Quantitative Tightening

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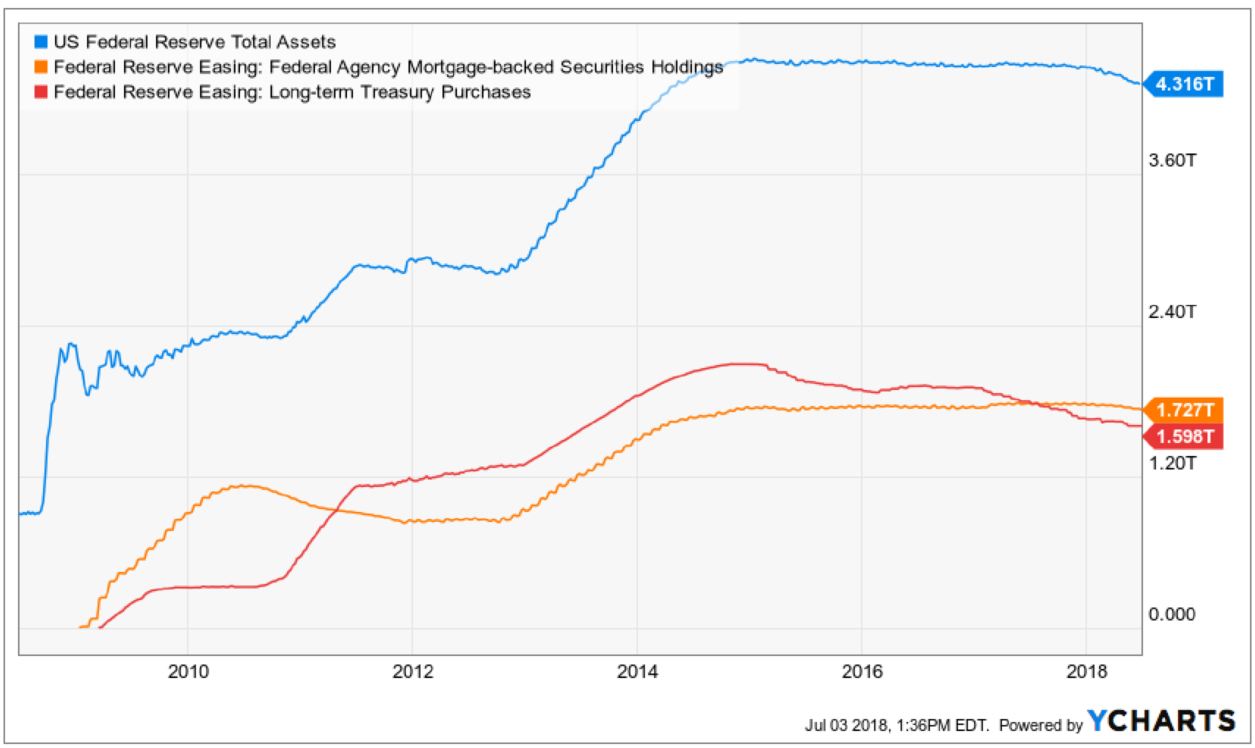
At the end of December 2007, the Federal Reserve Banks (the Fed) had total assets of $893.8 billion. At the end of June 2018, the Fed had total assets of $4,305.5 billion. During this span of time, US Treasury securities increased from $754.6 billion to $2,378.2 billion. Agency mortgage-backed securities increased from $0 to $1,721.3 billion. Capital barely increased and as a percentage of assets declined from 4.15% to 0.90%.

The Federal Reserve System's policy of increasing the assets on its balance sheet was referred to as "quantitative easing." Now, the Fed's "quantitative tightening" is reversing the process and reducing the assets on its balance sheet.



Federal Reserve System
Balance Sheet Comparison

	12/26/2007		6/27/2018	
	$US M	% of Assets	$US M	% of Assets
Assets				
Gold certificate account	11,037	1.23%	11,037	0.26%
SDR certificate account	2,200	0.25%	5,200	0.12%
Coin	1,173	0.13%	1,773	0.04%
Securities				
US Treasury	754,612	84.43%	2,378,250	55.24%
Federal agency debt			2,409	0.06%
Repurchase agreements	42,500	4.75%		
Agency mortgage backed securities			1,721,271	39.98%
Unamortized premium and discounts - net			135,809	3.15%
Loans - term auction credit and other	24,535	2.74%	181	0.00%
Net portfolio holdings of Maiden Lane LLC			1,710	0.04%
Bank premises	2,128	0.24%	2,188	0.05%
Foreign currency denominated assets			21,093	0.49%
Other assets	55,633	6.22%	24,570	0.57%
Total Assets	893,818	100.00%	4,305,491	100.00%
Liabilities				
Federal Reserve notes	791,801	88.59%	1,617,589	37.57%
Reverse repurchase agreements	40,542	4.54%	260,837	6.06%
Deposits	16,358	1.83%	2,381,975	55.32%
Other liabilities	8,005	0.90%	6,189	0.14%
Total Liabilities	856,706	95.85%	4,266,590	99.10%
Total Capital	37,112	4.15%	38,901	0.90%

Source: Federal Reserve statistical releases H.4.1

As the balance sheet comparison above shows, when banks and other owners sold US Treasury securities and mortgage-backed securities to the Fed during the last 10 years, much of the sales proceeds were simply deposited at the Federal Reserve Banks. At the end of June 2018, commercial bank excess reserves at the Fed amounted to approximately $1.9 trillion.

The Federal Open Market Committee of the Federal Reserve issued a policy statement on June 13. The Fed stated that it plans to continue to reduce securities holdings as they reach maturity of US Treasury securities by $18 billion per month and mortgage-backed securities by $12 billion per month during the month of June. Effective in July, the Fed plans to reduce assets at a faster pace with monthly reductions of $24 billion of US Treasury securities and $16 billion of mortgage-backed securities.

The Governing Council of the European Central Bank (ECB) announced on June 14 that it would continue its asset purchases at a rate of 30 billion euros per month until the end of September. During the fourth quarter, the ECB expects to purchase assets at a rate of 15 billion euros per month. The net purchase of assets is then expected to end at year-end. The ECB's impact on European fixed income markets is reflected in the negative interest rate yields on German government bonds with maturities up to 7 years. The German government 10-year bond currently has a yield of 0.30%.

The Bank of Japan (BOJ) published its latest policy statement on June 15. It will continue to apply a negative interest rate of -0.1% on balances held by financial institutions at the Bank of Japan. It plans to continue to purchase Japanese government bonds targeting an interest rate yield of 0.0% on its 10-year government bond. Shorter maturities currently have negative yields. The BOJ provided guidelines for net asset purchases at a monthly rate of:

- Japanese government bonds of 6.7 trillion yen (US$ 60.6 billion);
- Exchange-traded funds of 500 billion yen (US$ 4.5 billion);
- Japanese real estate investment trusts of 7.5 billion yen (US$ 67.8 million)

Of the three major central banks, the Fed is most aggressive in "normalizing" its balance sheet. The ECB is following the Fed's lead but at a much slower pace. The BOJ is maintaining a policy of expanding its balance sheet further.

Many financial market analysts believe that investors are underestimating the potential impact of the Fed's (and ECB's) quantitative tightening policy. Graham Summers of Phoenix Capital Research wrote, "The Fed is the single most important issue for the markets…not tariffs, not trade wards, not even the economy."

Some of the analysts believe that the Fed will become more dovish by necessity before the end of the year. The US economy has a high level of debt now in several sectors – the US government, corporations, student loans, subprime auto loans, mortgage debt, and margin debt on investment securities. Higher interest rates will make the servicing of debt more difficult. If there is a significant market correction or recession, the Fed will likely ease its rate of asset reduction and may temporarily put a halt to its asset reduction program altogether.

If you have any questions or comments, please contact me.

Sincerely,
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