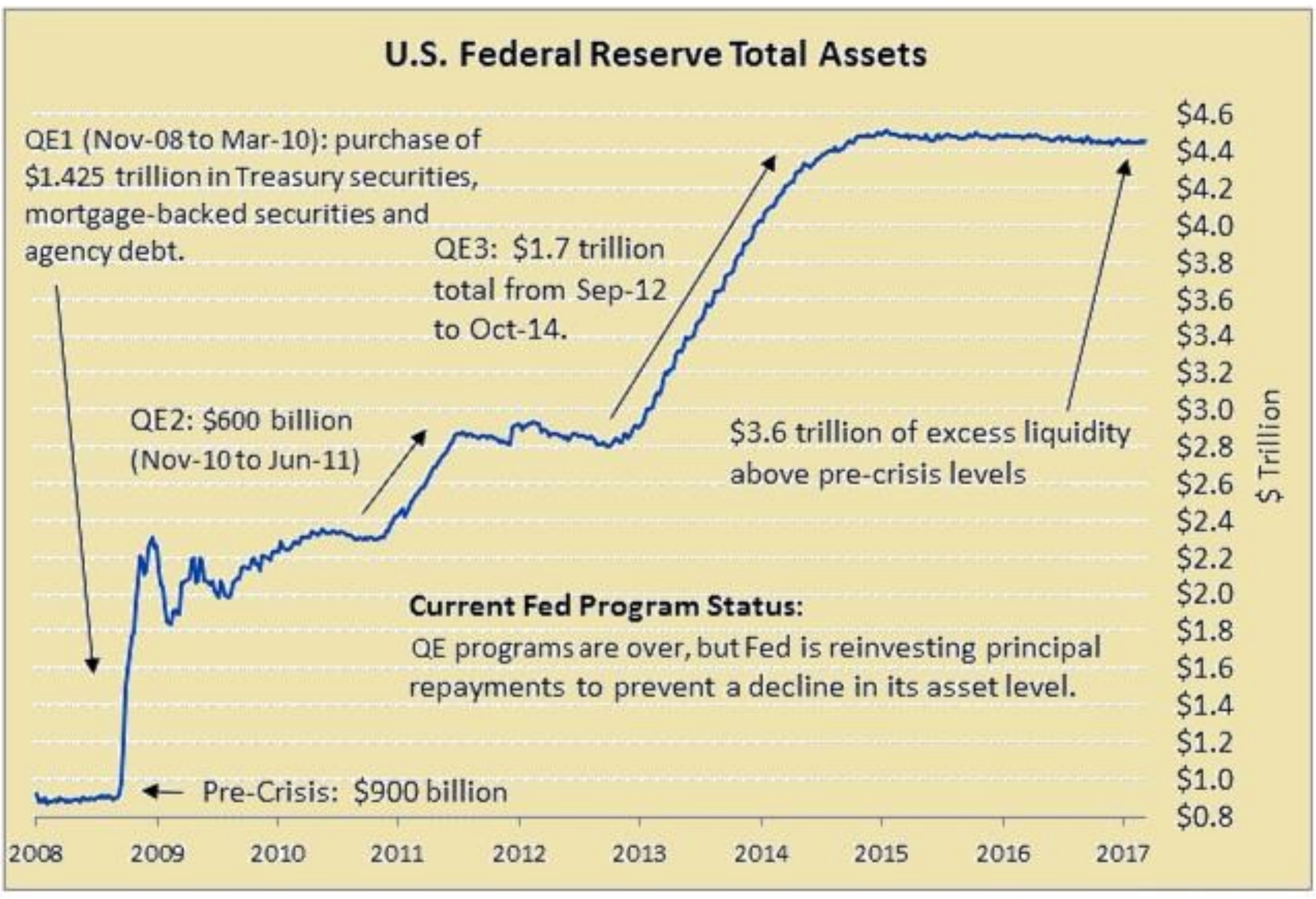
Chart of the Month

March 2017



The term "quantitative easing" (QE) was unknown outside the financial world until 2008 when the Federal Reserve employed this unconventional form of monetary policy to rescue an economy that was on life support. The Fed implemented QE by transferring cash electronically to commercial banks in exchange for a set *quantity* of U.S. Treasury, agency, and mortgage-backed securities with the goal of liquefying the financial system.

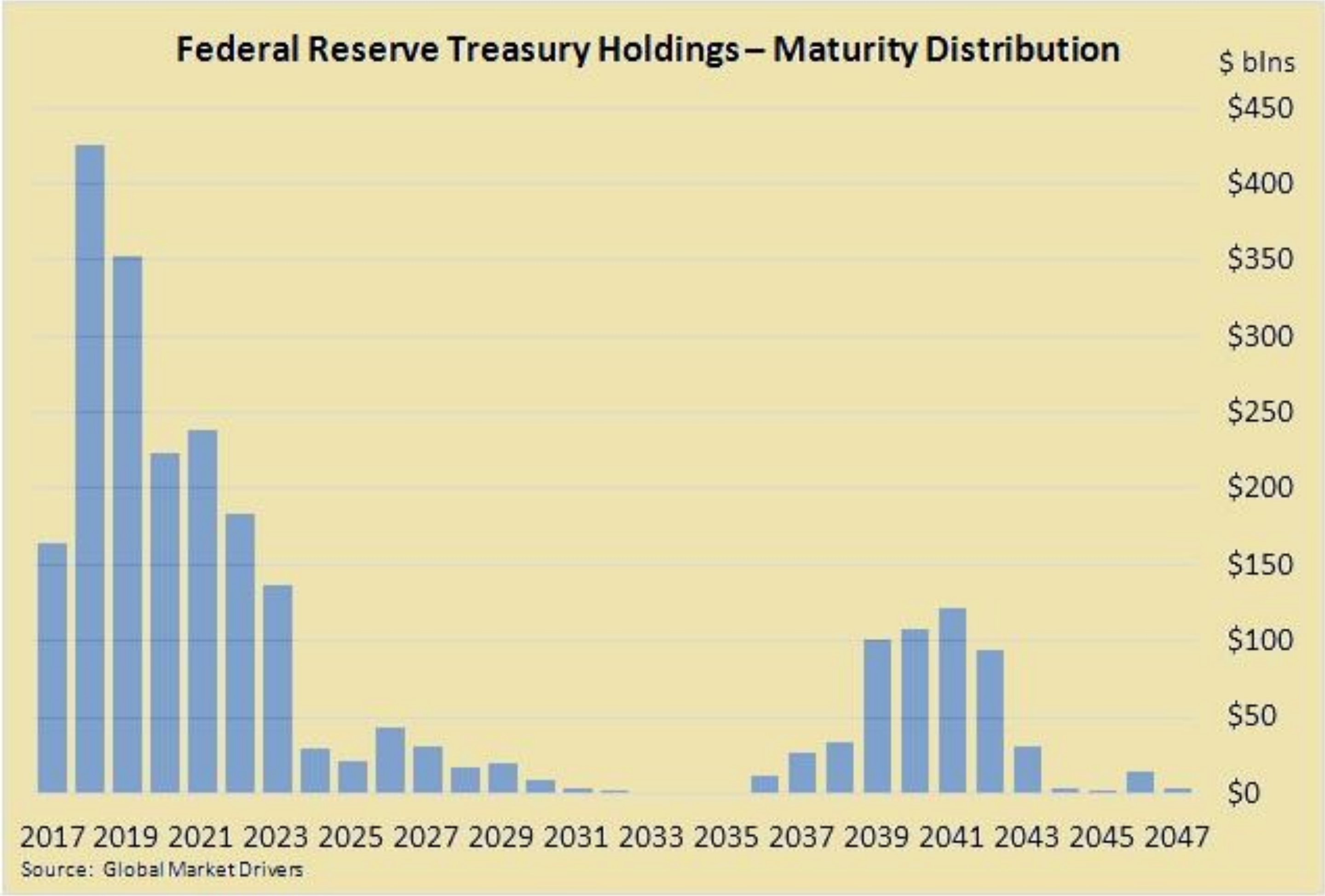
Although the initial concern was how this new policy would ignite inflation due to an increase in the money supply, the Fed was doing nothing more than swapping newly-created bank reserves for bonds to satisfy the world's huge demand for safe assets (such as cash, checking/savings deposits, and CDs). In other words, the Fed was not "printing money" as believed because the banks were simply using the funds to collateralize their growing deposits rather than for lending purposes.

Prior to the financial crisis, the Federal Reserve held $900 billion in assets as shown in the chart above. Over the ensuing six years, the central bank quintupled the size to $4.5 trillion in three distinct stages of quantitative easing, creating $3.6 trillion of additional liquidity. The Fed bought $1.4 trillion in assets between November 2008 and March 2010 in what is now known as QE1. The Fed backed off for eight months before enacting QE2 and purchasing another $600 billion in assets from November 2010 to June 2011. The Fed paused for over a year before putting in place QE3, which resulted in acquiring $1.7 trillion in assets (the largest of the three stages) between September 2012 and October 2014. The program has been put to rest now for 2-1/2 years but the portfolio has remained level as coupon payments and bond maturities have been reinvested in like securities.

As the economy strengthens and the world becomes less risk averse, it follows that the need for such massive cash reserves will dwindle. Therefore, it is incumbent on the Fed to begin winding down its balance sheet by curtailing the reinvestment of interest and principal and returning its composition to primarily Treasury securities over time.

While Fed Chair Janet Yellen has been virtually silent on the subject, at least six Fed presidents have spoken publicly about the need to reduce the size of the central bank's total assets since the last FOMC meeting two weeks ago. San Francisco Fed President John Williams is not alone in believing that the process of shrinking the Fed's balance sheet should happen in a "gradual and predictable way" over several years.

With $426 billion of Treasury securities maturing in 2018 and a total of $1.4 trillion coming due over the next five years (2018-2022) as detailed in the chart below, the Fed will need to finesse the amount it draws down so as not to unduly affect the financial markets. In the meantime, we believe that Fed officials will continue to comment on the balance sheet, softening up investors for an inevitable change in its reinvestment policy.



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