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The Great Escape

The roadmap to unwind the Fed's record balance sheet

By Jim Reber

One can make the case that investors in government bonds these days are trusting souls. Or gullible.

Now that the Federal Open Market Committee has wound down its Quantitative Easing 3 campaign, its balance sheet has peaked at more than $4.5 trillion dollars. Prior to the financial crisis that erupted in 2008, it was around $800 billion. Fed officials have insisted that they have a handle on things, and that they can unwind the $3 trillion-plus of stimulus in an orderly manner.

Investors have in turn continued to buy bonds whose yields have been artificially capped by all this QE business, and have taken the Fed at its word. Proof of this is the fact that interest rates have actually fallen year over year, even as the Fed has been very clear that it expects overnight rates to be on the rise—and soon.

Bond buyers large and small apparently believe the Fed can keep a lid on inflation, or can manage its way out of its huge portfolio. This month's column will drill down into what the balance sheet actually consists of, and will analyze how the investments may be drawn down.

Recent releases

Chair Janet Yellen and her associates have begun discussing the next phase, which will be to cease reinvestments of cash flows. In a press release Sept. 17, the Fed stated its "policy normalization principles and plans." These plans include:

- declaring that the target rate for Fed Funds will be raised "when warranted";
- the intention to use reverse repos as necessary to achieve its Fed Funds target;
- the expectation that the balance sheet will be drawn down primarily by simply ceasing to reinvest proceeds as they mature, but only after Fed Funds have begun to rise; and
- anticipating not having to sell any mortgage-backed securities (MBSs).

This last point is probably the most salient to community banks. During the QE3 phase, which was launched in December 2012, the Fed purchased enormous sums of MBSs, in some cases exactly the types that community banks buy. In fact, in some months, the Fed bought most of what was actually printed. If the largest owner of these products on the globe expects to hold them to maturity, this could preclude a market disruption. Which is what community bank portfolio managers are hoping for.

In stock

Of the $4.5 trillion on hand, the vast majority consists of two items: U.S. Treasury notes and bonds, and GSE MBSs. The Fed has termed its holdings of Treasuries as "longer-dated" that in fact have maturities ranging from one year to 30 years. On average, it's about eight years. It's actually in the shape of a barbell, with large amounts due between now and 2020, and large amounts due from 2039 to 2042.

The MBSs consist largely of 30-year pools with 3.5 percent and 4.0 percent interest rates ("coupons"), and smaller amounts of 15-year pools. At this point they are considered moderately seasoned, which is between one and three years old. Their coupons are such that they really aren't subject to much prepayment activity, so a lot of the cash flow is simply scheduled principal being paid on time. Which is good for you and me as taxpayers, because the balance sheet also includes more than $200 billion in premiums paid.

Run on autopilot

With all these longer-term assets, it's

Series Coming Soon

Community Bank Matters is ICBA Securities' highly popular webinar series. These educational events address a range of current topics affecting community banks' balance sheets. The calendar for the 2015 series, which is offered on a complimentary basis, will be announced soon.

perhaps surprising how much of the balance sheet will run off in the next five, 10 or 15 years. Assuming the Fed gets off the reinvestment train, and that the MBSs simply continue to prepay at their current (slow) speeds, almost $1.5 trillion will be gone by 2018. By the end of the decade, the number is up to $2.3 trillion. We get to $3 trillion by 2025.

Given that several Fed officials, including Chair Yellen, have commented that the longer-term equilibrium level of the balance sheet could be larger than in the past, it may be that the Fed might indeed not need to sell anything. Also, from a housekeeping standpoint, the Fed may choose to sell some MBS pools as they become tail pieces, but those probably wouldn't be in block sizes large enough to cause a market hiccup.

So, perhaps fixed-income investors, including community bankers, aren't gullible at all. It appears that the FOMC might have a handle on its record balance sheet. IB

Fed News

Craig Dismuke, Vining Sparks' chief economic strategist, will issue an Economic Flash shortly after the Fed's next meeting adjourns Dec. 17. To subscribe to Dismuke's emails, contact your sales rep or visit ***www.viningsparks.com.***