

CORNERSTONE MACRO

Economics, Policy, Strategy & Technicals

**FEDERAL RESERVE BANK OF NEW YORK
COLUMBIA UNIVERSITY'S SCHOOL OF INTERNATIONAL AND PUBLIC AFFAIRS**

Normalizing Central Banks' Balance Sheets: What Is The New Normal? Strategic Issues

JULY 11, 2017

Roberto Perli

Founding Partner and Head of Global Policy Analysis

Copyright 2017 Cornerstone Macro. All rights reserved. This report is prepared exclusively for the use of Cornerstone Macro institutional clients and may not be redistributed, retransmitted or disclosed, in whole or part, or in any form or manner, without the express written consent of Cornerstone Macro.

KEY POINTS

1. Fed communication seems to have been very good of late:

- Balance sheet reduction being treated by markets very differently from QE tapering;
- But some luck may have helped as well.

2. Could the way in which messages are communicated make a difference?

- “Autopilot” vs. data-dependent balance sheet changes;
- Are we seeing some evidence of markets supporting the “signaling” view of QE?

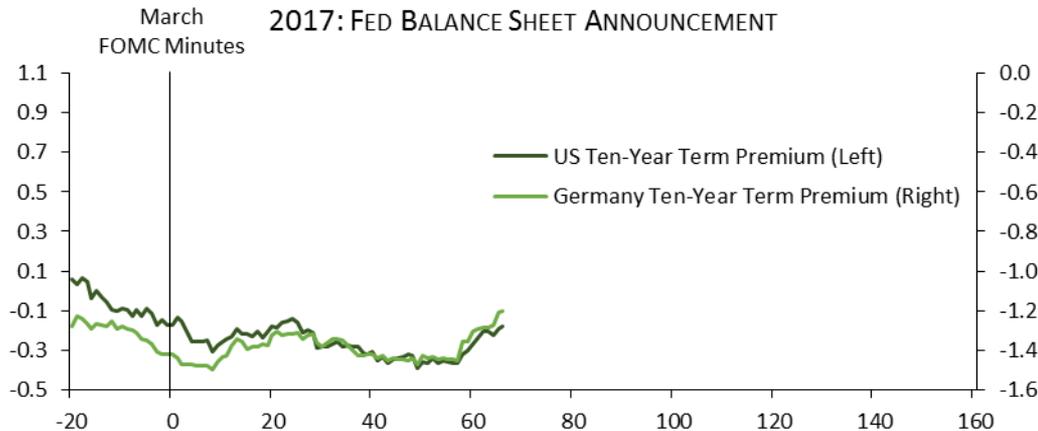
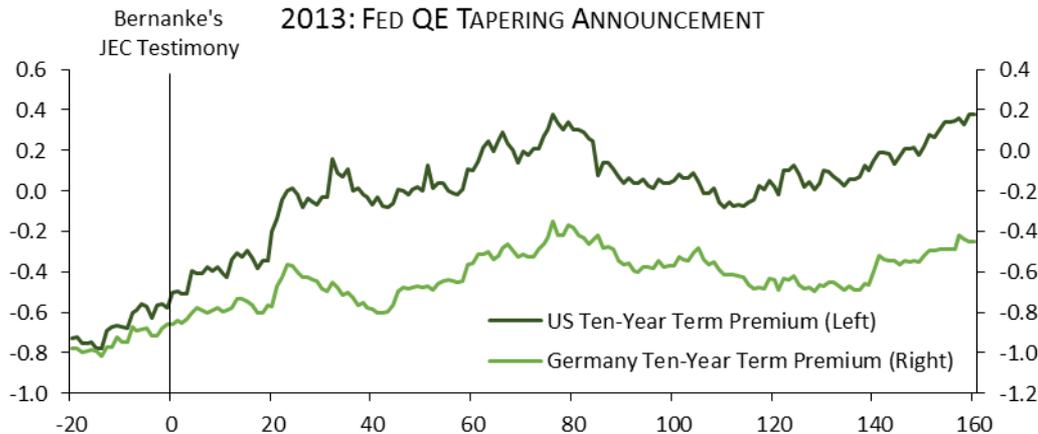
3. There are still several things the Fed should let markets know:

- The future composition of its liabilities and the “right” size of the balance sheet the Fed has in mind are important.

4. Interaction of balance sheet developments and financial stability:

- Availability of high-quality liquid assets will be affected – unclear how;
- The larger the balance sheet, the better.

COMMUNICATION MATTERS – PART 1



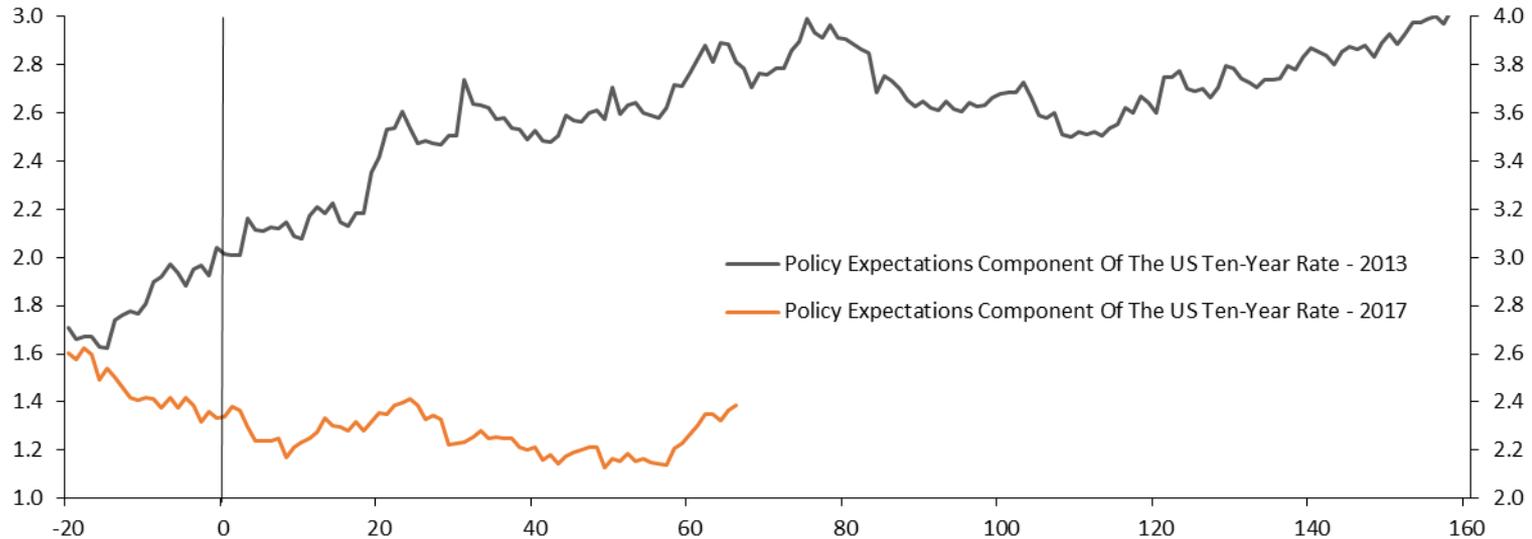
Chairman Bernanke's JEC testimony on May 22, 2013 caught investors by surprise (even though it shouldn't have):

- The ensuing "taper tantrum" pushed up the US ten-year term premium by almost 90 bps in less than 3 months;
- Term premium for "substitute" securities (e.g., German Bunds) moved up too, albeit less.

An equivalent point for a change in reinvestment policy was the release of the March FOMC minutes on April 5:

- "Most" participants wanted to start reducing reinvestments "this year;"
- But the public discussion started long before then;
- And "later this year" made it clear a change was not imminent.

COMMUNICATION MATTERS – PART 2



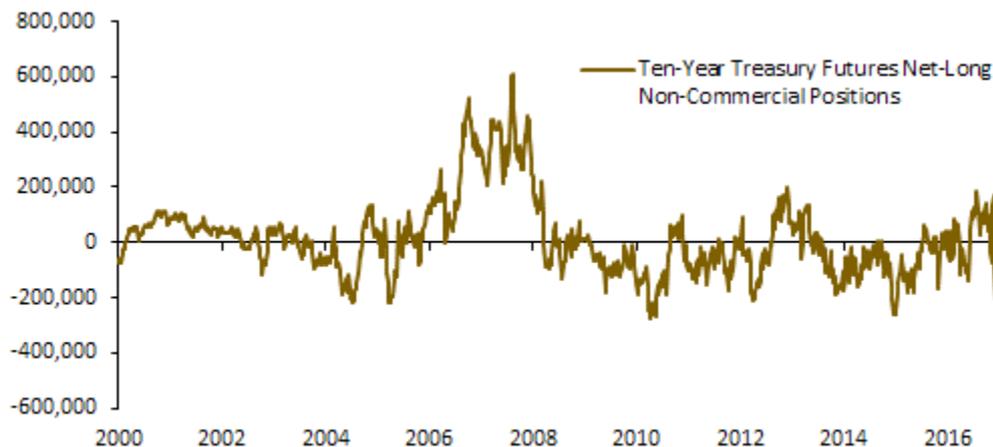
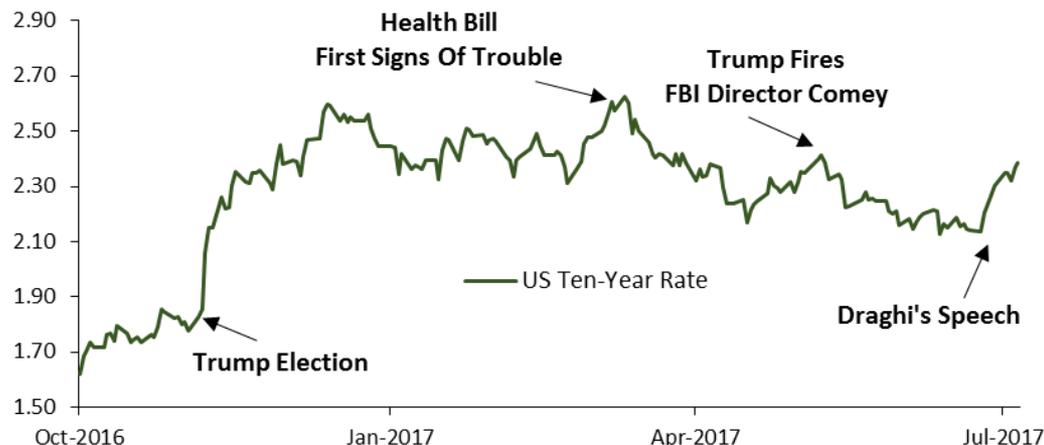
In 2013 the market mixed up QE tapering signals with signals about rate hikes. In 2017 it didn't:

- Careful and consistent recent communication about rate hikes on the part of the FOMC (the “dots” have barely changed since December);
- Rate hikes have been under way for a while, so no need to guess the onset of rate hikes;
- Communication about the importance of the low neutral rate, so no need to fear large moves by the FOMC;
- **Overall better understanding of the Fed's policy framework, thanks to clear communication.**

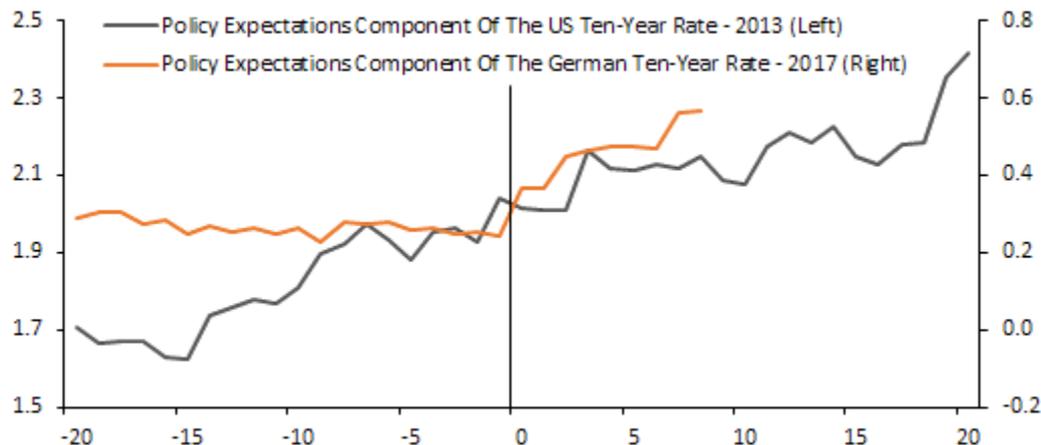
GOOD LUCK MATTERS TOO...

Immediately after the election, the bond market priced in substantial hopes that the Trump Administration would implement policies that could change the outlook for the US economy.

- Those hopes lasted until the spring, when the troubles with the health care bill became evident in the House;
- The firing of FBI Director Comey, the intensification of the Russia investigation, etc. also helped quash those hopes;
- **Bond investors went from massively short to massively long, and pushed down yields in the process, masking whatever (small) balance sheet effect there was.**



BUT WHAT ABOUT WHAT'S HAPPENING IN EUROPE?



It's very early to tell for sure, but the initial signs are that the market is reacting to Draghi's June 27th speech just like it reacted to Bernanke's testimony in 2013:

- Term premiums are going up;
- Rate expectations are going up as well – the market is not convinced about ECB's forward guidance;
- **Might support the “signaling effect” view of QE.**

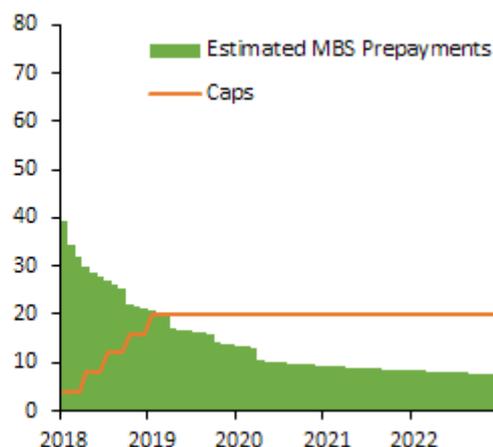
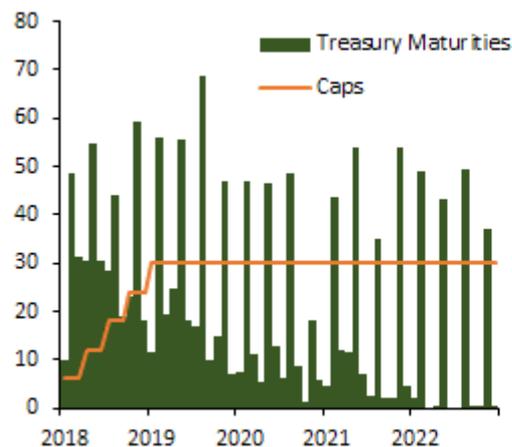
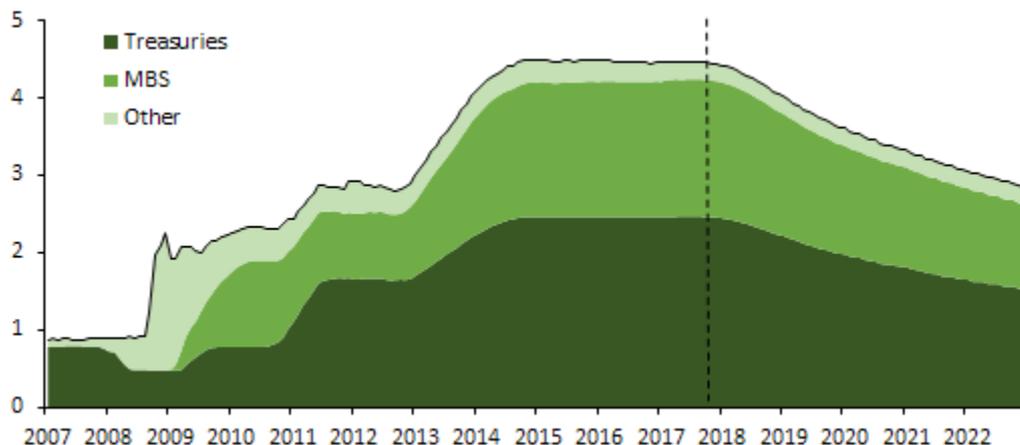
Why then is the market taking no signal from the Fed's balance sheet shrinking?

- **Maybe because the “autopilot” messaging effectively removes such signals;**
- Markets view balance sheet shrinking as largely independent of economic conditions, unlike ECB QE tapering.

WHAT MARKETS NEED TO KNOW ABOUT BALANCE SHEET PLANS

- ✓ **Pace of balance sheet shrinking:**
 - Cap system is very clear and predictable.
- ✓ **Plans for the asset side of the balance sheet:**
 - The same cap system is very clear in this regard as well;
 - Still, some implications for HQLA.
- ✓ **Timing of initial move:**
 - Not announced yet but known within a few months as a strong base case;
 - The market probably leans towards September but wouldn't be shocked about December;
 - A July first move would be a surprise.
- ✗ **Plans for the liability side of the balance sheet:**
 - Important for banks because of reliance on reserves as HQLA;
 - Important for money funds because of RRP facility;
 - Important for markets in general because of impact on rates.
- ✗ **Ultimate “right” size of the balance sheet or duration of the shrinking process:**
 - Same reasons as above;
 - Important for financial stability implications.

PROJECTION FOR THE ASSET SIDE OF THE FED'S BALANCE SHEET



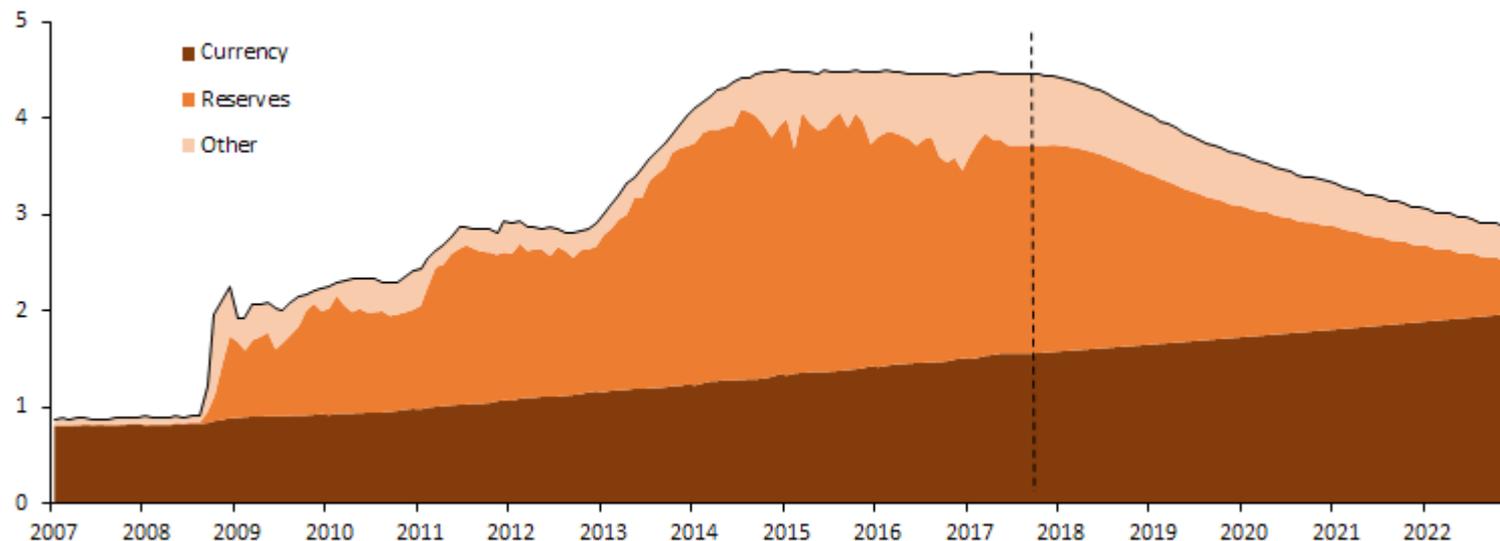
Things are very clear here (up to a point):

- Cap system;
- Very small caps initially;
- Gradually increasing up to a maximum of \$30 bn per month for Treasuries; and \$20 bn per month for MBS;
- Caps for MBS will be binding only for the first year or so (depending on actual prepayments);
- Caps for Treasuries remain occasionally binding for several years.

But what is the “right” size of the balance sheet, and by what time frame?

- Assuming a five-year horizon, Treasury holdings would decline about \$930 bn and MBS holdings about \$675 bn.
- Balance sheet down to about \$2.85 tn.

PROJECTION FOR THE LIABILITY SIDE OF THE FED'S BALANCE SHEET



Things are not clear at all: Investors know very little about the intended composition of liabilities.

Some (very arbitrary) assumptions: A five-year horizon; currency will increase at the recent US nominal GDP growth rate (less than the past many years) and “other liabilities” will be managed down at 15% per year.

- Then reserves shrink by \$1.6 trillion, to about \$550 billion; seems like a big drop...
- Reserves are important because they are a Level 1 asset for HQLA and LCR purposes.

THE IMPACT OF BALANCE SHEET SHRINKING ON HQLA

Reserves and Treasuries are both Level 1 assets and subject to 0% haircut, so they are interchangeable:

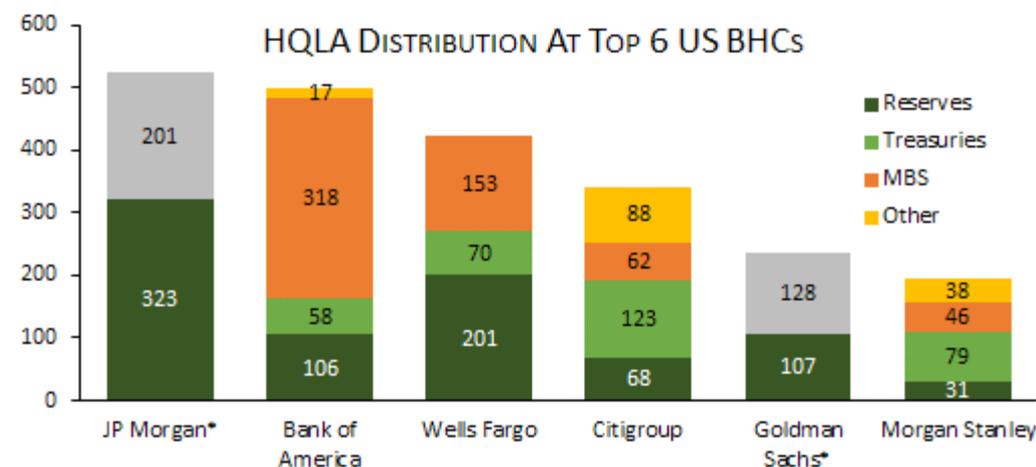
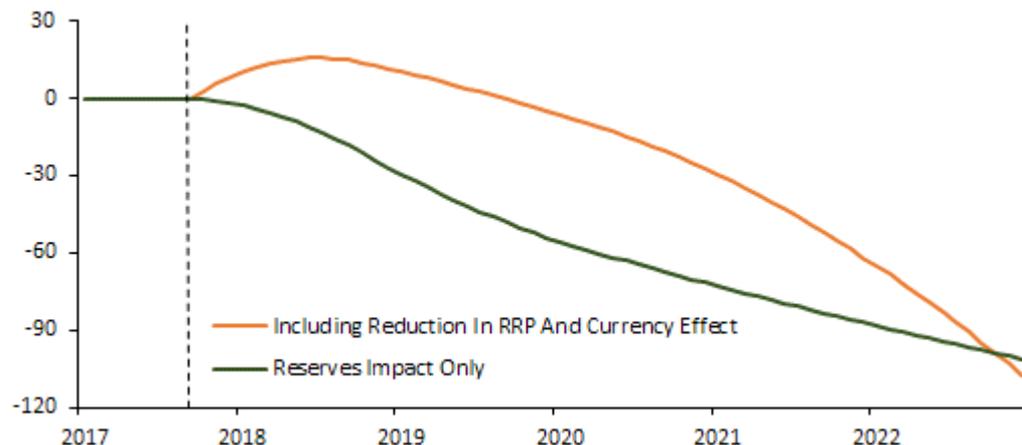
- \$X billion reduction in reserves is matched with \$X billion increase in supply of Treasuries = zero net effect.

But MBS are a Level 2A asset and subject to a 15% haircut:

- \$X billion reduction in reserves is matched with \$X billion increase in supply of MBS, but banks can use only $0.85 * \$X$ billion = net reduction in supply of HQLA.
- MBS are a large part of HQLA, especially at some banks (e.g., BOA and WFC).

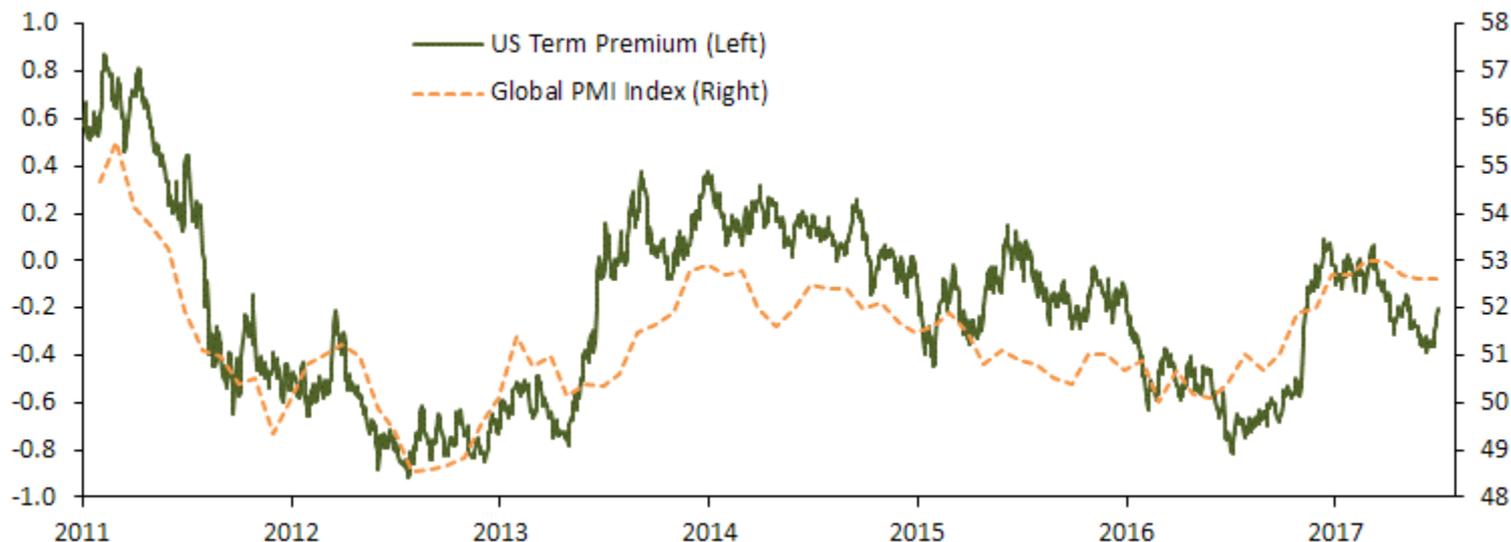
The reduction in supply of HQLA might be undesirable; it could be mitigated by reducing the size of the RRP facility:

- **Bad for other aspects of financial stability;**
- **Keeping a large balance sheet seems the best solution.**



(*) JP Morgan Chase and Goldman Sachs don't provide a securities breakdown.

THE IMPACT OF BALANCE SHEET SHRINKING ON MARKET RATES



In principle, balance sheet shrinking should push term premiums up. But:

- Removal of signaling effect of balance sheet shrinking might argue for muted response;
- Other factors matter as well, e.g. the global growth outlook (flight-to-quality connection);
- What the Fed does with its liabilities matters too (effect on supply of HQLA);
- And what the Treasury does is also very important (any coordination between Fed/Treasury?).

Bottom line: It's far from obvious that balance sheet shrinking will result in a meaningful backup in term premiums and rates.