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# The Fed Unwinds

SEPTEMBER 2017

**Snapshot**

- The Federal Reserve announced a detailed plan to gradually decrease trillions of dollars' worth of bonds that it has accumulated in an attempt to keep interest rates low and support financial markets and the economy.
- The central bank will cease to reinvest $10 billion per month of principal proceeds beginning in October.
- While markets now expect tighter Fed policy, SEI believes the risk of recession or a serious monetary-policy error by the Fed remains quite low.

The Federal Reserve (the Fed) announced a detailed plan on September 20th to gradually decrease the trillions of dollars' worth of bonds accumulated through its quantitative-easing programs over the past 10 years.

Acquiring these bonds—during and after the Great Recession in an attempt to keep interest rates low and support financial markets and the economy—has been popularly referred to as the Fed "expanding its balance sheet."

## A Wide U-Turn

The Fed finally stopped expanding its balance sheet in 2014. However, it has continued to reinvest the proceeds of maturing bonds in order to keep these supportive conditions in place, effectively maintaining the size of its expanded balance sheet.

Now, the Fed has announced intentions to slowly begin curbing this reinvestment activity, which means its bond stockpile will start to shrink. The central bank will cease to reinvest $10 billion per month of principal proceeds beginning in October.

The Fed has accumulated $2.4 trillion in U.S. Treasurys and $1.7 trillion in agency mortgage-backed securities (MBS) since late 2008, and will unwind its balance sheet in proportionate fashion, by ceasing to reinvest $6 billion of principal proceeds from Treasurys and $4 billion from MBS per month.

These amounts will increase every three months, by a respective $6 billion and $4 billion, until $30 billion in Treasurys and $20 billion in MBS principal proceeds are retired per month.

There are no plans at this stage to engage in balance sheet asset sales.

## Market Reaction

U.S. stocks initially declined on the announcement, but then recovered, finishing the day essentially where they began. The U.S. dollar advanced relative to other major currencies, but appeared to give back some of those gains the following day. The 10-year U.S. Treasury yield jumped following the announcement, and—similarly to the U.S. dollar—retraced part of its climb the next day.

## SEI's View

The Fed's plan to unwind its balance sheet was well telegraphed, and its implementation will be slow. U.S. central bankers intentionally sought to avoid another taper tantrum like we saw in 2013, when U.S. Treasury yields rose in response to the Fed's announcement that it would gradually taper its bond purchases to slow—and eventually stop—its balance sheet expansion.

As we saw following the announcement, short-term volatility is likely. However, the market appears to have settled back to levels that are still largely in line with recent trends.

The Fed also projected a drop in the long-term Federal Funds target rate from 3% to 2.80%. There's a perception that removing balance sheet assets will drive rates higher, but we believe that other forces will put a cap on the rise in interest rates.

While markets now expect tighter Fed policy than they did just a couple of weeks ago, we believe the risk of recession or a serious monetary-policy error by the Fed (or fiscal policy error by Congress) remains quite low.

In terms of future action, the Fed indicated it will remain side-lined until they can see what—if any—impact their October actions have on interest rates.

### Glossary

**Quantitative easing:** Quantitative easing refers to expansionary efforts by central banks to help increase the supply of money in the economy.

### Important Information

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