
FED WATCH: MOVING ON...AND RATHER QUICKLY

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The [Fed's](#) announcement to begin [tapering](#) its [balance sheet](#) was a well-telegraphed development that, in and of itself, should not really have any meaningful impact on the money and bond markets. Sure, the actual implementation of scaling back its asset purchases could potentially impact U.S. Treasury (UST) and [mortgage-backed securities \(MBS\) valuations](#), but it appears as if the policymakers succeeded with its “forward guidance” on this front, and the focus has already turned to the next phase of the exit strategy: [rate hikes](#).

Back to the Fed balance sheet for a moment to get some perspective on this pandemic-related round of [quantitative easing \(QE\)](#). As a reminder, the Fed's balance sheet is actually made up of more than just its UST and MBS holdings, and the actual component where QE shows up is its [System Open Market Account](#), or SOMA. During this QE4 operation, the Fed added more than \$4.1 trillion to its UST and MBS holdings, more than doubling SOMA to \$8.0 trillion. This was an enormous addition to the Fed's balance sheet and compares to total QE purchases of \$3.25 trillion during the financial crisis-related tranches of QE.

One final note on tapering before I turn to rate hikes. Keep in mind that the policymakers are reducing the size of future asset purchases, it is not ending them. Thus, QE4 is still alive and well; it is just operating at a scaled-back pace. If history is any guide, even when the Fed ends new purchases of UST and MBS, it will more than likely reinvest any maturing proceeds from its holdings, keeping SOMA flat at an elevated level, accordingly.

On to rate hikes! Readers of my blog are fully aware that this aspect of the Fed's exit strategy is the one I've been focusing on quite a bit. I'm not alone. Not only has the 2-5-year sector of the UST market begun pricing in “liftoff,” but the [Fed Funds](#) Futures arena has made a visible shift in this direction as well. In fact, the implied probability analysis factored in not just one rate hike for 2022, but two and a half increases. I know there's no such thing as half of a Fed Funds increase, but I think you get the picture here—i.e., there is a growing perception the Fed may implement more than two rate hikes next year. In addition, the timing for the “liftoff” has been pushed up to next July.

Conclusion

As much as Chair Powell appears to be trying to de-link, if not outright downplay, rate hikes, the collective market, thus far anyway, hasn't been listening. It kind of reminds me of the whole “[inflation](#) is transitory” argument to some extent, which, by the way, the Fed seems to be reluctantly admitting could mean up to a year, not just a month or two. Looking ahead, the bottom-line message is that monetary policy is likely embarking on the process of turning from a tailwind to a potential headwind for bond portfolios... plan accordingly!

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DEFINITIONS

Federal Reserve: The Federal Reserve System is the central banking system of the United States.

Tapering: A shift in monetary policy by which the Federal Reserve would begin decreasing the amount of bonds it purchases.

Balance sheet: refers to the cash and cash equivalents part of the Current Assets on a firm's balance sheet and cash available for purchasing new position.

Mortgage-backed securities: Fixed income securities that are composed of multiple underlying mortgages.

Valuation: Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

Rate Hike: refers to an increase in the policy rate set by a central bank. In the U.S., this generally refers to the Federal Funds Target Rate.

Quantitative Easing (QE): A government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital, in an effort to promote increased lending and liquidity.

System Open Market Account (SOMA): An account that is managed by the Federal Reserve Bank, containing assets acquired through operations in the open market. The assets in SOMA serve as a management tool for the Federal Reserve's assets, a store of liquidity to be used in an emergency event where the need for liquidity arises, and as collateral for the liabilities on the Federal Reserve's balance sheet such as U.S. dollars in circulation.

Federal Funds (Fed Funds): Excess reserves that commercial banks and other financial institutions deposit at regional Federal Reserve banks

Inflation: Characterized by rising price levels.