PRE-FOMC: A DIFFERENT TYPE OF TAPER

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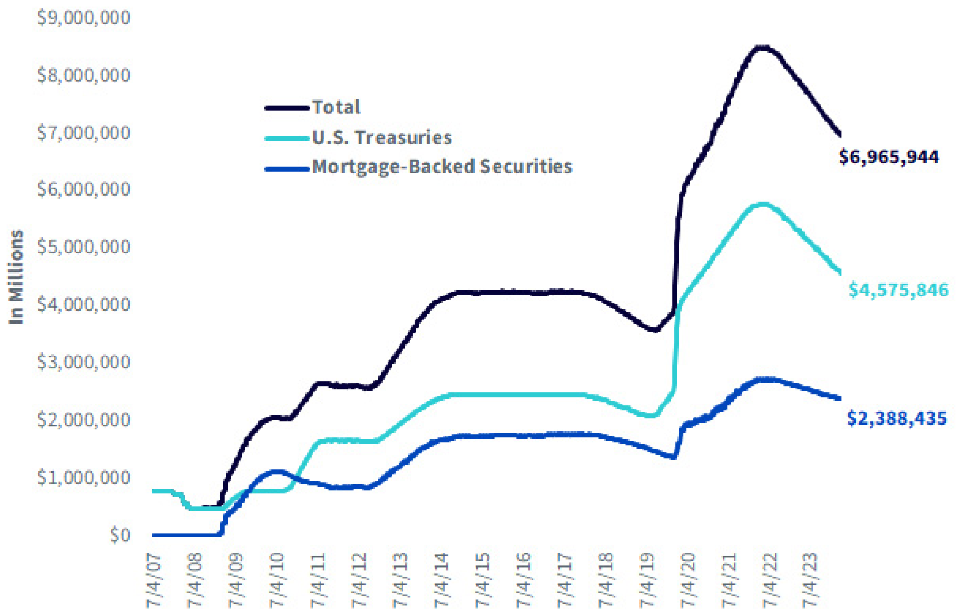
Following last week's "hotter" than expected CPI release, the sole focus for the money and bond markets was to, yet again, dial back their Fed rate cut expectations. However, there is another aspect of Fed policy decision-making that has been flying under the radar, and that involves its balance sheet. With the May 1 FOMC meeting only two weeks away, I thought it would be a good idea to discuss this part of monetary policy because, at this point, it appears as if this facet may make headlines well before actual rate cuts do.

So, what exactly am I referring to when talking about the Fed's balance sheet? The simple answer is the Securities Held Outright line items. For a little Fed Balance Sheet 101, this is also known as the System Open Market Account or SOMA. The reader probably is more familiar with the terms quantitative easing (QE) and quantitative tightening (QT) when addressing the Fed's balance sheet.

Securities Held Outright by the Fed



Source: St. Louis Fed, as of 4/12/24

Recall that while the policy maker was busy implementing historic rate hikes from 2022-2023, it was also reducing its holdings of Treasuries and mortgage-backed securities (MBS), which had ballooned in size as a result of the COVID-19-related QE program. This latter portion of monetary policy tightening was QT. Fast-forward to the present, and it appears as if the FOMC is ready to start paring back the pace of QT, even if it is not ready to start implementing rate cuts.

Let's look at the Fed's securities holdings to get some perspective on how the current

QT program has been working. At its peak, SOMA reached as high as $8.5 trillion in May 2022, and since QT went into effect in June of that year, total holdings have dropped more than $1.5 trillion to $6.97 trillion as of this writing. This reduction is the result of the Fed's present plan to let its Treasury and MBS positions roll off by a combined $95 billion per month. Remember, the Fed is not outright selling any securities; it is just not reinvesting the total amount of holdings that are maturing or being redeemed.

Based on last week's release of the March FOMC minutes, the Fed seems to be considering reducing the aforementioned roll-off amount in half, which could amount to roughly $50 billion per month. In addition, the policy maker's preference seems to be to pare back only the pace of QT that includes the Treasuries portion of its overall holdings, not MBS.

Interestingly, several Fed officials have gone on record that the ultimate goal would be to have *only* Treasury securities on its balance sheet. However, this could take quite some time, as the Fed's balance sheet is holding nearly $2.4 trillion in MBS, and the current pace of the roll-off here is $35 billion per month.

Conclusion

While the money and bond markets await guidance on rate cuts, they may be getting another announcement as soon as the upcoming May FOMC meeting that a "QT taper" is on the immediate horizon instead.

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DEFINITIONS

Consumer Price Index (CPI) : A measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. The CPI is calculated by taking price changes for each item in the predetermined basket of goods and averaging them; the goods are weighted according to their importance. Changes in CPI are used to assess price changes associated with the cost of living.

Bond market : The bond market—often called the debt market, fixed-income market, or credit market—is the collective name given to all trades and issues of debt securities. Governments typically issue bonds in order to raise capital to pay down debts or fund infrastructural improvements.

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

Rate Cut : A decision by a central bank to reduce its main interest rate, usually to influence rates charged by other financial institution.

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

Federal Open Market Committee (FOMC) : The branch of the Federal Reserve Board that determines the direction of monetary policy.

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.

Quantitative Tightening : Quantitative easing is a process whereby a central bank targets lowering longer-term interest rates by purchasing bonds and other securities to stimulate the economy. Quantitative tightening is the reverse process whereby securities are either sold or the proceeds of maturing securities are not reinvested with the goal of tightening economic conditions to prevent the economy from overheating.

Treasury : Debt obligation issued by the U.S. government with payments of principal and interest backed by the full faith and credit of the U.S. government.

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