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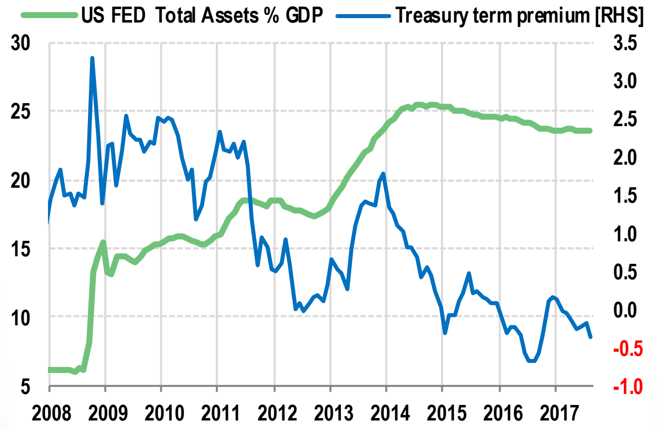
Pictures at an exhibition. On reducing the Fed's balance sheet

■ The Fed will probably announce the start of the reduction of its balance sheet at its meeting next week ■ Although not without risks, markets are relaxed about it ■ Fed forward guidance and rate decisions are more important than the balance sheet

In the minds of many market participants, they have received the following invite: *"Your presence is requested at the vernissage in Washington DC on 20 September 2017"*. Based on a recent survey of investors by the Federal Reserve of New York, 57% expect an announcement of the start of the balance sheet reduction at the FOMC meeting next week. Janet Yellen described the gradual scaling back of the Federal Reserve's balance sheet with the now famous metaphor of watching paint dry, i.e. uneventful. This begs the question of whether in reality the piece of art will look like some modern monochrome painting or a Jackson Pollock. Perhaps we should go for the description given by Andrew Filardo of the BIS at a recent conference: it will be like performance art with the audience influencing the outcome.

For the time being at least, the audience, that is the markets, seem relaxed at this stage. The term premium, that is the risk premium for holding long-dated paper rather than short-term treasury bills, has been on a solid downtrend. In the above mentioned Fed survey, the median expected cumulative impact on 10 year treasury yields was +25 basis points over the coming two years. Simulations by the Federal Reserve of Kansas City point towards a similar, small increase, though the authors insist it could be as low as zero and as high as 75 basis points.

US BALANCE SHEET & TERM PREMIUM



Source : Federal Reserve Bank of New York, BNP Paribas

Reducing the size of the balance sheet means the "artificial" buyer of old days (during QE) now becomes an artificial seller. Everything else being the same, this would require lower prices and higher yields to balance the bond market. Reality is far more complex with many moving parts: fluctuations in risk appetite, international capital flows, bank credit, intended savings and investments. Eventually, the FOMC is still holding the key: via forward guidance and rate decisions it can influence the entire curve, thereby avoiding that an increase in the term premium would end up harming the economy. Looking at the balance sheet may very well be as exciting as watching paint dry but the real fun will be watching the Fed, as always.

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