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

So, there we have it. Deflation has started.

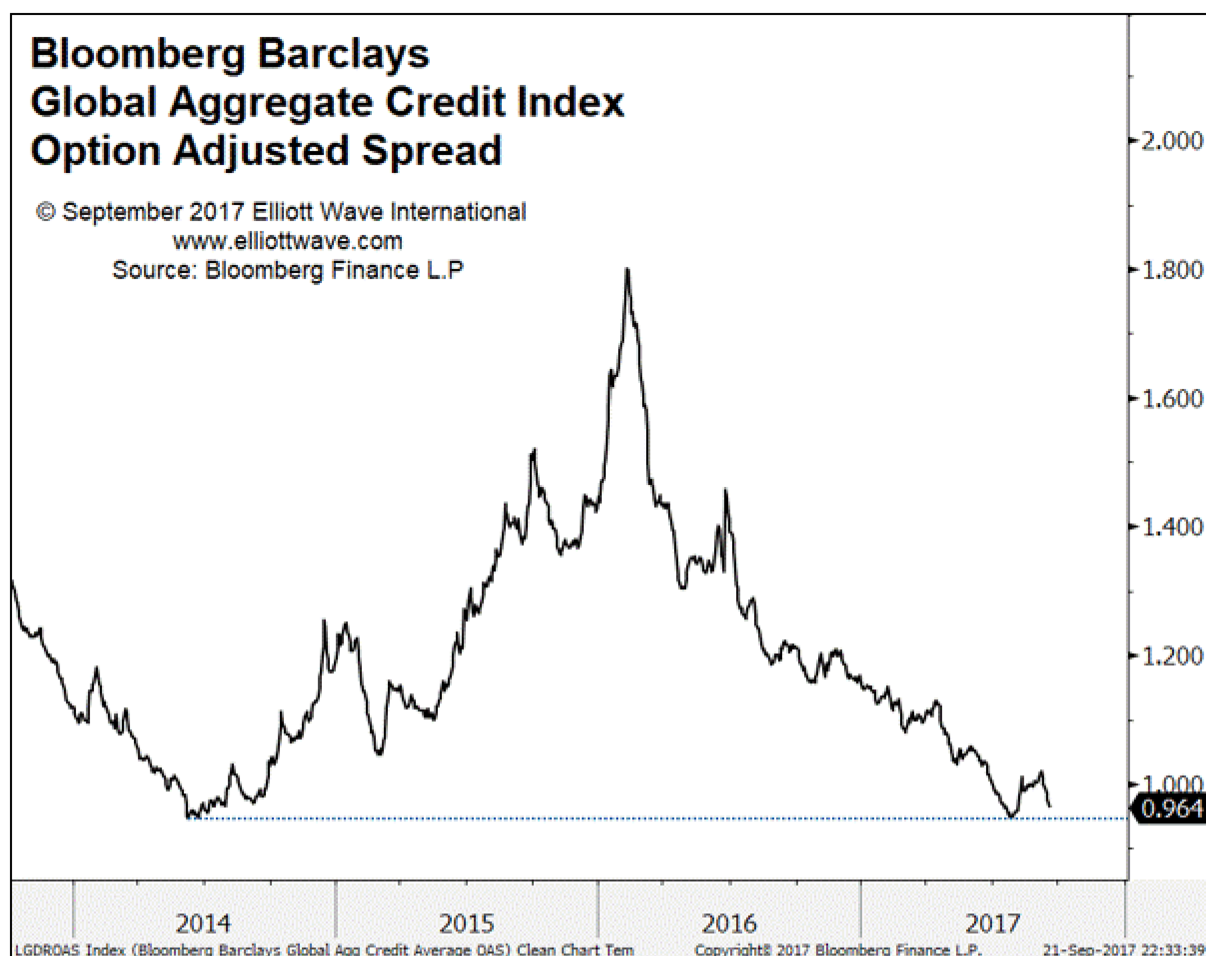
The Federal Reserve announced last month that they would start to reduce their $4.5 trillion balance sheet in October, thereby starting the process we call Quantitative Tightening (QT). As expected, they are aiming to do it gently and quietly, by not reinvesting bonds as they mature, starting with sums 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.



Your Bond Fund: It's Riskier Than You Think

Quantitative Easing (QE) changed the bond markets in ways many don't realize. And now that QE is unwinding, investing in bonds comes with pitfalls that are too risky to overlook. This new resource from EWI's Murray Gunn offers insights you don't want to miss. Get your free report, **Your Bond Fund: It's Riskier Than You Think**.

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the Fed FINALLY Reduces Its $4.5 Trillion Balance Sheet?. EWI is the world's largest market forecasting firm. Its staff of full-time analysts led by Chartered Market Technician Robert Prechter provides 24-hour-a-day market analysis to institutional and private investors around the world.

Some Thoughts Before The Fed Meeting

The Fed is back at it again on Wednesday of this week. And as with every Fed meeting, we get to play the "will they" or "won't they" game.

Our team at Macro Ops believes there's a very low probability of a rate hike this meeting. Now we don't believe in a near zero percent probability (like the one the market is pricing in) but a low chance nonetheless. The terrible payroll reading plus the low UMich inflation expectations number (a favorite of Yellen's) will likely stay the Fed's hand. And this is not to mention the Brexit vote coming up in a few weeks. No need to stir the pot even more beforehand…

The committee will still likely come out in classic fashion and jawbone about a high chance of raising in July. But we seriously doubt this "forward guidance" will have much of an effect on markets this time around. The Fed is in increasing danger of losing their signaling control over markets. They just don't have credibility they used to.

At this point the Fed is becoming less of a key factor in the current macro game. They're slowly realizing that their hands are tied and there's little more they can do.

They can't hike. It's too late in the cycle and the economy is becoming increasingly fragile. And if they don't move rates higher this week or next month, they'll lose their window, since politically it's unlikely they hike any later in an election cycle. The Fed fell behind the curve on this business cycle and will now be left with little dry powder to fight the next downturn. They should have hiked in 2013 while things were running hotter. That was their chance.

The Fed also can't lower or resume QE this meeting either. For that to happen, things first need to get much worse in the market. And that will likely only occur after elections. So as we said, their hands are tied, which makes them a non-factor.

The far more important factors in the current macro game are the BOJ, PBoC, and ECB. Any breakdown in their currency truce (Shanghai Accord) will effectively cause tightening by sending the dollar higher and widening spreads. And looking at Europe and China, we see the growing potential for some serious exogenous shocks in the form of a banking crisis and currency flight.

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