# Fed Preview: The Great Unveiling?

- **Dot plot to push back against rate cut pricing;**
- **The Fed's revised balance sheet strategy may well be presented;**
- **Padding required reserves could provide cover for a late year hike.**

**The Federal Reserve will be the main focal point when it issues a decision and broader communications next Wednesday.**

Trying to find new ways to say they're not doing anything for a while, refreshing macro forecasts and presenting a new dot plot would be a tall enough order for the FOMC to deliver upon next Wednesday. **The added twist could come from more detailed guidance on balance sheet plans.**

## THE FOUR BUZZWORDS

Before turning to the balance sheet, core Fed expectations include repeated reference to "watching," "waiting," "patient," and "flexible" as the Fed evaluates what it has described as "crosscurrents and conflicting signals" in the global economy. They include matters like Brexit, US-China trade talks, the risk of auto tariffs, the outlook for the US budget and funding matters tied into the debt ceiling among other factors beyond baseline global fundamentals. Reference to job gains as "strong" could be softened in the wake of February's payrolls disappoint, but it may be premature given the prior months' overshoot. Projected GDP growth is likely to be softened a touch at least in 2019 to acknowledge a weaker starting point and forecast uncertainty but there may be little need to materially alter inflation projections.

## TAMPED DOWN DOTS, BUT NO CUTS

**The Summary of Economic Projections of FOMC members is also likely to tamp down the dot plot somewhat but I would be surprised to see hikes entirely removed from the projection horizon.** I expect the dot-plot to contradict market pricing in fed funds futures toward possible rate cuts. Instead of two hikes in 2019 as in the December dot plot, the FOMC median estimate may show one hike which is Scotia's house forecast for late this year, and then one more hike in 2020 as they currently show which is also our house forecast. After that, the dot plot may show the policy rate flat-lining around a 2.875% mid-point of the fed funds target range. It is also unlikely that the neutral policy rate over the long-run will be altered from 2.75% at present. **The main message should be that the Fed doesn't think it is done hiking but is nearing an end and is patient toward timing the next move.** To repeat, whatever they do precisely with the dots, I don't expect any median consensus forecast in favour of market pricing for policy easing.

## BALANCE SHEET STRATEGY

**The greater intrigue may surround whether the Fed does a deeper dive into its plans for the balance sheet.** Recall that at the January 30th–31st meeting, the minutes (recap here) indicated the following:

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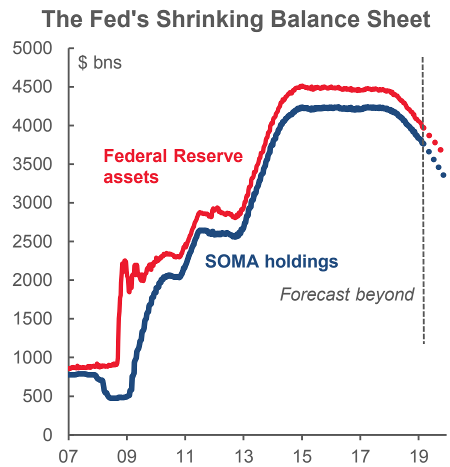
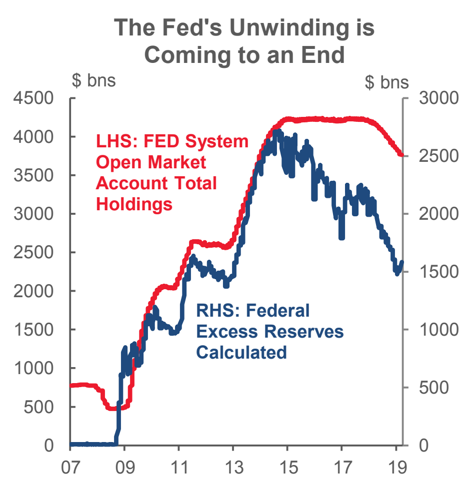
Chart 1




Sources: Scotiabank Economics.

Chart 2




Sources: Scotiabank Economics,, Bloomberg.

> "Almost all participants thought that it would be desirable to announce before too long a plan to stop reducing the Federal Reserve's asset holdings later this year."

Then more recently, Chair Powell stated:

> "We've worked out, I think, the framework of a plan that we hope to be able to announce soon, that will light the way all the way to the end of balance sheet normalization."

**It is therefore feasible that the outlines of the revised balance sheet plans will be shared as soon as next week while reinforcing that the unwinding of the balance sheet will be halted later in the year.** The Fed may retain its optionality by not mentioning a specific date for ending unwinding which would be consistent with prior uses of later in the year references such as in the initial stages of tapering asset purchases. Nevertheless, why declare that the framework has been broadly agreed upon only to keep it a mystery? Announce in March, implement as soon as September or possibly later.

## TIMING THE FED'S TARGETED BALANCE SHEET AND RESERVES

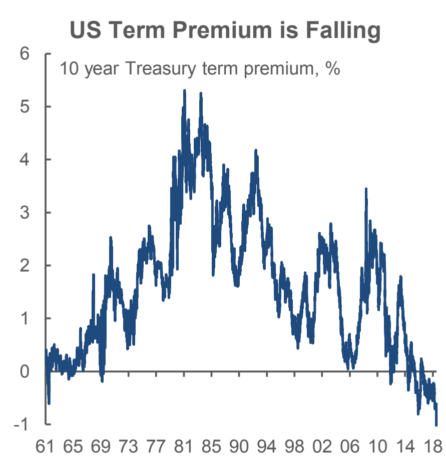
**Why implement in September or possibly later?** Powell's guidance has indicated two things. First, that he thinks the present US$4 trillion balance sheet is likely to settle in around 16–17% of GDP when reduction ends. At a projected roughly US$21.4 trillion US economy in nominal GDP terms this year using Scotiabank Economics' forecast, this target equates to **a balance sheet of around US$3½ trillion**. I figure the Fed would hit that level toward year-end at the present pace of run-off given the present caps on US$30 billion of reinvested Treasuries subjected to maturing flows and US$20 billion on MBS each month (chart 1).

**Second, Powell has guided that the optimal level of reserves in the system is uncertain but that US$1 trillion plus a buffer is a "reasonable starting point."** It is important to acknowledge that there is so much guesswork involved when estimating optimal reserves that padding guesstimates and not risking going too low is the order of the day; the Fed significantly relies upon surveys of US primary dealers including our answers. Chart 2 depicts the drawdown of reserves that banks hold at the Fed and the shrinking size of the Fed's System Open Market Account (SOMA) through which they directed purchases of Treasuries, agencies and mortgage bonds during QE1–3. From about US$1.6 trillion now, a continuation of the recent pace of unwinding could risk bringing reserves down toward the US$1 trillion level and hence back to 2010 levels into early 2020. **This removal of liquidity could be too rapid from the standpoint of the proper functioning of markets.** Stopping before year-end perhaps around September would be more consistent with Powell's guidance.

## WHY PAD RESERVES?

**This action should not be taken as a negative signal toward the outlook so much as it is an indication that the Fed is highly uncertain about the optimal level of reserves and wishes to err on the side of overestimating them from a risk management standpoint.** Shrinking the balance sheet by reinvesting less out of coupon and maturing flows from Treasuries and MBS drains reserves from the banking system. Draining reserves runs against the need for banks to hold high quality liquid assets including through but not limited to the impact of the Liquidity Coverage Ratio (LCR). **Draining reserves too far and too fast risks negative effects upon markets by motivating banks to substitute holdings away from other less liquid assets in order to maintain required liquid holdings, or to sell other assets to buy Treasuries that are also favoured by the LCR.** Hence the cross-asset class implications that highlight the interconnectedness of regulatory change with unwinding unconventional stimulus and how the effects can distort market appetite toward safe havens. **This mechanism can be destabilizing to markets and spark greater disturbances in short-term rates markets** even if the effects of unwinding the balance sheet are not showing up in a reversal of the Treasury term premium (chart 3). For a good discussion of how the Fed views related topics see the recent speech by Vice Chair Quarles here.

Chart 3




Sources: Scotiabank Economics, New York Federal Reserve.

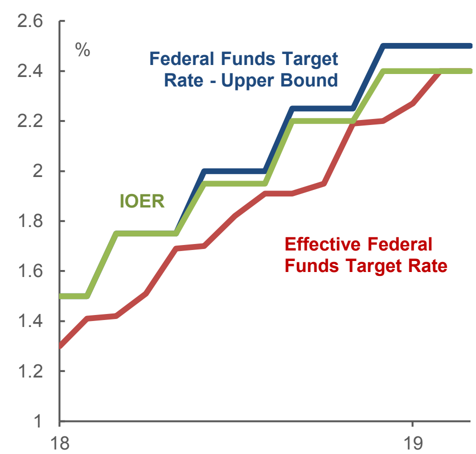
**Further, padding reserves and ending balance sheet unwinding earlier than perhaps necessary could connote greater flexibility to tailor future rate hikes toward an expected improvement in the outlook.** Scotia anticipates a rate hike in December.

## OTHER BALANCE SHEET DETAILS

Amidst the uncertainty, **Powell could well wind up saying that they're not quite ready to announce a full balance sheet strategy next week because important details need to be worked out, but he could outline more of the parameters.** For instance, the Fed has long guided that ultimately they want the balance sheet to be mostly comprised of Treasuries but a) will they sell MBS holdings outright to get to this point and over what time frame, and b) will their holdings of Treasuries match the duration of outstanding securities or will they be skewed toward shorter or longer maturities? Recall minutes to the December FOMC meeting at which **'several' preferred shortening maturities of Treasuries being held** to "provide greater flexibility to lengthen maturity if warranted by an economic downturn." The prospect of a 'twist' of sorts to Treasury holdings could not only serve the purpose of being able to ramp up longer term Treasury holdings in the event of a future downside surprise to the economy, but also first serve the purpose of steepening the curve.  Also recall that those same minutes noted that on managing the MBS portfolio over the longer run, 'several' suggested reducing agency MBS holdings "somewhat more quickly than the passive approach" by selling MBS "sometime after the size of the balance sheet had been normalized."

Finally, the Fed's revised plans may include discussion or possible roll-out of a **standing repo facility** designed to offer funds toward the purpose of controlling short-term market rates around the interest on excess reserves rate and its spread to fed funds given past pressures (chart 4). This would build upon efforts to contain potential upward pressure upon money market rates as excess reserves decline. Recall that the minutes to the December FOMC meeting indicated **there was a discussion about how to keep the effective fed funds rate within the FOMC's target range as reserves are drained** from the system beyond utilizing IOER cuts relative to the upper limit including adding new counterparties to the Open Market Desk's operations. On managing potential upward pressure upon money market rates as excess reserves decline, 'several' participants flagged using IOER technical adjustments, 'some' advocated slowing the pace of decline in reserves using standard open market operations, or ending portfolio redemptions at relatively high reserves. 'Several' participants were concerned that slowing redemptions "could be misinterpreted as a signal about the stance of monetary policy."

Chart 4 EFF and IOER




Sources: Scotiabank Economics, Bloomberg.