CAPITAL ADVISORS

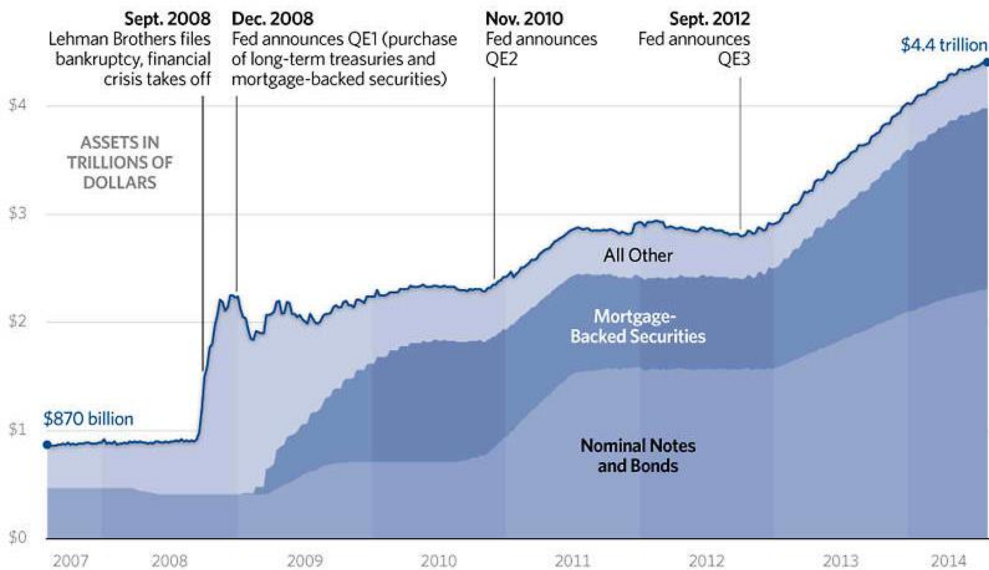
RESEARCH UPDATE
July 17, 2017

Federal Reserve (Fed) Balance Sheet Reduction

Much has been discussed about what the Fed will do to unwind its easy monetary policy. Up until this point, all that has been done has been four 0.25% increases in the interest rate at which banks lend reserves to each other overnight, or the "Fed Funds Rate."[1] More recently the Fed has turned some of its attention to a gradual unwind of its balance sheet. Goldman Sachs recently projected the central bank will ultimately shrink its balance sheet by just $1.1 trillion, or about 25%, a process that would take until late 2020.[2] **Capital Advisors believes this is likely to be a very gradual process, and clients should not fear this unwind.**

The Fed's balance sheet currently holds approximately $4.4 trillion in assets, about the same level as represented below in 2014 after multiple rounds of Quantitative Easing (QE). The majority of its holdings consist of U.S. Treasuries (TSY) and Agency Mortgage-Backed Securities (MBS).

Federal Reserve Balance Sheet Expansion
9-30-07 to 8-04-14



Source: Board of Governors of the Federal Reserve System, "Credit and Liquidity Programs and the Balance Sheet: Total Assets of the Federal Reserve," http://www.federalreserve.gov/monetarypolicy/bst_recenttrends.htm (accessed August 5, 2014).

In June the Fed laid out its plans to "normalize" its balance sheet, which it expects to reduce by trimming reinvestments in TSY at a rate of $6 billion per month initially, and MBS at $4 billion per month, or a total of $10 billion per month. The Fed expects to increase the reinvestment caps in steps of $10 billion at three month intervals over 12 months until it reaches a total of $50 billion per month.[3]

Please see back page for disclosures

[1] Source: Bloomberg
[2] Source: Goldman Sachs
[3] Source: Federal Reserve

The Federal Open Market Committee currently anticipates reducing the asset base, over time, to a level appreciably below that seen in recent years, but larger than before the financial crisis. With a tremendous amount of liquidity in the global financial system, a reduction in Fed demand for these high quality securities should be absorbed by a myriad of global investors whose alternative may be near-zero yields abroad.

We looked back to where we were prior to the third round of QE in September 2012, when the Fed's balance sheet was close to Goldman's projected terminal balance. It is interesting to note that **Treasury yields were approximately 0.70% lower in yield than they are today.** Moreover, both growth and inflation measures were higher than the level of activity today. The major improvements lie in the jobs and equity markets, where significant gains have been made.

	Sept 30, 2012	July 13, 2017	Difference
Unemployment Rate	7.8%	4.4%	-3.4%
Inflation - Consumer Price Index (CPI)	2.0%	1.7%	-0.3%
Growth - Gross Domestic Product (GDP)	2.4%	2.1%	-0.3%
10-year Treasury Yield	1.6%	2.3%	0.7%

Source: Bloomberg

The point of all of this is to note that **a gradual reduction in the balance sheet need not cause a massive increase in the level of interest rates.** Although we are arguably in a better global position than we were five years ago, much of what drives yields is real economic growth and pricing pressures, something we are yet to witness at levels that should impact interest rates too dramatically.

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