Fed Balance Sheet May Shrink By $100 Billion A Month, Adding To Stock Market Risk

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04:28 PM ET 01/13/2022

The Federal Reserve gave the stock market a jolt on Jan. 5 when minutes from the December meeting revealed a consensus that Covid-era asset purchases should unwind sooner and at a faster pace than they did after the last crisis. Now, as the major indexes recover, a key question is whether there will be further shocks in the next few months as the Fed spells out its plan for shrinking its balance sheet.

Wall Street economists are beginning to place their bets, framing a baseline view of what to expect from the Fed's quantitative tightening — the use of its balance sheet rather than its benchmark interest rate to tighten policy. They're also offering some hints about what it might mean for the economy and financial markets.

On Thursday, economists from Deutsche Bank and Nomura wrote that they expect the Federal Reserve to announce their decision to begin shrinking the balance sheet in July. However, Deutsche Bank chief U.S. economist Matthew Luzzetti and rates strategist Steven Zeng noted a risk that the Fed brings forward the start of QT to June, which "could lead to a stronger market reaction."

Fed chief Jerome Powell said in his Dec. 15 news conference that policymakers will decide "in coming meetings" what to do with the $4.5 trillion worth of Treasuries and government-backed mortgage securities purchased since the start of the pandemic. The final purchases will wrap up in March.

Unless the Fed makes a decision to reinvest all of the principal as the bonds mature, the balance sheet will naturally shrink.

Pace Of Federal Reserve Balance-Sheet Runoff

The pace of balance-sheet runoff will be another key policy decision that the stock market and bond market will have to digest. During the previous QT episode from 2017 to 2019, the Federal Reserve started unloading $10 billion in assets per month and gradually lifted the cap to $50 billion per month a year later.

In a Jan. 6 note, Bank of America economist Aditya Bhave said the Fed could begin its balance-sheet unwind in October. The pace could start at about $17.5 billion per month and rise to $70 billion by the start of 2023.

However, Deutsche Bank economists are expecting a more rapid wind-down, starting at $35 billion per month in August and reaching $105 billion per month by December.

JPMorgan predicts that QT will start in July, reaching a $100-billion monthly pace by year-end.

In a Reuters interview, Atlanta Fed President Raphael Bostic, who is in a nonvoting role this year, said he'd like to see the balance sheet shrink by $100 billion per month.

QT = Rate Hikes

Unlike the last cycle, Federal Reserve policymakers are now discussing balance-sheet reduction as complementing or even serving as an alternative to interest-rate hikes. Minutes from the Dec. 14-15 meeting indicated that "some participants" saw tightening more via balance sheet-reduction than rate hikes "could help limit yield curve flattening."

Short-term government bonds move in tandem with rate-hike expectations, but long-end Treasury yields can often fall as short rates rise, flattening the yield curve. That can happen, for example, if markets think that hawkish Fed policy will slow the economy.

One takeaway is that a reliance on QT rather than rate hikes is positive for financial firms' net interest margins.

Another possible takeaway is that Fed interest-rate projections may understate the amount of tightening on the way. December economic projections, which are already a bit dated, showed that Fed members expected the benchmark rate to rise from a target range of 0%-0.25% now to 1.5%-1.75% at the end of 2023 and 2%-2.25% in 2024.

The appearance was dovish, with members seeing their policy rate below the long-term neutral rate of 2.5%. But Deutsche Bank economists postulated that Fed members saw QT as a substitute for rate increases, to some extent. They figure that a $1.5-trillion reduction in the balance sheet by the end of 2023 would equate to between 2.5 and 3.5 quarter-point rate hikes.

Is QT Riskier For Stock Market Than In 2018?

Last time around, QT went off without any issues for the first year, even as the Federal Reserve accelerated its rate-hiking plans to get ahead of a potential rise in inflation that never happened. But the stock market tanked in the fall of 2018, flirting with bear-market territory. Eventually, the Fed signaled retreat in early 2019, as rate hikes turned to rate cuts and QT gave way to more bond purchases.

"In dealing with balance sheet issues, we've learned that it's best to take a careful sort of methodical approach," Powell said at his Dec. 15 news conference. "Markets can be sensitive to it."

Those lessons learned and deference to Wall Street might soothe investors. However, it was a pretty simple matter for the Fed to backpedal in early 2019 since inflation was tame.

"Where this period could eventually be more serious than in 2018 is the fact that inflation is now a serious issue," Deutsche Bank strategist Jim Reid wrote. "This could reduce the ability of the Fed to pivot on a dime if financial conditions deteriorate sharply."

The Federal Reserve could offer more clarity on balance sheet plans at the Jan. 25-26 meeting and in Powell's post-announcement news conference.

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