Independent Banker

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Portfolio

[tag] Portfolio Management

[hed] **The Fed loosens up**

[dek] A slowdown in quantitative tightening has an element of policy easing.

[byline] By Jim Reber, ICBA Securities

Running in the background, ambient noise, under the radar, off the grid, afterthought—these terms have at least the connotation of being insignificant or immaterial. I, for one, would rather be visible or noticed, particularly if I’m doing something morally and ethically acceptable. And yet, over the past two years, the Fed has quietly executed a strategy that has increased the possibility of a recession, without precipitating a hard landing. It also—impressively, by my reckoning—has decreased the likelihood of another spike in inflation.

Not many people have noticed that the Fed has shrunk its balance sheet by nearly 20% since 2022. To be sure, chairman Jay Powell told us several years ago it was time to start unwinding the massive buildup of quantitative easing (QE) that really kicked into gear in March 2020 as the nation and world fell into the grip of the pandemic.

The size and scope of that bond-buying spree is still quite remarkable. In barely 90 days between March and June 2020, the Fed grew its balance sheet by $3 trillion.

**[subhed] What $3 trillion gets you**

To frame this up, $3 trillion is roughly equal to the annual gross domestic product (GDP) of the United Kingdom, the total revenue for the U.S. federal government in fiscal year 2014, or the market capitalization of Microsoft.

Looking back a bit further, the numbers get even more impressive. For example, the Fed’s balance sheet didn’t eclipse the $1 trillion mark until 2008, and it hadn’t ever hit $3 trillion until 2013. But by the end of June 2020, it stood at $7 trillion. We all knew at the time there would be an unwinding; we just didn’t know when or how fast.

Ultimately, assets hit $9 trillion in April 2022. That was the point that the QE phase ended, as the Fed quit buying a combination of treasuries and mortgage-backed securities (MBS), although for several months it continued to reinvest the maturities into similar items, so its total footings stayed constant.

**[subhed] The great runoff**

The term quantitative tightening (QT) entered the building in mid-2022. The Fed has been running off $95 billion per month since then, and there has been no noticeable market disruption due to two factors. The first is the Fed made the announcement prior to the tapering, so the market was aware. The second is that there have been sufficient maturities in its treasury holdings that simply let them go away.

Still, while it appears to be unnecessary to take the drastic step of outright selling securities, of implementing QT, the Fed has retained its right to do so if needed to get inflation back into the central bank’s comfort zone. The Fed has been able to stay away from open market transactions thanks to the gradual (though stubborn) retreat in all the major price indices, which has made for relatively stable market conditions since QE ended. Through mid-2024, the aggregate runoff has hit $1.4 trillion.

**[subhed] Tapering the taper?**

The big risk in taking bonds off the Fed’s balance sheet is that it was removing stimulus from the economy at a time when nominal interest rates were their highest in a generation. The hope was that the runoff was gradual enough to keep the economy out of the ditch until the Fed was satisfied it was time to move into a rate-cutting phase. Of course, we now know that the phase will begin later than we had anticipated at the start of 2024.

The conversation among Fed watchers, and among the Federal Reserve board members themselves, has turned to cutting the amount of monthly QT. The minutes to the Fed’s March meeting said, “participants generally favored reducing the monthly pace of runoff by roughly half from the recent overall pace.” So, follow the bouncing ball: A tapering of the tapering is effectively stimulative to the economy, as there are fewer bonds being loosed into the market, and bank reserves and money supply are higher.

If our monetary policymakers were desirous of a wind-down strategy that lacked panache, their wish has been granted. There’s still ground to cover: For example, the Fed still owns about one-quarter of the entire MBS market, the vast majority of which comprises low-coupon 30-year pools.

However, a 20% reduction in its holdings while GDP growth has remained positive is quite the accomplishment. And this revelation: Discreet and anonymous do not mean irrelevant.

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Stay tuned for a new viewpoint

Next issue, we welcome an additional contributor to this column. Michael Benedict, CFA, is the managing director in fixed income strategies for Stifel, ICBA Securities’ exclusive broker-dealer. Michael’s columns will discuss popular investment products and trends for community bank balance sheets.

[sidebar] Education on tap

Virtual bond basics series this month

Registration has opened for Stifel’s virtual bond school June 11–13, which runs each day from 1 p.m. to 3 p.m. Eastern. Up to nine hours of CPE are offered. To register, contact your Stifel rep or Jim Reber at jreber@icbasecurities.com.

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