[What Happens When the Fed FINALLY Reduces Its $4.5 Trillion Balance Sheet?]

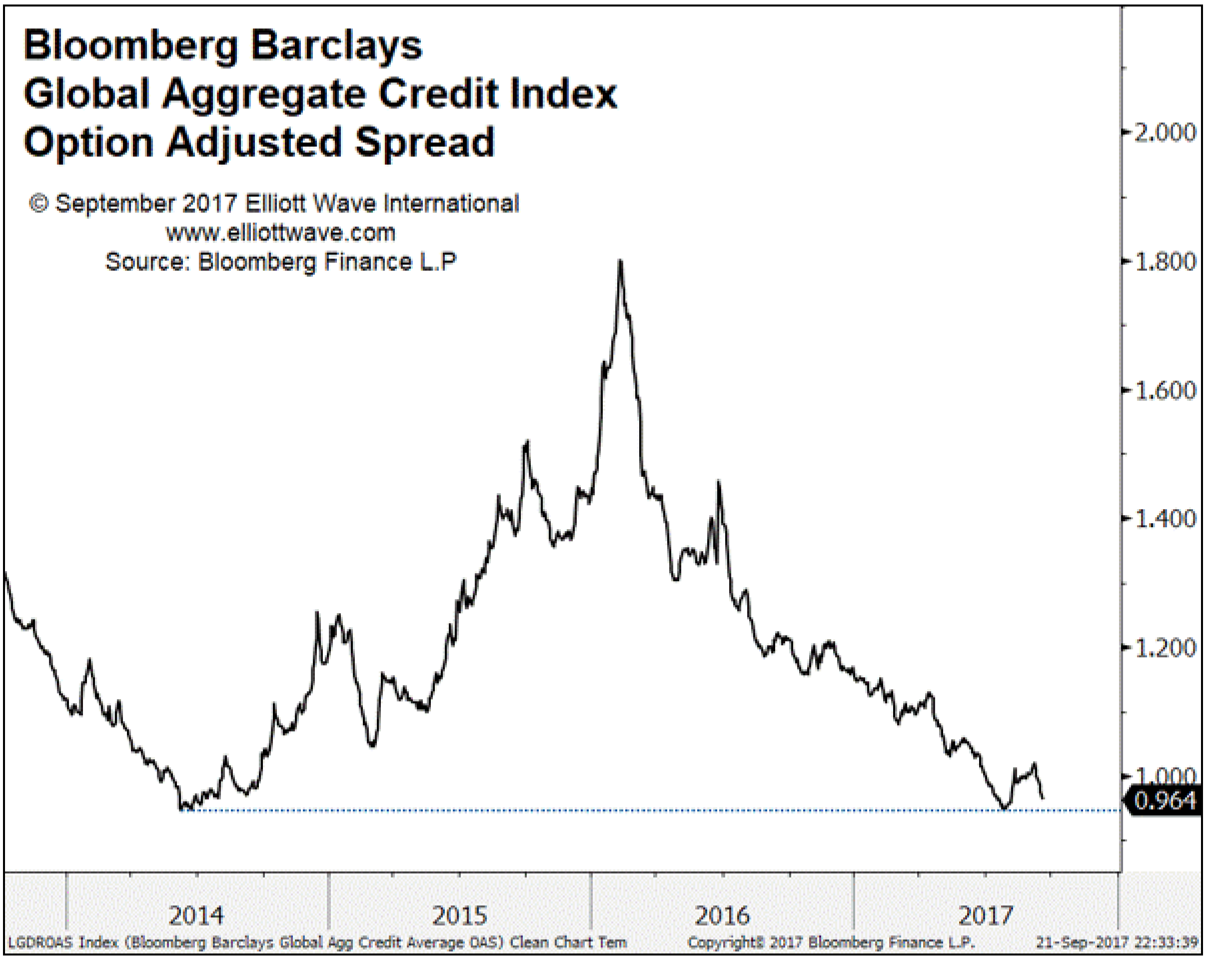
So, there we have it. Deflation has started.

The Federal Reserve announced last month that they would start to reduce their $4.5 trillion balance sheet in October, thereby starting the process we call Quantitative Tightening (QT). As expected, they are aiming to do it gently and quietly, by not reinvesting bonds as they mature, starting with sums of around $6 billion of Treasuries and $4 billion in Mortgage-Backed Securities (MBS). The scale of non-reinvestment will gradually increase. Once in full swing, the Fed's balance sheet could reduce by up to $150 billion each quarter.

Conventional analysis might conclude that the Fed's balance sheet reduction (deflation) would be bad for US Treasuries and MBS – after all, those are the instruments not now being bought by the Fed. Notwithstanding the fact that we dismiss that sort of causality thinking anyway, we're not conventional analysts, and take a different angle.

As the Insights column of our *Interest Rates Pro Service* alluded to last month, the Fed's QE program has crowded out investors in the US Treasury space. The market supply of US Treasuries was reduced by the Fed's program and so it forced bond investors to buy other instruments, such as corporate bonds. Now that more US Treasuries are going to be available for investment, those funds may be tempted to switch the corporate bonds they hold back into ("safer") US Treasuries. The unintended consequence of QT, therefore, may well turn out to be a widening in corporate bond yield spreads.

So, what to look for? Our Bond Market Monitor tracks corporate bond spreads on a daily basis, so the first sign of stress can be seen there. We will be keeping an especially close eye on the trend of the Bloomberg Barclays Global Aggregate Credit index yield spread because, as our chart below shows, it may have found solid support at the old 2014 low.



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