

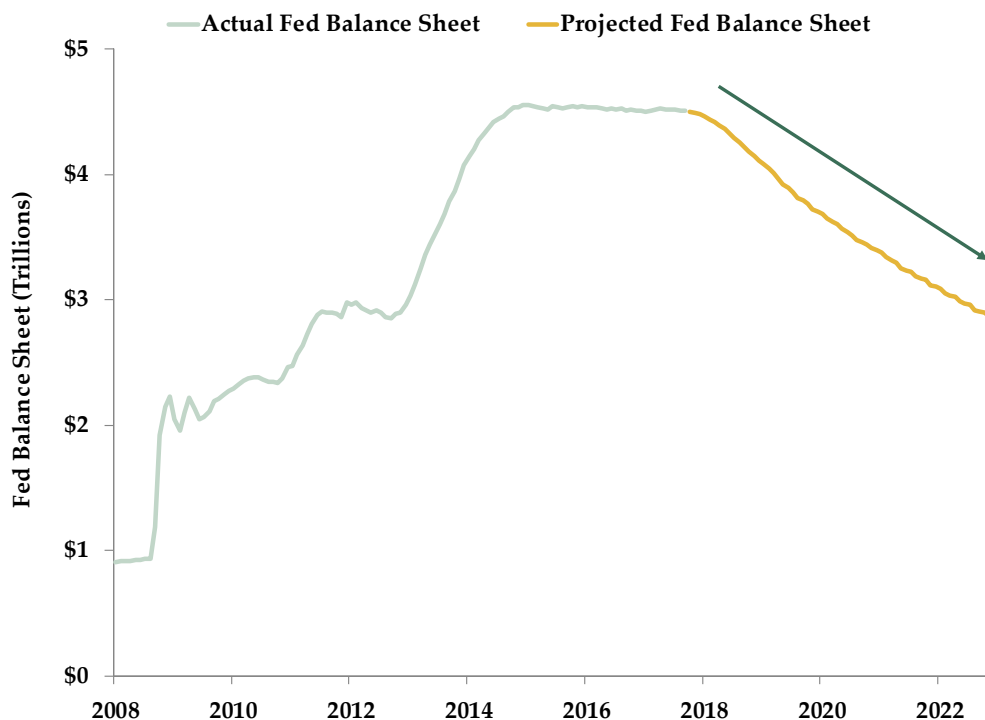
Unwinding of the Fed Balance Sheet

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In October 2017, the Federal Reserve began the process of unwinding its balance sheet. It will now begin to let a portion of the long-term Treasuries and mortgage-backed securities mature off its balance sheet without reinvesting the proceeds. While many investors continue to speculate about the downstream effects of this unwinding, the planned rate of reduction is slow. We do not believe this will be detrimental to money supply or lending in the US, nor do we believe it will put significant upward pressure on long rates.

The Fed has been very transparent about their plan. In October it started letting up to \$10 billion of assets (0.2% of its \$4.5 trillion total assets) go un-reinvested each month (\$6 billion in US Treasuries; \$4 billion in mortgage-backed securities). It will raise that monthly cap by \$10 billion once a quarter until it reaches \$50 billion in Q1 2019. At that point, assuming the Fed has not changed course, it will let the balance sheet shrink by up to \$50 billion monthly (\$30 billion in US Treasury's; \$20 billion in mortgage-backed securities) until an unspecified time in the future.

Exhibit 1: The Federal Reserve's unwinding will be slow and steady.



Source: FactSet, total assets supplying reserve funds (trillions, USD) from 1/1/2008 to 31/10/2017, projected from 31/11/2017 to 31/12/2022.



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Many believe this unwinding will contract money supply and stifle lending. However, we don't believe purchasing these assets under quantitative easing (QE) encouraged lending in the first place, as it reduced banks' profits by pushing down long term rates and flattening the yield curve. While QE's bond buying injected huge quantities of money into banks' excess reserves, most of those funds did not make their way into the broader economy (Exhibits 2 & 3). The Fed relies on banks to extend loans to increase the quantity of money, but loan growth has been historically weak during this cycle. Money supply and loan growth actually started accelerating after the Fed ended QE (Exhibits 3 & 4). Therefore, moving further past QE with Fed balance sheet normalisation should not be feared.

Exhibit 2: QE increased Banks' excess reserves...

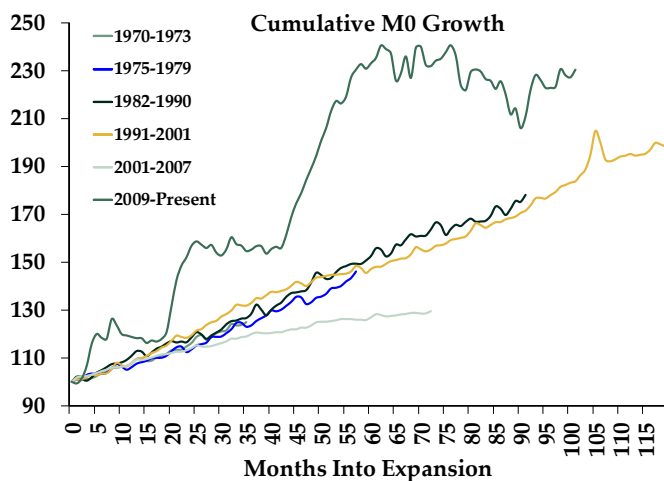


Exhibit 3: ...But those excess reserves did not lead to money supply growth.

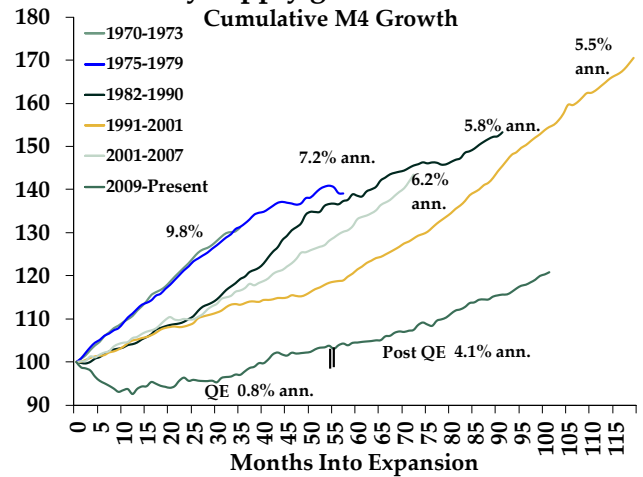
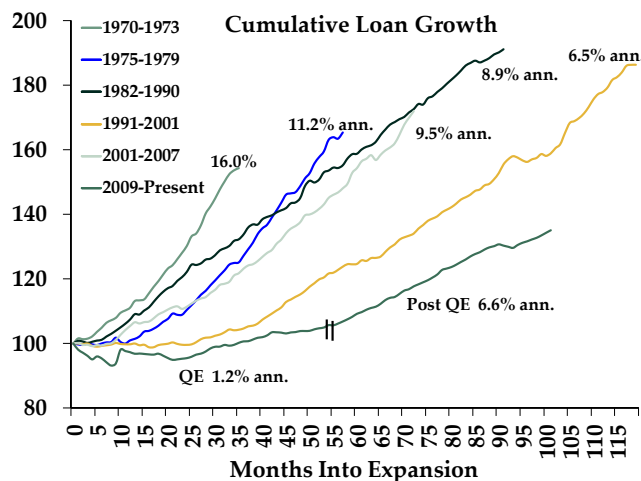


Exhibit 4: Loan growth actually accelerated after Fed tapering



Source: Federal Reserve and Centre for Financial Stability as of November 2017.

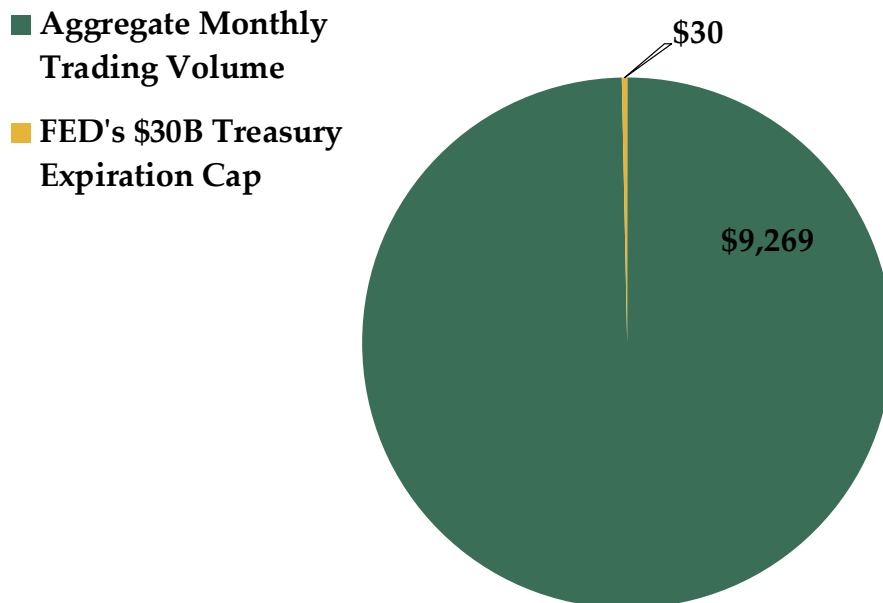


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If anything, balance sheet reduction should positively contribute to the yield curve spread, as increasing bond supply – all else equal – puts slight upward pressure on bond rates. However, the slow rate of unwinding likely mitigates this impact. The Federal Reserve will likely still buy some long-term Treasuries and mortgage-backed securities to replace maturing ones – just fewer than before. If they stick to their current plan, in 2019 they should reach their cap of allowing \$30 billion in Treasuries to go un-reinvested each month – only .3% of US Treasury's aggregate monthly trading volume (Exhibit 5). This should not be significant enough to have a huge impact on long-term rates.

Exhibit 5: Fewer Federal Reserve buys are insignificant in the highly liquid Treasury market



Source: *The securities Industry and Financials Markets Association; US Treasury average daily trading volume from 30/09/2007 to 31/08/2017.*

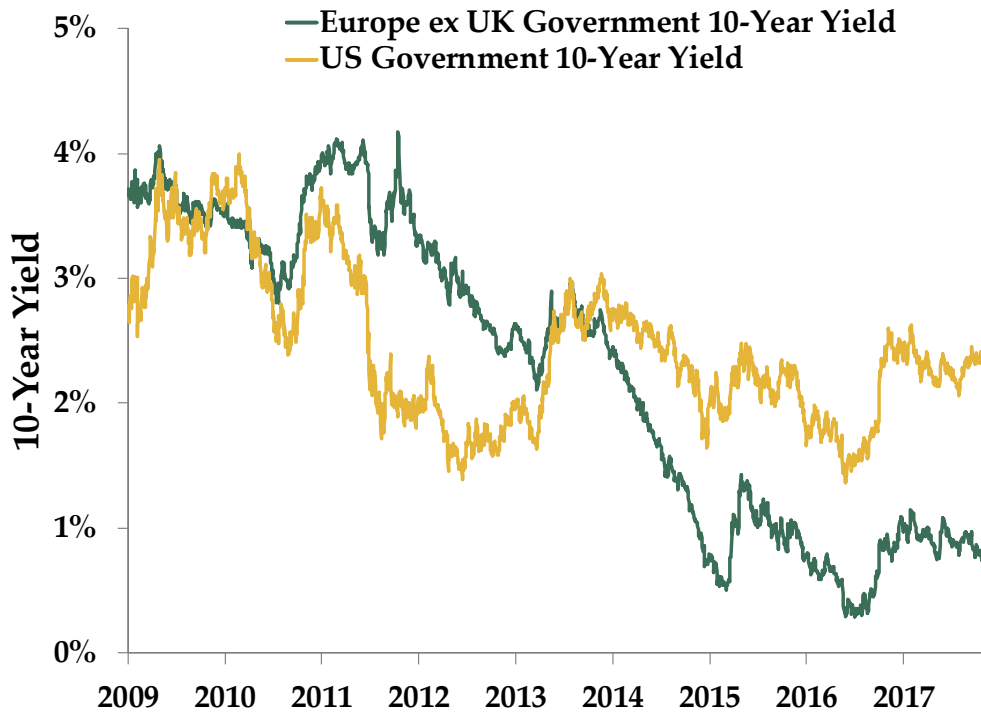


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Moreover, long-term rates should continue to face downward pressure from non-US demand for higher yields (Exhibit 6) and the disinflationary effects of recent Fed rate hikes.

Exhibit 6: US yields face downward pressure from Non-US demand for higher yields



Source: FactSet, as of 31/12/2017. Europe ex UK is GDP Weighted 10 year yield.

To conclude, although fears of unwinding persist, we believe the Fed's current plan for balance sheet reduction is too gradual to materially impact markets. The Fed's charting of a stable, predictable course weakens the surprise power needed to move markets and perhaps slightly eases the risk of a sudden monetary policy error. While the risk of Fed missteps always exists, we do not see balance sheet slimming as a reason to fear.



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Source: Fisher Investments

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