READY, SET, HIKE…

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The New Year is now in full swing as the Federal Reserve has officially weighed in on the direction of interest rates…they're going up! Obviously, the lion's share of investor attention focuses on the outlook for Fed Funds, but it is also important to include the Fed's thoughts on how and when balance sheet normalization could come into play.

First up, rate hikes. Unless an unexpected turn of events occurs on the economic/inflation front, the voting members seemed to have confirmed the market's expectation that lift off will be in March. Even though there was no dot plot this time around, the Fed also didn't seem to push back on the newfound belief that four rate hikes could be forthcoming this year. In fact, instead of a presumed timetable for "gradual," or "measured," rate increases as we have seen mentioned in past rate hike cycles, Powell & Co. are guiding the markets toward the notion that each FOMC meeting will be live. In other words, a rate hike could occur at any future FOMC meeting.

That brings us to the balance sheet, or let's call it quantitative tightening, a.k.a QT. That's right, just as the Fed's large-scale asset purchases of Treasuries (UST) and mortgage-backed securities (MBS) is an easing tool of monetary policy (QE), QT should be viewed as just the opposite, a tightening tool of monetary policy.

What exactly is QT? One thing it is not is tapering. Remember, tapering is still adding to the Fed's balance sheet, but at a lesser pace, so think of it as 'QE-lite'. In contrast, QT is when the policy makers actually reduce their holdings of UST and MBS to shrink their balance sheet. It can come in two forms: 1) actually selling these aforementioned holdings or 2) letting their UST/MBS positions mature and/or redeem without replacing them. With regard to option #2, the Fed can decide to let the maturities/redemptions occur in full or the policy makers could choose to let a portion 'run-off' and reinvest the remainder of what actually matured/redeemed.

The timing of the Fed's QT program is what will set this early rate hike cycle apart from the prior episode. Indeed, the policymakers stated that they expect to begin reducing their balance sheet "after the process of increasing the target range for the federal funds rate has begun." With March looking like the timing for lift-off now, QT could start any time after that.

Conclusion

So, besides trying to determine when to raise rates throughout the course of this year, the FOMC will also be determining how and when to proceed with their balance sheet drawdown. Recently, there has been a lot of conjecture that the Fed could raise rates more than four times in 2022. However, I would advise to not lose sight of the power of the balance sheet option. A drawdown of their UST and MBS holdings should be viewed as akin to a quarter-point rate hike, and perhaps that's how the Fed gets to five 'rate hikes' this year.

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DEFINITIONS

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

Interest rates : The rate at which interest is paid by a borrower for the use of money.

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.

Inflation : Characterized by rising price levels.

Dot Plot : a chart based on the economic projections of the Federal Reserve board members that illustrates their views on the appropriate pace of policy firming and provides a target range or target level for the federal funds rat.

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

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.

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.

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

Drawdowns : Periods of sustained negative trends of return.