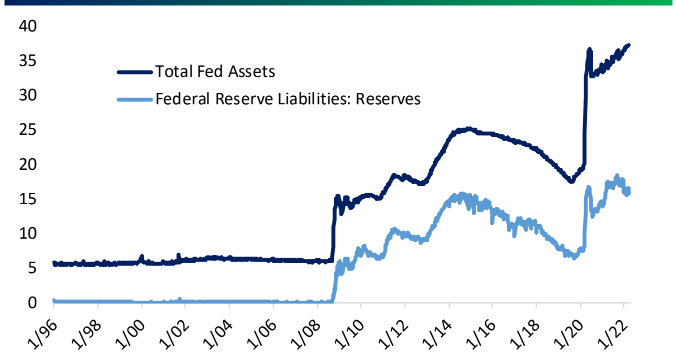
March Minutes Reaction, Balance Sheet Runoff, Neighbor Data, EIA

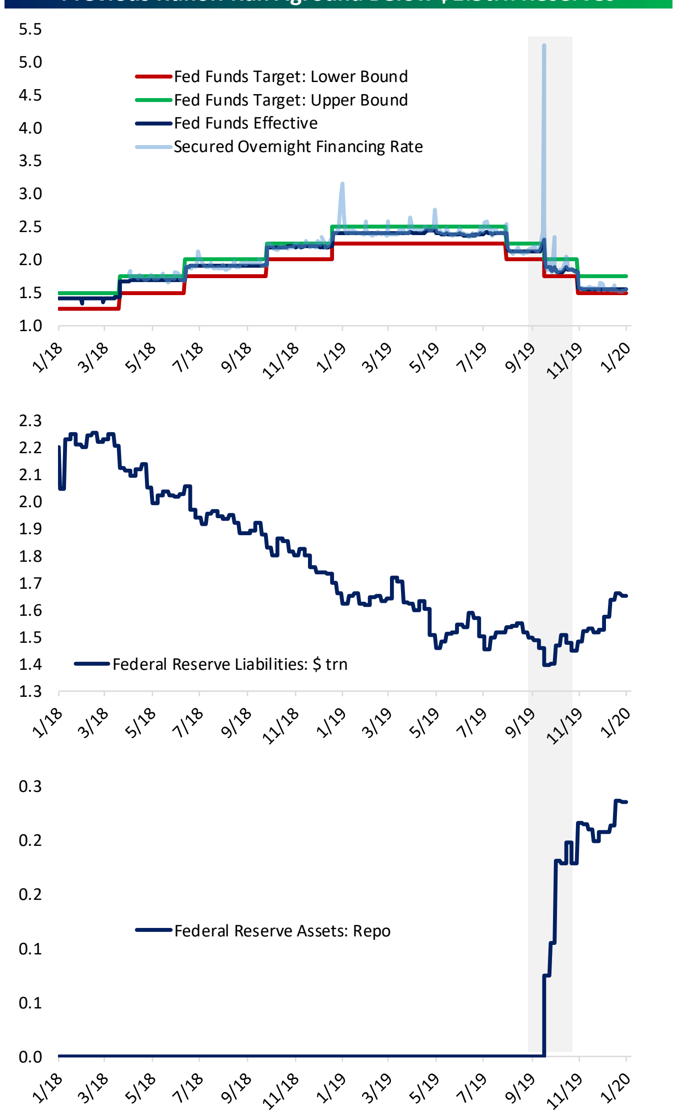
- Today the Federal Reserve released the minutes from the FOMC's March policy meeting.
- The minutes contained few revelations, but there were some notable details on the FOMC's assessment of the economy and plans for policy.
- "*Many*" FOMC members said they wanted to go 50 bps in March but "*a number*" noted they elected a 25 bps hike due to uncertainties related to Russia's invasion of Ukraine.
- "*Many*" participants said "*one or more 50 bps increases in the target range could be appropriate at future meetings*" which in our view is a clear signal that barring a major change to the outlook over the next month the FOMC will hike by 50 bps in at their May meeting.
- The FOMC is deeply concerned about inflation, with "*many*" participants reporting that business contacts are passing through "*substantial increases in wages and input prices...without any significant decrease in demand*".
- While "a few" FOMC members focused on short-term inflation expectations "*at historically high levels*", "*several other*" participants argued longer-term measures of inflation expectations "*remain well anchored*".
- With labor markets "*extremely tight*" and an assessment that "*demand for labor continued to substantially exceed available supply*", the FOMC emphasized that inflation is their focus: "*All participants indicated their strong commitment and determination to take the measures necessary to restore price stability.*"
- The more interesting new information was related to the FOMC's outlook for the balance sheet, which the FOMC expects to start running off "*at a coming meeting, with a faster pace of decline in securities holdings*" than the last balance sheet runoff.
- When runoff begins, the FOMC will halt reinvestment of maturing Treasury securities and the principal portion of MBS cashflows, as in the last episode.
- In months when coupon Treasury and MBS principal repayments do not hit their caps ($60bn and $35bn respectively), the NY Fed will not reinvest short-term bill maturities; in months when caps are hit, any excess repayments will be reinvested.
- The result will be a predictable decline in the securities portfolio that ramps up over a few months before hitting the $95bn target, at which point the balance sheet will run off at slightly more than twice the pace it did during the last runoff period of 2017-2019.
- The one rub here is MBS, which have slower principal repayments during periods of rising rates; consumers refinance only when they move or default, reducing cashflows from repayments.
- That means that the MBS portfolio may struggle to run off at the $35bn target, meaning that achieving a long-term goal of holding primarily Treasuries on the balance sheet will require sales.
- Participants "*generally agreed*" that sales would only take place "*after balance sheet runoff was well underway*" which may make it either a late 2022 or early 2023 story.

- While a Federal Reserve balance sheet equivalent to 37% of GDP is large by any standard, it's worth remembering what happened the last time the Fed ran off its balance sheet.
- When total assets fell to about 17.5% of GDP (with reserves provided standing at about 6.5% of GDP), the Fed lost control of the repo market and short-term interest rates moved outside of the Fed Funds target band.
- In other words, there was insufficient liquidity in Fed Funds and repo markets to meet private sector demand, sending interest rates soaring on a short-term basis.
- Changing private sector demand for liquid assets (largely driven by regulation) mean that the minimum size of the Fed's balance sheet is much larger today than it was prior to the plentiful reserves framework adopted following the global financial crisis, and runoff may overshoot as it did in 2019.
- The Fed is aware of this, and recently introduced a standing repo facility to provide reserves to the market as-needed.
- This is the inverse facility to the overnight reverse repo facility that is currently keeping rates below the bottom of the Fed Funds target range, and in the process is draining approximately $1.7trn in reserves.
- At least that amount (~18 months worth of runoff) can be safely drained before worrying about the Fed balance sheet getting too small, meaning optimizing the size of the balance sheet is a discussion for 2024 at the absolute earliest barring some significant shift or exogenous shock over the next several years that requires renewed asset purchases.

Federal Reserve Assets And Fed Funds Liabilities % GDP



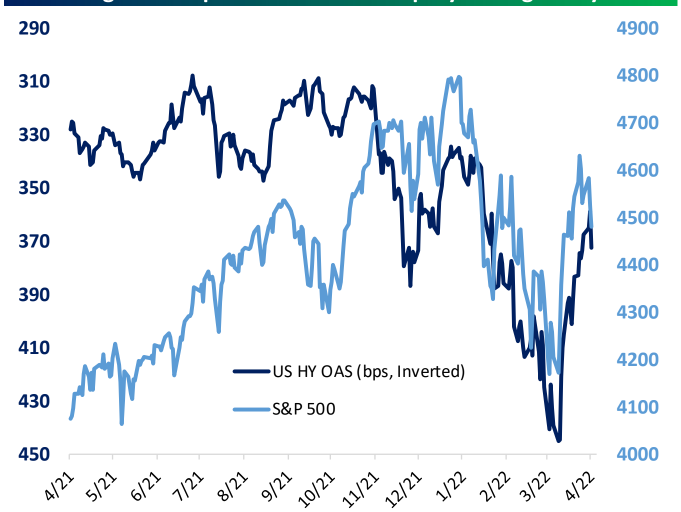
Previous Runoff Ran Aground Below $1.5trn Reserves



- Turning to markets today, the release of the Fed minutes sparked a confused response from US stocks.
- As shown at right, the S&P 500 had rallied into the minutes and briefly surged, before collapsing to session lows in a 91 bps decline over the course of about 15 minutes.
- The market then surged 1.1% to session highs before once again swinging lower.
- In our view, the minutes revealed nothing novel about the committed hawkish policy outlook from the FOMC.
- The confusion about clear signals from the Fed about their willingness to smash asset prices remains a mystery to us, and the price action today illustrates the market's confusion too.
- On a cross asset basis, we do note that today was the worst price action in high yield since the recent risk rally off early March lows kicked off.
- Dollar high yield spreads were 14 bps wider with all major nonfinancial sectors wider and underperformance versus CDS.
- At least inflation pricing isn't running out of control.
- In the chart at right, we show the first 10 years of the inflation swap term structure, decomposed into discrete two year forwards.
- While two year inflation swaps are at extreme levels despite recent declines, the rest of the term structure is pricing forward CPI around 2.8%; that's not weak, but it certainly doesn't represent out-of-control risk premiums from markets.

Extremely Confused Reaction To Fed Minutes From Equities

High Yield Spreads Confirmed Equity Selling Today



Inflation Swaps Still Pricing Modest Risk Premium