Easing off the Accelerator? An Insight into the Fed's QE Program

Manager Call with Canterbury Consulting and Gurtin Capital Management

On December 18, 2017, Jonathan Hill discussed how the Federal Reserve's Quantitative Easing (QE) program has been a unique and unconventional central bank policy post the Great Financial Crisis. Mr. Hill reviewed the mechanisms used by the Federal Reserve to implement QE and provided insight on the future path for U.S. interest rates as well as the Fed's balance sheet unwind. Below are highlights from the presentation:

HISTORY OF THE FEDERAL RESERVE'S LARGE SCALE ASSET PURCHASE (LSAP) PROGRAM

- The Fed's LSAP program (otherwise known as Quantitative Easing or QE) was completed in stages:
  - LSAP 1 (Dec. 08-Mar. 10): $50 billion/month of treasurys. Transitioned from purchasing only treasurys to also purchasing MBS ($83 billion/month)
  - LSAP 2 (Nov. 10-Jun. 11): $75 billion/month. Fed was also reinvesting prepayments back into treasurys.
  - LSAP 3: (Jun. 13-Oct. 14): $45 billion/month of treasurys and $40 billion/month of MBS
- The market tends to follow the asset side of the balance sheet, however the liability side is just as important to understand. When the Fed 'printed money' to purchase securities, it didn't create currency, but instead credited banks' reserves accounts (money from banks left at the Fed). The Fed would then credit a banks reserve account for the treasurys purchased. The Fed paid interest on the excess reserves which incentivized banks to not withdraw (this would have created currency). Since liabilities were in excess reserves and not in currency, the implementation did not lead to hyperinflation
- QE was executed through the purchasing of securities in the secondary market. Bond prices increased and yields declined
- The Fed soaked up the majority of the large treasury supply (due to the deficit) during QE. Treasury and the Fed are two separate entities that act independently

TREASURY REINVESTMENT PERIOD & BALANCE SHEET UNWIND

- The Fed reinvested matured holdings starting in 2014. This was done through a 'System Open Market Account' (SOMA), which was an add-on to treasury auctions. As a result, the treasury increased auction sizes to exactly offset SOMA demand
- The Fed has been out of the secondary treasury market since 2014
- The Fed is active in the secondary MBS market. Reinvestments have remained substantial since 2014
- Balance sheet normalization should continue as planned. The bar to deviate from the Fed's guidance is very high
- Treasury will need to fund SOMA redemptions as the Fed stops reinvesting maturing treasurys. As a result, the Treasury can now target where increased issuance occurs along the yield curve

OUTLOOK

- The Fed has implemented a predictable reinvestment schedule for treasuries. This should help minimize volatility as the balance sheet unwinds
- The private sector will need to absorb excess supply of MBS. The reinvestment schedule is path dependent given how prepayments are affected by interest rates. Therefore, the schedule is smooth, but unpredictable

- From the liability side, excess reserves will wind down as total liabilities decline. Currency will steadily grow alongside GDP growth
- The balance sheet should not get below a range of $2.5-$3.0 trillion. In other words, we will not see the same balance sheet levels pre-financial crisis
- Private takedown of debt will exponentially increase over the next five years. The public will need to absorb a large amount of net Treasury issuance to fund both SOMA and the deficits. This could lead to more volatility, especially if a recession occurs
- Global QE has continued to significantly grow. Europe and Japan have continued to ease and their balance sheets have massively ballooned

Q: HOW DOES A FLATTENING YIELD CURVE AFFECT THE FED'S ABILITY TO HIKE GOING INTO 2018? WHAT ARE YOUR VIEWS ON INFLATION?

- The Fed will remain active and tactical in managing the yield curve
- The lack of inflation is a global phenomenon, given the expansionary central bank policy
- Demographics, technology and unforeseen factors are affecting inflation
- The Fed will continue to hike for the following reasons:
    - Positive financial conditions
    - Lack of inflation and pricing pressure
    - The market's ability to absorb interest rate hikes

Q: WHEN THE 10 YEAR WAS BELOW 2%, DIDN'T THE TREASURY MISS AN OPPORTUNITY TO EXTEND MATURITIES TO MINIMZE LONG-TERM INTEREST COSTS?

- Weighted average maturity for treasuries is at an all-time high
- Treasury issues over $150 billion per year
- The Treasury doesn't want to wildly alter issuance. This could potentially create additional volatility

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Prior to joining Gurtin Municipal Bond Management in July 2017, Mr. Hill worked as an associate trader within the U.S. Treasuries department at the Federal Reserve Bank of New York where he performed analysis of domestic and global financial developments, with a focus on impacts of U.S. fixed income markets. Previously, Mr. Hill worked as an international research analyst for the Federal Reserve Bank of New York. Mr. Hill earned a master's in public administration from Harvard and a bachelor's in public policy from the University of Michigan, graduating with distinction. Mr. Hill is also a CFA charterholder.