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BALANCE SHEET BALLYHOO

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KEY TAKEAWAYS

The Fed is expected to offer details about when it will begin reducing its balance sheet this week.

We expect the short-term market impact to be minimal, but that could change as the reduction accelerates in coming years.

Other global central banks are still providing liquidity to markets, helping ease the impact of monetary policy normalization.

The Federal Reserve (Fed) is widely expected to announce more details about the timing of its balance sheet reduction during the Federal Reserve Open Market Committee (FOMC) meeting this week, and markets are buzzing with anticipation. The Fed has purchased more than \$4.2 trillion of bonds since 2008 through multiple quantitative easing (QE) programs in order to decrease supply in the market and push interest rates lower to catalyze borrowing and economic growth. With the economy expanding consistently, albeit modestly, and the Fed having achieved one of its two mandates (reaching full employment), the Fed believes that balance sheet reduction is an appropriate step toward monetary policy normalization. But is this cause for an uproar? Based on the expected gradual pace, we don't think so.

A MOVE THAT'S BEEN THREE YEARS IN THE MAKING

Even though the latest QE program in the U.S. ended nearly three years ago (October 2014), these holdings, known as the Fed's balance sheet, have remained stable [Figure 1]. The Fed has rolled the proceeds from maturing bonds into new purchases, keeping the size of the Fed's balance sheet relatively constant over the past few years, and also likely keeping rates slightly lower than they otherwise would be. With QE long over, curiosity as to when the Fed will actually start to reduce the balance sheet has been building in the markets.

1 STILL NO REDUCTION IN FED BALANCE SHEET, THREE YEARS AFTER THE END OF QE

Asset Type	Securities Held (\$Millions) as of 09/14/17	1 Year or Less	1-5 Years	5-10 Years	Over 10 Years
Treasuries	\$2,465,469	\$361,937	\$1,144,904	\$325,435	\$633,193
Mortgage-Backed Securities	\$1,782,346	\$1	\$93	\$17,608	\$1,764,644
Total	\$4,247,815	\$361,938	\$1,144,997	\$343,043	\$2,397,837

Source: LPL Research, Bloomberg 09/14/17

The Fed will likely announce this week that it will slowly begin to reduce the amount that it reinvests each month. The immediate impact of normalization is likely to be limited given that it will start with allowing just \$10 billion of maturing bonds to roll off the \$4.5 trillion balance sheet each month (\$6 billion of Treasuries and \$4 billion of mortgage-backed securities [MBS]). However, these amounts will increase over time until the total roll-off reaches \$50 billion per month as detailed in the [Fed's Addendum to the Policy Normalization Principles and Plans](#).

WHAT DOES THIS MEAN?

The implementation of this policy is not expected to cause commotion, as markets are forward looking and widely anticipated this policy shift for much of 2017. However, over the course of a few years the impact could become larger, with \$1.2 trillion in Treasuries maturing within one to five years. On the MBS front, the effect would take a little longer to feel. The majority of the \$1.7 trillion in MBS on the Fed's balance sheet will mature in more than 10 years, though the potential for mortgage borrowers to pay down their loans early (refinancing, home sales, or even just additional payments) means that the impact could end up being felt sooner.

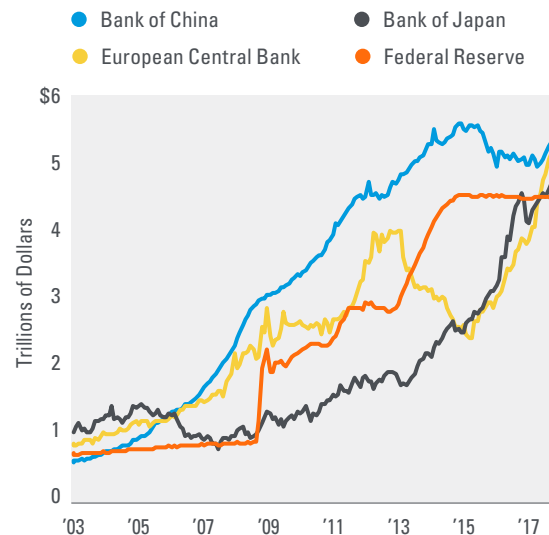
It is important to note that the balance sheet will not be reduced to zero. The Fed has indicated that the process will be very gradual and the balance sheet will remain above \$3 trillion until late 2019. Market consensus indicates that the long-term balance sheet may fall near \$2.5 trillion, still far above the pre-financial crisis balance sheet, which was less than \$1 trillion.

LIQUIDITY LINGERS

Along with pushing interest rates lower to stimulate borrowing and economic growth, QE also injected liquidity into the financial system. Many market participants fear that balance sheet reduction will lead to a decrease in liquidity, which could strain financial markets, especially if meaningful headwinds appear for equities. It is important to remember, however, that the Fed is just one of many central banks in a global financial system in which capital can move quite quickly from one country or region to another.

There are now three other central banks in the world with balance sheets larger than the Fed's [Figure 2]. Scale is important, but directionality is as well. Although the Fed may be reducing its balance sheet, these three central banks are increasing the size of their balance sheets, limiting the impact of normalization on global liquidity.

2 GLOBAL CENTRAL BANKS PROVIDE LIQUIDITY EVEN WITH FED NORMALIZING



Source: LPL Research, Bloomberg, Moody's, Federal Reserve 09/18/17

WHAT COULD CHANGE THE FED'S COURSE?

Under the Trump administration, the makeup of the Fed may change, and so may its policies. President Trump is not expected to tap Fed Chair Janet Yellen for reappointment (though he could do so in order to quell financial market uncertainty), and Vice Chair Stanley Fischer resigned from his post early, effective October 13. Trump's influence goes beyond the chair and vice chair nominations, however, as four of the seven Fed board seats are currently vacant. This means that Trump will appoint a higher percentage of the Fed's board of governors than any president since Woodrow Wilson, who selected the original board of governors. This could result in a shift in Fed policy, or a continuation of Yellen-era policy, but only time will tell. A more hawkish Fed could implement a more aggressive balance sheet normalization process, which could alter the market's reaction to the current gradual approach employed by the Fed under Yellen. A more dovish Fed could potentially do the opposite.

The Fed's balance sheet normalization plan for the coming years implicitly operates under the assumption that the economy and markets will behave normally and a recession will not occur. Should the economy fall into a recession, the balance sheet reduction would likely be slowed down, curbed all together, or even reversed, with the Fed buying assets once again in QE fashion to stimulate an economic recovery.

CONCLUSION

This week, the Fed is expected to announce more concrete timing for the reduction of its balance sheet. Although the undertaking is massive and unprecedented, we believe that the impact will not be severe in the short term, as this move has been well telegraphed by the Fed to forward-looking market participants. As the roll-off accelerates over the coming years, we could see more dramatic effects, such as higher long-term interest rates, assuming the Fed retains policy continuity and the economy avoids a recession that could most certainly knock the Fed off its stated course. ■

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