

FOMC Preview — A Great Balance Sheet Experiment

The FOMC meeting on Tuesday and Wednesday culminates in a statement-only outcome on Wednesday at 2pmET. There will be no forecast updates or press conference with this one. The statement should be fairly brief and remain on course with a substantial portion of the language used in the last statement in March.

Consensus unanimously expects no change to the Fed funds target range of 0.75–1.0%. Fed funds futures contracts are assigning around 15% odds to a hike next week. **The scope for surprise from a central bank that tends to prefer to have markets and consensus lined up more favourably in advance of policy changes is probably very low.** Given the distance to the next meeting on June 14th, a direct signal on hiking at that meeting is also unlikely. Markets are pricing about two-thirds odds to a hike then.

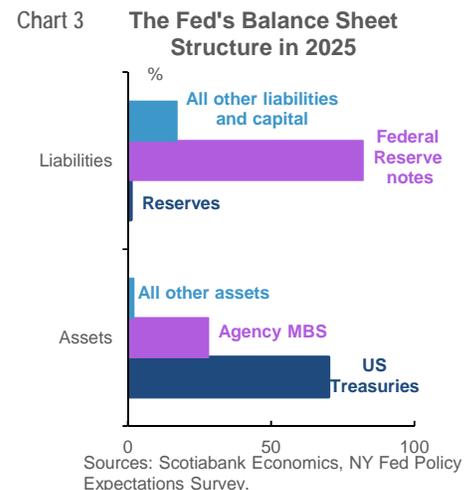
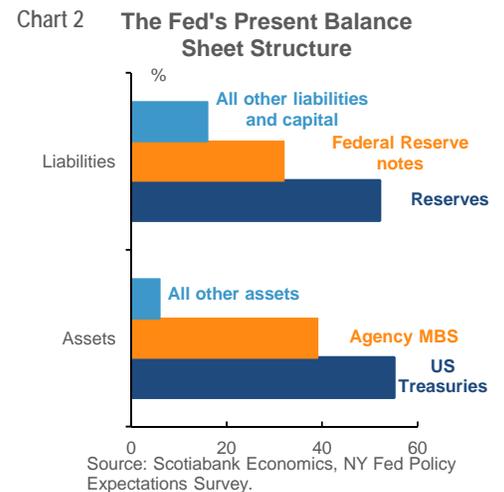
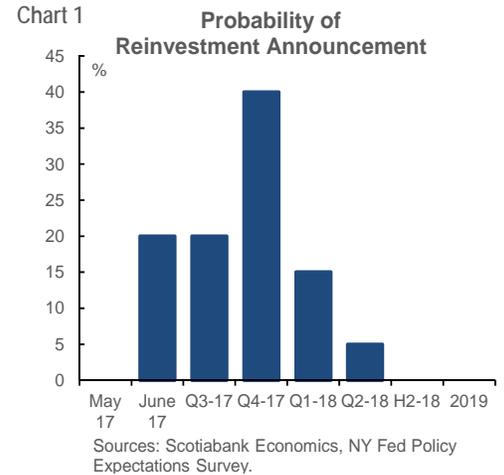
There are also enough question marks to merit a patient data-dependent posture. One is soft economic growth in Q1 despite evidence that business investment is slowly on the mend. The fact that it was consumer spending that was so weak in Q1 works against residual seasonality arguments affecting GDP in many first quarters over the years in that there is little to no evidence of residual seasonality in consumption. It is possible that the Fed moderates its prior reference to how household spending has “continued to rise moderately”. Another factor is what the Treasury market may be telling policymakers and investors. The ten year Treasury yield peaked at 2.63% two days before the Fed hiked on March 15th and has since shed 32bps. The lack of clarity on other fiscal, trade and regulatory policy measures in Washington also remains unhelpful to the Fed’s task of deciphering risks to the economic outlook.

It’s likely that the main change will be to wording surrounding reinvestment policy in favour of some style of “later this year” statement-codification of guidance provided in the minutes to the March 14–15th meeting. Markets would then be formally on notice to watch for a future change in language that makes a policy shift toward reducing reinvestment of maturing Treasuries and MBS flows sound more imminent. It’s unlikely that the Fed will move toward phasing out reinvestment as soon as the June or July meetings if it adds “later this year” to next week’s statement. Indeed, we would take such a reference as confirmation—for now—of our base case view that the Fed announces and implements a policy of partial reinvestment at the December meeting (chart 1).

The debate on when to begin scaling back reinvestment drives the outlook for the Fed’s balance sheet. We assume that once it is announced, reinvestment will be phased out gradually, over a period of 6 to 12 months, likely at a pace of reduction equal to an average of \$5–7 billion per month for each of Treasuries and MBS simultaneously. It is not clear whether a dollar amount of the reduction is suitable or a percentage amount, as the amounts to consider reinvesting vary from month to month both in terms of MBS (prepayments) and Treasuries (volume of maturities). The Fed has provided inadequate guidance on this issue. As reinvestment phases out, and assuming no asset sales, the shape of today’s Fed balance sheet (chart 2) will undergo dramatic change. Treasuries will become a greater share of the shrinking balance sheet we project to fall to US\$2.5 trillion by 2025 from US\$4.48 trillion at present. Reserves will shrink back to pre-crisis levels driven primarily by currency in circulation, while Federal Reserve notes will sharply rise as a share of liabilities and capital (chart 3). What would derail such change would be anything short of steady state assumptions on the economy and markets.

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