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Watching Paint Dry?

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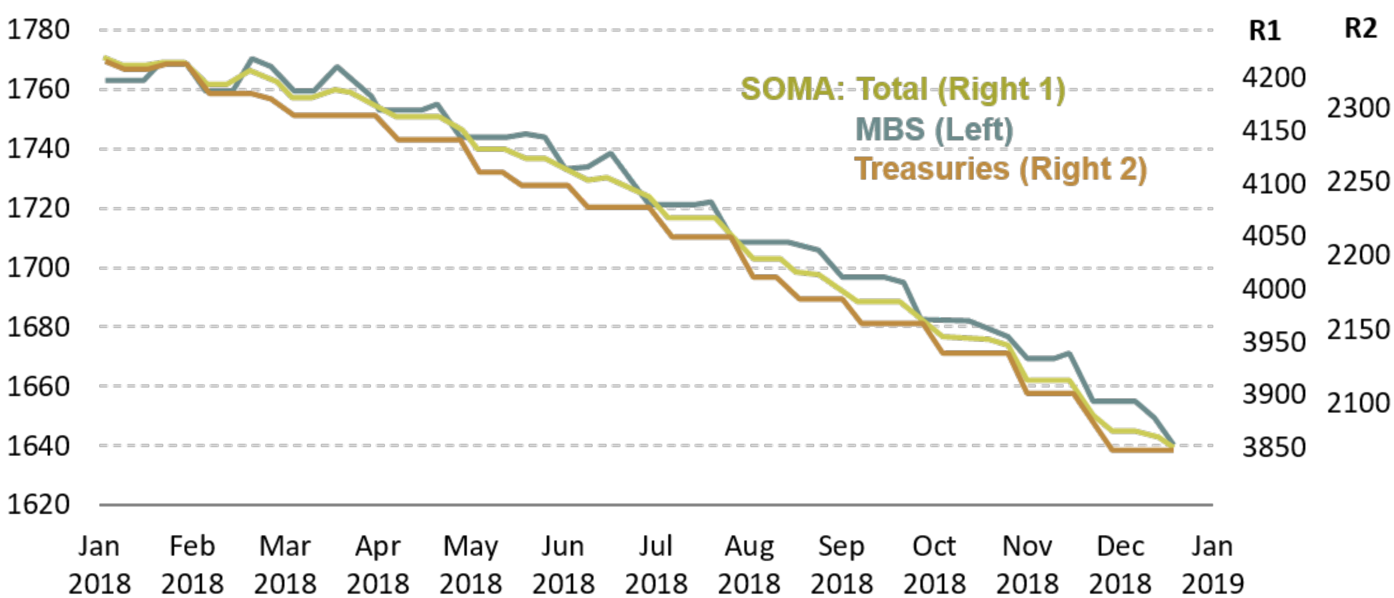
My colleagues have blogged extensively about quantitative tightening (QT) and the cadence of rate hikes leading up to the December Federal Reserve (Fed) meeting. Let's take a closer look at the contents of the Fed's balance sheet to determine whether it could actually slow down the pace of QT or rate hikes. Chart 1 below shows the Fed's total System Open Market Account (SOMA) holdings, which declined from $4.204T on December 27, 2017, to $3.858T on December 26, 2018. That's a $346B balance sheet reduction in 2018, comprised of $227B of Treasuries and $128B of mortgage-backed securities (MBS). To aid this process, the Fed introduced caps which were designed to limit the reinvestment of maturing securities, and as the cap increases, the amount of reinvestment decreases. As we know, the $50B per month runoff cap recently took effect in October 2018. Prior to that, the runoff caps for Treasury and MBS redemption were much lower, starting from the low level of $20B per month in 1Q 2018. These lower runoff caps suppressed the speed of balance sheet reduction in the first three quarters of 2018 (see Charts 2 and 3). Even with that suppression, the actual balance sheet runoff was still slower at $346B than the suggested $470B embedded with the runoff caps. Since Fed's first hike in December 2015, QT seems to have taken the approach of "faster rate hikes and slower balance sheet unwinding" with nine hikes already and only 74% of the planned balance sheet runoff. Therefore, Fed and market expectations may be misaligned, where the central bank perceives the pace of QT as slow and investors think it's too quick, particularly given the number of increases to the fed funds rate.

Chart 1: Fed's Total System Open Market Account Holdings (SOMA)

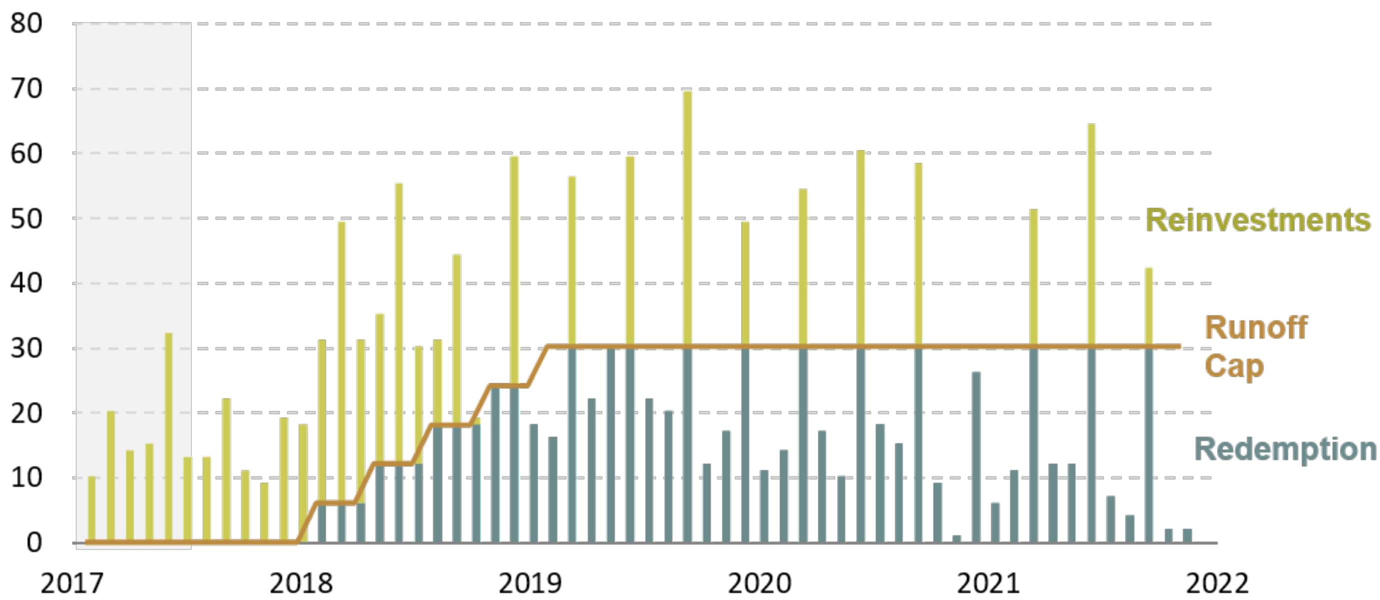
$Billions, As of 12/31/2018



Source: Bloomberg (© 2019, Bloomberg Finance LP)

Chart 2: Projected SOMA Treasury Securities Maturity Profile

$Billions, As of 7/31/2018

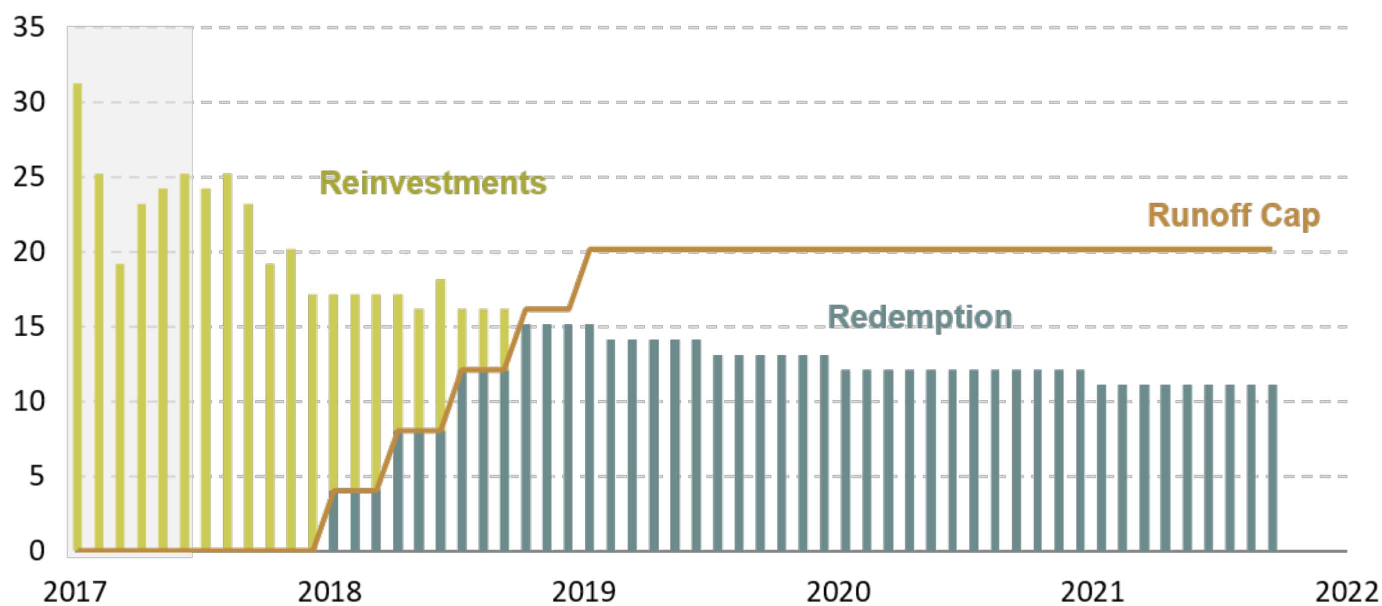


Source: Federal Reserve Bank of New York

Notes: Figures are monthly. Figures for January through May 2017 are historical maturities. The maturity profile is associated with the median liabilities scenario. Projected figures are rounded.

Chart 3: Projected SOMA Agency Debt and MBS Principal Pay-Down Profile

$Billions, As of 7/31/2018



Source: Federal Reserve Bank of New York

Note: Figures are monthly. Figures for January through May 2017 are historical pay-downs. The pay-down profile is associated with the median liabilities scenario. Projected figures are rounded.

Given the runoff rates in 2018, the situation may change in 2019, as the balance sheet reduction could

accelerate from here as the maximum runoff caps are phased in. Will the Fed take the opposite approach of "slower rate hikes and faster balance sheet unwinding" this year? While the amount of maturing Treasury securities can be projected with certainty, the principal pay-downs of MBS are model-based estimates due to the embedded prepayment option, driven by variables like the path of interest rates, housing price movements, mortgage credit conditions, and employment situations of homeowners, etc. Based on the maturity schedule, the Federal Reserve Bank of New York (see Chart 2) projected Treasury redemption could reach $262B—assuming normal maturity and subject to the caps—and the projected MBS reduction hovers around $163B; however, a 200 basis point downward rate shock to the mortgage rate could push MBS runoff to exceed $240B. So in its base scenario, we can get $425B reduction, a 23% increase from the $346B in 2018. We believe the increase in the speed of the Fed balance sheet runoff could have a significant impact on the market, especially the long-end of the Treasury curve, as most of the Fed's holdings are long-dated. With almost all major central banks reversing quantitative easing—including the European Central Bank's recent coda to its asset purchases—we could face more of a dollar liquidity shortage. These are just a few reasons why the Fed should consider taking it slow with regard to both forms of tightening; given Chairman Jay Powell's recent comments on January 4, we think he and other Fed officials are finally open to reevaluating this pace.

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