FOMC Preview—A Delayed Balance Sheet Fuse?

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The Federal Reserve retreats for another two day FOMC meeting on Tuesday and Wednesday of next week that culminates in a statement-only affair Wednesday at 2pmET. There will be no press conference or forecast updates at this one and so that alone should temper any expectations for material policy tweaks that require further explanations. That said, there are two debates worth entertaining.

The lesser of the two, in my opinion, is the debate regarding **when the Fed will hike next**. Not yet, and with no firm guidance on when are entirely reasonable assumptions for next week. Chair Yellen recently stated that the Fed will evaluate data and conditions "over the coming months" which is Fed-speak for don't expect a reassessment until perhaps the following FOMC meeting on March 14th–15th when another batch of forecasts will be released, or more likely two meetings later at the June 13th–14th meeting when yet another batch of forecasts will be presented. It is along that time line that we need to get through the debt ceiling decision as it approaches around mid-March, the need for a Federal Budget to be proposed to Congress and passed, and with it answers to some very fundamental questions on stimulus timing and amounts and how it will all be funded. While it is possible that statement language captures this pause argument, it is more probable that the minutes to the meeting may further the dialogue when they are released on February 22nd.

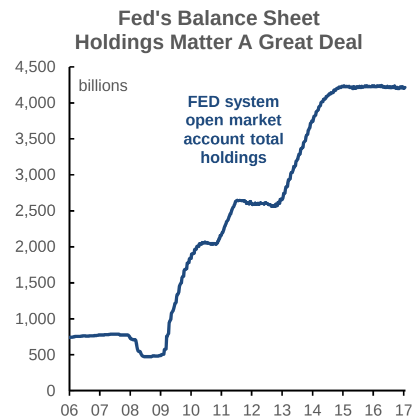
The more important of the two debates is with respect to when the Fed may begin to provide firmer signals on balance sheet management. With two out of our three hikes forecast for this year already priced into fed fund futures, **the greater bond market risk compared to what is presently priced is a further elaboration by the FOMC on when it may begin to partially phase out reinvestment of maturing Treasury, agency and MBS holdings.** This is a huge issue to the bond market—and by extension other correlated trades—in no small part because of the size of the Securities Open Market Account (chart 1), its composition by security (chart 2) and the volume of maturing Treasury holdings over coming years (chart 3). The topic has been hinted at but generally not with much substance to date. Until recently, the FOMC only guided that reinvestment would continue until the rate normalization process was "well underway". Recent references have signaled rising discomfort with leaving it at that. For example, the minutes to the December 2016 meeting simply said the following:

> "Several participants noted circumstances that might warrant changes to the path for the federal funds rate could also have implications for the reinvestment of proceeds from maturing Treasury securities and principal payments from agency debt and mortgage-backed securities."

In language used by the Fed's minutes, "several participants" does not connote a stream of thought driven by a majority. That was nevertheless a tone shift from the minutes to the November and previous meetings that said:

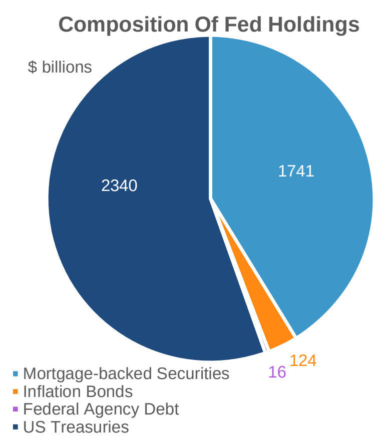
> "The Committee also decided to maintain its existing policy of reinvesting principal payments from its holdings of agency debt and agency mortgage-backed securities in agency mortgage-backed securities and of rolling over maturing Treasury securities at auction, and it anticipated

Chart 1



Sources: Scotiabank Economics, Federal Reserve.

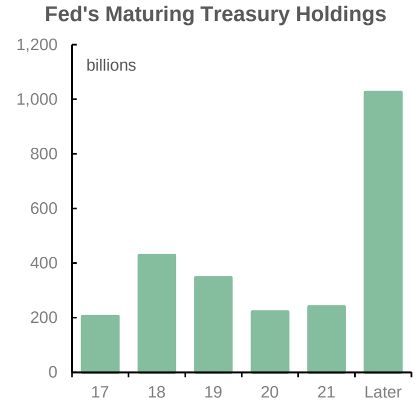
Chart 2



Sources: Scotiabank Economics, Federal Reserve.

doing so until normalization of the level of the federal funds rate is well under way. Members noted that this policy, by keeping the Committee's holdings of longer-term securities at sizable levels, should help maintain accommodative financial conditions."

Chart 3



Sources: Scotiabank Economics, Federal Reserve Bank of New York.

More recently, several FOMC officials have elaborated a touch in such fashion as to add to expectations that this topic will be a major point of discussion next week. Governor Brainard recently stated that the conditions for phasing out reinvestment in the face of significant fiscal stimulus could be achieved "sooner than they otherwise would have been." Regional Fed Presidents Rosengren, Bullard, Williams, Harker and Kaplan have also recently noted the need to discuss phasing out reinvestment and the latter two get policy votes this year. We may hear more on the topic from next week's presently lone FOMC speaker, Charles Evans (voting 2017) who speaks two days after the FOMC meeting and therefore may be the first to hint at a view whether consensus or filtered. For now, there really hasn't been much meat to the discussion but the communication signals point to elevated attention placed upon this topic in the two day meeting that will otherwise have no reason to alter guidance on other policy tools.

At the moment, **our best guess is that reinvestment will commence being partially phased out toward the end of 2018 or early 2019** and thus within about a 24+ month horizon. That is conditioned upon the largely arbitrary assumption that a 2% Fed funds target rate qualifies for a rate normalization process that is "well underway" and we don't expect to hit that level until late 2018. Policy signals on phasing out reinvestment will likely be delivered well in advance of action and so markets will price such expectations ahead of time. We don't think the Fed will go cold turkey and suddenly end reinvestment and we assign about 75% odds to gradually phasing out reinvestments of both maturing Treasuries currently reinvested at auction and principal payments of agency debt and agency MBS in agency MBS. Firming up a definition of "well underway" may be one form by which the minutes may convey the criteria for possibly altering balance sheet management but commitment to a precise point estimate is likely to be avoided.

There are two tailed risks to the timing of this decision on when to begin phasing out reinvestment that we presently judge to be skewed to earlier (perhaps late this year or early next) rather than later. It is the mountain of maturing Treasuries next year as shown in chart 3 that creates some sense of urgency to have a fuller dialogue with the markets on this topic sooner rather than springing a destabilizing surprise later. Equally challenging may be the coincident consideration that Chair Yellen's term will be up in early February 2018 and Vice Chair Fischer's term will expire in June 2018. **Having to manage down the balance sheet while supply pressures may be of rising concern and at the same time as leadership uncertainty exists at the Fed is a massive potential combination of risks overhanging the bond market.** External political influences upon this process must be avoided or handled with extreme care for the potential consequences. Our assumptions may be revisited after we get through the debt ceiling debate and can evaluate an approved Federal Budget. At this point, it is less than obvious when and by how much reinvestment could be curtailed should Treasury issuance soar to fund deficit spending. The conditions for financial repression and lowering borrowing costs during the post-crisis years may be giving way to the perception that monetary policy is more overtly funding fiscal policy initiatives.