# Fed starts shrinking its balance sheet

## News from the financial markets

**The Federal Reserve will give the go-ahead for the sale of Treasuries and mortgage-backed securities at its meeting on Wednesday (May 4). We discuss the consequences for individual asset classes.**

The Fed's move should not come as a surprise to the financial markets. After all, the central bank set the path early on and already published details of the balance sheet reduction in the minutes of its March meeting. Why the Fed starts to prune its balance sheet so soon after the first rate hike, how it is proceeding and what impact this could have on interest rates, the stock markets and the U.S. dollar, is what we will discuss below.

### Why is the Fed moving now?

The reduction in Treasuries and mortgage-backed securities is designed to remove liquidity from the markets, thereby enhancing the effect of rate hikes to fight inflation. The minutes of the Federal Open Market Committee's December meeting suggest that the balance sheet reduction is seen to some extent as a substitute for rate hikes. The tightening of monetary policy includes interest rate hikes and balance sheet reduction, the minutes stated at the time. Therefore, the interest rate hike path priced in by markets is only moderate compared to the current inflation rates. The fed fund futures are signaling a high of 3% for the current tightening cycle.

### How does the Fed plan to proceed?

The Fed has already provided key details with the minutes of its March meeting. The holdings of Treasury and mortgage-backed securities will be reduced each month by USD 60 bn and USD 35 bn, respectively. Maturing securities will no longer be reinvested. Going forward, the Fed could increase, reduce or even completely stop the monthly runoff volume, depending on how inflation and the economy develop. According to the minutes, the FOMC wants some flexibility. And there is no need to worry that the Fed will quickly run out of bonds. After all, after the outbreak of the Corona pandemic, the U.S. central bank bought securities worth USD 4.6 trillion. Since 2009, the volume has reached almost USD 8 trillion.

### Is the Fed entering unchartered territory?

No, the Fed was reducing its balance sheet once before. That was in October 2017, starting with a USD 10 bn monthly reduction. The amount was then gradually increased by 10 bn each month until the volume reached 50 bn monthly. The process finally ended in September 2019 as the Fed had achieved its goals, at least for the moment. Inflation rates were once again below the target level of 2%. Important leading economic indicators weakened noticeably, so that there was no risk of an overheating economy either.

### What does the withdrawal of liquidity mean for money markets?

The episode between 2017 and 2019 showed: With rising asset runoff volumes, tension in money markets was increasing. This can be seen in the interest rate differential between unsecured and secured short-term loans among banks. While this ratio is usually showing credit concerns in the banking sector, at the time it was caused by the Fed's balance sheet reduction. If liquidity is withdrawn there will be consequences for money markets. Once again, it can be assumed that the interbank markets will briefly see higher risk premia for unsecured money lending. However, in order to be able to address liquidity bottlenecks, the Fed has introduced new tools since then.

### What is the effect on interest rates?

Here, too, it is worth taking a look at history. The Fed's interest rate hikes and balance sheet reduction had initially led to a rise in US 10-year Treasury yields of around 170 basis points from 2016 to 2018. Then, as it became clear to financial markets that tighter monetary policy would lead to a slowdown of the U.S. economy, Treasury yields shifted into reverse. The rise in yields that had previously taken place over three years was reversed within just a year. While 10-year Treasuries were still hovering around 3.20% at the beginning of 2019, they were down to 1.50% by the end of the year. This could happen again in a similar form this time around if economic risks came to the fore. As a result, we reduced our strong tactical underweight in government bonds at the April meeting of the Investment Committee following the sharp rise in yields.

### Is the US dollar getting stronger?

There is no obvious trend for the dollar when looking at the last monetary policy tightening cycle. With the start of the balance sheet reduction, the greenback even depreciated sharply. In the first few months of 2018, the euro traded at levels of 1.25 against the dollar. It was only when the Fed accelerated its balance sheet reduction and significantly increased key interest rates compared to major central banks that the U.S. currency rallied. However, the appreciation started from levels at which the dollar was rather undervalued. Today, the currency is already strong from a valuation point of view and, in contrast to the last monetary policy tightening cycle, other major central banks are also tightening their monetary policy. Against this backdropfurther dollar strength can by no means be inferred.

### What is the impact of monetary tightening on equities?

Higher capital costs and liquidity withdrawal lead to lower valuations on the stock markets. In addition, volatility can increase when monetary policy is changing. This particularly affects growth stocks, the communications sector and companies with weak balance sheets. This has already been observed in recent weeks. In our view, defensive positioning is advisable. In the portfolio context, we are therefore tactically underweight and rely, among other things, on the minimum variance approach. We also see companies with predictable cash flows, solid balance sheet management and stable dividends at an advantage. In the past, small-cap companies have on average outperformed the market as a whole. However, extreme deviations, both positive and negative, can always occur with small caps. At present, they do not appear to be any more promising than the overall market in our view.

### How are corporate bonds affected?

Corporate bonds have benefited doubly from the expansion of balance sheets by central banks. First, by falling risk-free rates and second, by the triggered search for yield. As a result, credit spreads have fallen far below the level that would have been achieved in a free market. In the event of a tightening of monetary policy, corporate bonds are thus more affected than government bonds. This is exacerbated by high leverage - corporate debt in the USA has more than doubled since the financial crisis in 2007. Rising interest rates and credit spreads thus hurt all the more. The distortion in credit prices is also likely to have led to misallocations. Companies that would not have been able to borrow at market rates are likely to be the first to falter.

### How is gold doing?

Gold does not yield a recurring income. If interest rates rise, the opportunity costs of gold increase. That would argue against gold at the moment. However, in the past, the gold price has on average performed significantly better than the U.S. stock market in the months following the Fed's first interest rate hike. This was also true for the last rate hike cycle in 2017 and 2018. Despite increasing headwinds from rising interest rate expectations, higher real interest rates and a stronger U.S. dollar, the gold price has also proven resilient in recent months. This reinforces our view that gold is an important building block for the portfolio construction. Especially in times when the uncertainty in financial markets is elevated.

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