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EX FORUM

Of Markets and Market Participants

ON THE FED'S BALANCE SHEET NORMALIZATION

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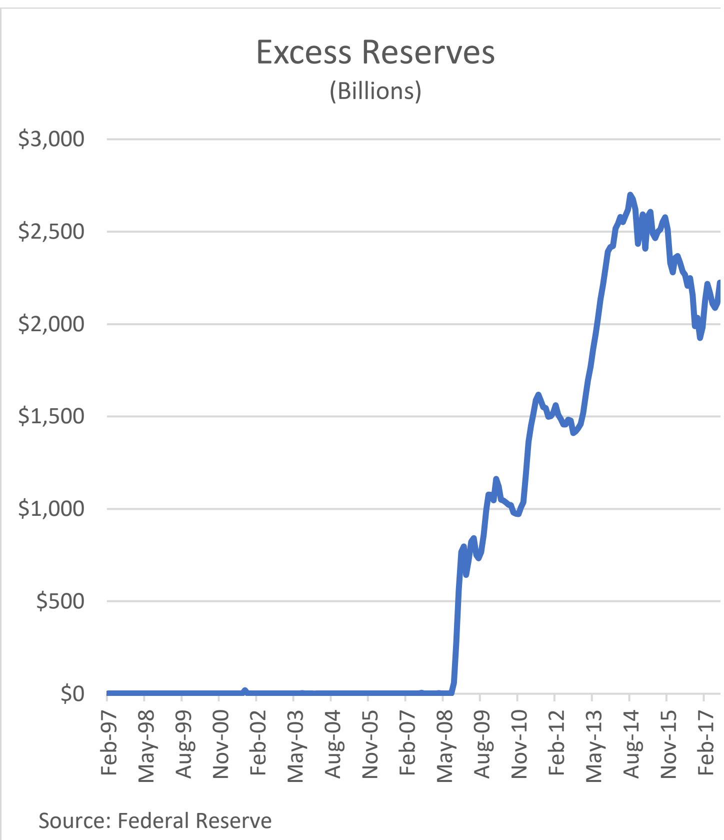
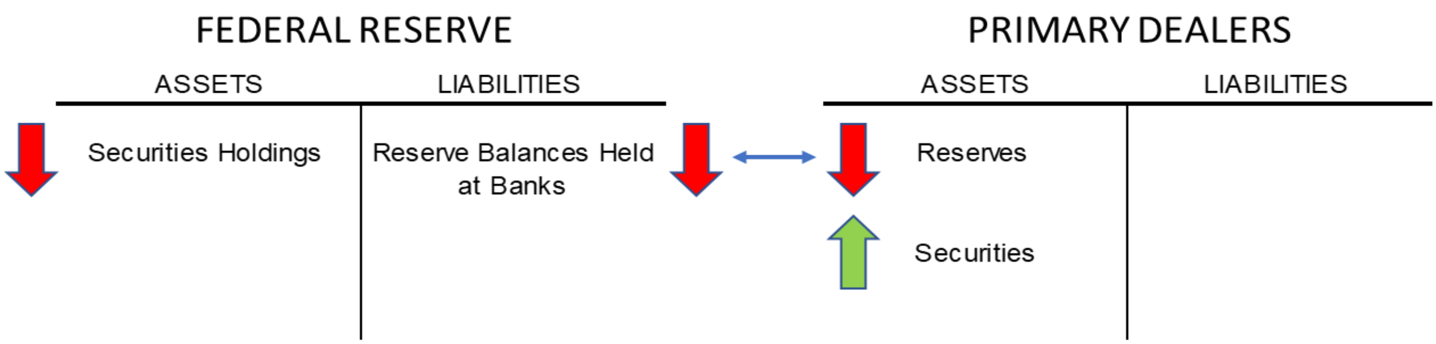
As the Fed continues its path to normalization, their past securities purchases still sit on its inflated balance sheet—now at $4.4 Trillion. Excess Reserves in the banking system are a direct result as the liabilities were created *ex nihilo* to produce an asset for banks dealing with the Fed. These reserves distort the markets determining interest rates—to a degree which nobody knows. In other words, an abnormal amount of money seeking a place to earn interest overnight would continually push rates lower as there is little demand to borrow (due to the surplus). This lack of responsiveness to money supply in the market is why the Fed has created a "floor" to set interest rates (See September 5th *Ex Forum*). The next step is to reduce the size of the balance sheet, ergo reduce the excess funds in the system to create a more balanced market for setting overnight interest rates, and re-establish their traditional ways of implementing monetary policy.



This reduction is not an overnight process (no pun intended). In recent times, the Fed has been held captive by market participants and expectations. They are reluctant to create any negative disruptions within the market. Although positive market influence is always welcome at their convenience, when the action needs to be reversed, they slowly tip-toe their way out by "signaling" their steps. This allows the market to come to terms with the plan. As any economist, they are well-trained in adaptive expectations. No matter what the plan, their models tell them the market can be assuaged into an orderly rise in rates. There is no need for formulaic justification, they suspect, as they believe that market participants' impulsive reactions can be blunted with enough foreshadowing. It is an elegant strategy, but **reducing the size of a balance sheet nearly 23% of GDP will certainly create externalities**, and its influence in the markets, which have become accustomed to the Fed demand, will be tested.

Although the scheduled purchases have ended, the Fed is still buying securities to maintain the size of the balance sheet. If they do not tend it, the balance sheet will naturally dwindle from maturities and amortizations of mortgage securities. Remember, this is no ordinary balance sheet where a maturity of a bond simply moves to the cash line item, resulting in no change. Since the Fed paid for the asset by creating a liability to the seller, the principal payment of the bond will simply remove that liability (a reduction in reserves). Both sides of the ledger will be reduced. In essence, the maturing bond demands someone to rollover the debt; The private sector is now depleting its funds to refinance the Treasury or GSE rather than the Federal Reserve. As these bonds pay down, the balance sheet will decrease at a semi-predictable rate, barring any large moves in interest rates.

After years of proposing different exit strategies, the Fed announced their plan this past month. They are using "caps" to smooth the reduction of the balance sheet. These "caps" in both Treasuries and Mortgages represent what they will not re-invest, i.e. the amount that the balance sheet will "run-off." The initial caps are: $10 Billion a month ($6 Billion in Treasuries and $4 Billion in Mortgages) and will increase every three months by $10 Billion until they reach $50 Billion each month ($30 billion of Treasuries and $20 Billion of Mortgages). In fifteen months, the caps are planned to be above the typical paydown and maturities, and would only occasionally affect the schedule. The reduction in the size of the balance sheet would be subject to the cash-flow schedule of the holdings. In about 4 years, their balance sheet is predicted to be "normalized."



In the graphic above, you can see the initial moving parts in this process. Reserves are going down between both counterparties, while the net result is securities being transferred to the primary dealers' balance sheets. The ultimate home of these securities is yet to be seen, but just as the dealers acted as conduits to create the balance sheet, they will play their role to "normalize" the Fed's balance sheet. Many predict that these large institutions will hold a portion to comply with liquidity regulations. Either way, you can see that the financing of this portion of Treasury and Agency debt will no longer be the onus of the Fed, rather the private sector must pay for it.

There is no doubt that this unconventional monetary policy has painted the Fed into a corner they are trying to escape. In an overt attempt to "signal" to the market that there is nothing to see here, Chairman Yellen likened the balance sheet portfolio reduction as "watching paint dry." In this process of shifting $2 Trillion of debt into other creditors' hands, they are taking all precautions as they try to lead the market into a complacent view of this extraordinary re-allocation. If everything goes according to plan, it would be quite a feat. And even though it will likely start at a few billion a month, ultimately, the largest buyer of Treasuries and Mortgages will be cutting their holdings by over $2 Trillion in the next few years. The debt markets seem to be taking this all in stride—for now.

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