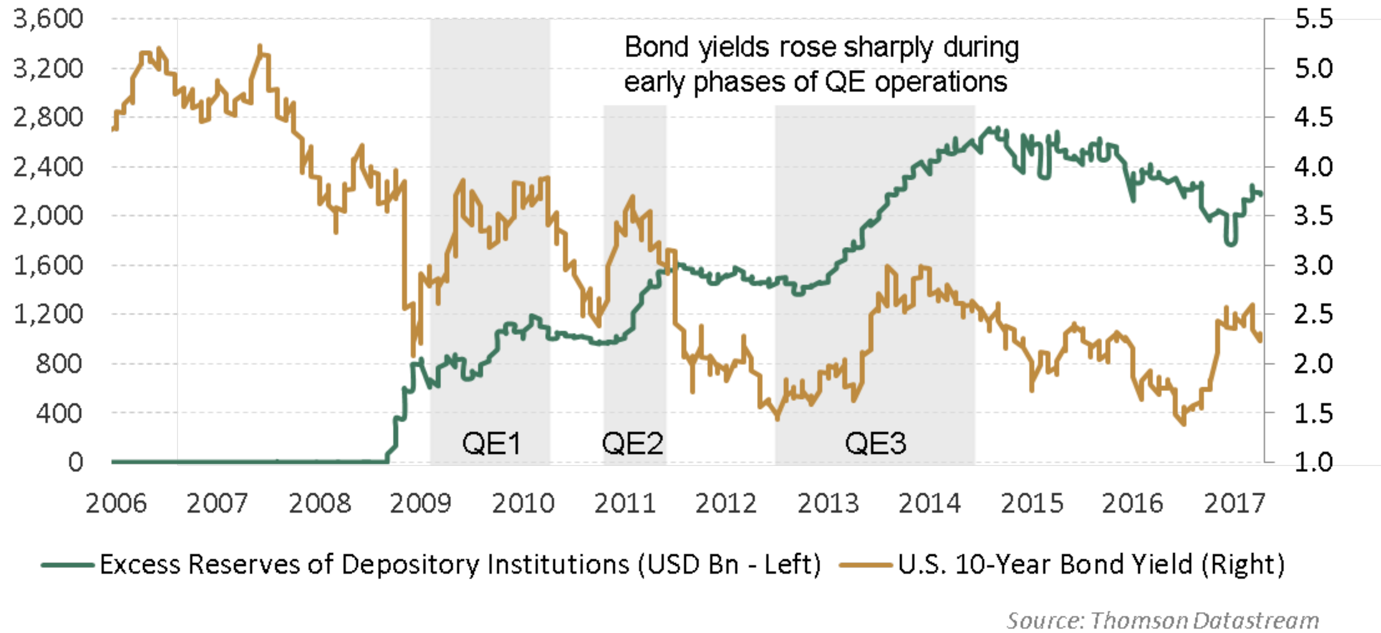
The conventional view is that QE has artificially depressed long-term bond yields. A recent staff paper at the Fed is the latest effort to put some numbers to the calculus, estimating a term premium effect on the 10-year Treasury yield from the entire QE program of 100 basis points. Fed simulations conclude that reducing the balance sheet by a little less than $2 trillion and lowering excess reserves by $2 trillion, back to pre-crisis normalcy, would take the term premium down to 10 basis points by the end of 2024. Spread out over 7 or 8 years, this scenario would imply a steady increase in Treasury yields of a little more than 10 basis points a year relative to the baseline—hardly a disruptive agenda, at least incrementally.

A less conventional view emerges when one looks at the actual data. Bond yields actually rose quite sharply throughout much of each QE program (see Chart 1). Looking at the excess reserves fostered by the first QE program (QE1), the yield on 10-year notes rose back to levels that existed in early 2008. Yields subsequently declined as QE1 lapsed and reserves eased lower. The second wave (QE2) saw reserves and yields ratchet higher once again, and once more the end of the program coincided with another reduction in bond yields, in this instance quite a large drop in 2011. This drop in yields marked the beginning of the European Sovereign Debt crisis, which introduced a strong deflationary impulse to the global economy. The third QE program (QE3) coincided with another period of rising bond yields. The latter peaked the same year that Chairman Ben

Bernanke warned of the tapering in yields. Since then, yields have drifted lower until the most recent bounce in excess reserves.

Chart 1: 10-Year Treasury Yield and Quantitative Easing

U.S. Dollars in Billions; As of 4/28/2017

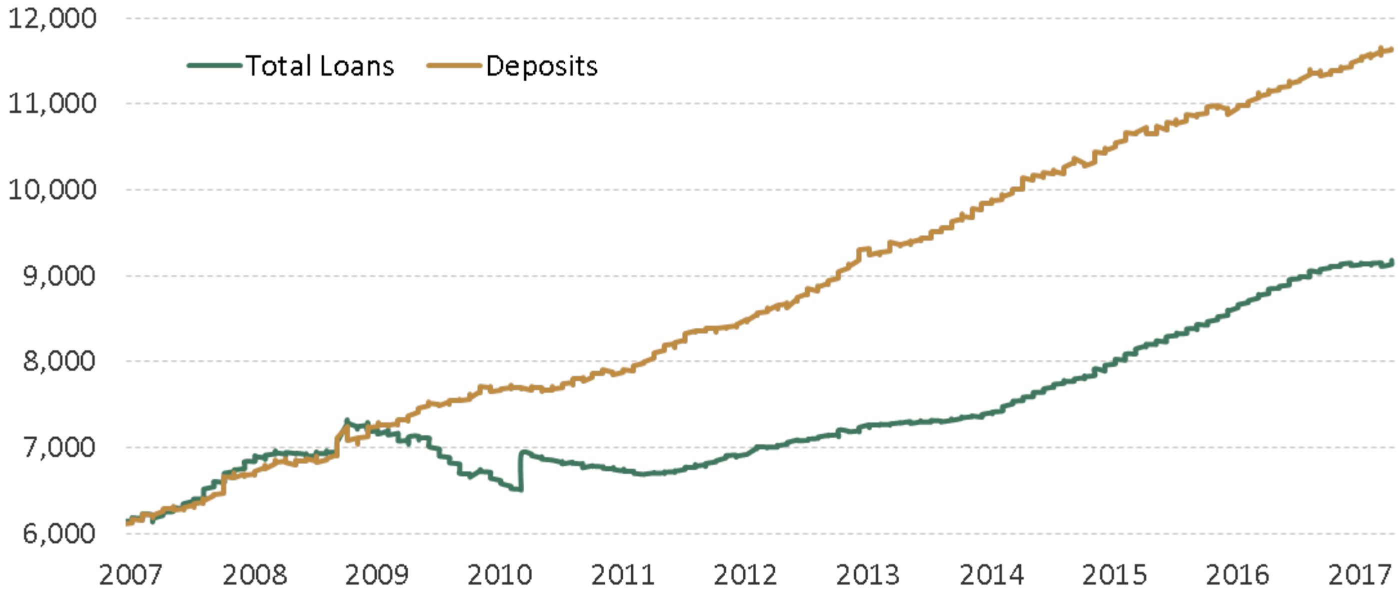


The directional correlations in Chart 1 raise the question of whether the conventional story is an example of financial industry “herd thinking” or even fake news. True, excess reserves are higher now than in 2008 and bond yields lower. But the bond market has been in a 30-year bull market, and nominal GDP growth has been depressed ever since 2008. Normal fundamentals explain much of the trend in bond yields. The positive directional correlation with impulses to the level of excess reserves suggests instead that QE at least initially created a reflationary impulse that was duly reflected in nominal bond yields. Bond yields regressed lower once excess reserves began to retreat and the reflationary impulse ended. By itself, the directional correlation in this graph suggests that the kind of reduction in excess reserves entertained in the previous Fed staff study might drive bond yields to zero.

Chart 2 considers the less conventional view from another perspective. It shows the trend in commercial bank deposits and loans following the global financial crisis. It is obvious from this chart that the public has held a much higher percentage of deposits relative to loans than in the past. Even though this end result has come about through a reduction in loan creation relative to the trend, the relationship speaks to an upward shift in the demand for money triggered by the anxiety and fear associated with the global financial crisis.

Chart 2: U.S. Commercial Banks: Loans & Deposits

U.S. Dollars in Billions; As of 4/19/2017



Source: Thomson Datastream

In a very direct sense, this chart suggests that QE amounted to the central bank supplying commercial banks with the necessary liquidity to in turn meet the public's increased demand for liquidity held in the form of bank deposits. By extension, it would be extremely restrictive, therefore, to shrink the balance sheet and excess reserves without a corresponding reduction in the public's willingness to hold cash.

Timing Balance Sheet Reduction

What indicators or data should the Fed wait to see before shrinking the balance sheet? The answer is simple: Rapid loan creation. The high level of excess reserves means that commercial banks have the firepower to unleash a barrage of new lending. Every trillion dollars in excess reserves put back to work and recycled into lending could generate $3 to 4 trillion in new loans, based on the money multiplier relationship between the monetary base and M2 money supply. This result is clearly possible if depositors become more confident, or the Trump administration is able to rouse the "animal spirits." But absent rapid credit growth, reduction of the balance sheet amounts to policy tightening, which may possibly be severe.

Conclusion

The Fed has had a tough time in setting market expectations over the last several years. Staff forecasts have been perennially over-optimistic, and FOMC members have been consistently premature in anticipating conditions for some measure of "normalization." There is solid evidence for believing the Fed can *slowly* lift rates, but balance sheet reduction would most likely be overkill. Members of the FOMC are clearly uncomfortable with the size of the balance sheet and worry about its longer-term consequences if sustained. But the case for balance sheet reduction is weak without a significant surge in lending and releveraging of the private sector. The good news is that the Fed is rational and reacts appropriately if it gets signals that policy is wrong-footed. The bad news is that it is the financial markets which do the signalling.

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