ODDO BHF
CORPORATES & MARKETS

Economy

Focus US
N° 2021 - 38

Fed's balance sheet: +$ 5tn

Friday 15 October 2021

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This is roughly the amount that the portfolio of securities held by the Fed will have increased when the asset purchase programme draws to a close around mid-2022. The Fed holds approximately one-quarter of the outstanding federal debt (15% before the pandemic), which acts as a drag on long-term rates. There is an excess of liquidity in the money market, as evidenced by the massive use of the reverse repo facility. Even so, the central bank is not actively reducing its imprint in the bond market. Its priority at this time is to exit an emergency measure and to signal, as inexpensively as possible, its vigilance on the inflation risk.

The week's focus

Even before it is made official next month, the Fed's tapering of asset purchases is accepted by all. The progress made by the US economy since December 2020 is considered sufficient to make the leap. There was no panic like in 2014. Jerome Powell made the preparation for the tapering a non-event. The process will be spread over eight months if, as seems to be the preferred option, the pace of purchases is reduced by $ 15bn per month. By June 2022, the Fed's balance sheet will be close to $ 9,000bn, or the equivalent of 38% of GDP. In the previous tapering in 2015, the peak was 26% of GDP. In short, since the start of the pandemic, the Fed's balance sheet will have been inflated by nearly $5tn (chart lhs). On the assets side, the increase is due to the securities portfolio. During the acute phase of the crisis, the Fed also increased its lending and swap facilities, but these items are now normalised. On the liabilities side, there has been an increase in bank deposits and, in recent months, a surge in the Reverse Repo. This shows that the interbank market is brimming with liquidity. There's no need to add more.

What does the Fed weigh on the bond market? It holds approximately 25% of total outstandings of federal securities and MBS. Its share of Treasuries' holdings was higher in the 1970s, but this was not the result of an active policy to support the markets but rather a passive adjustment to changes in fiscal policy (chart rhs). QE is now part of the monetary toolkit. In the future, it could take different forms as needed. In a recent paper[1], Fed economists suggested that QE be modulated (fixed amount, open programme with adjustable flows, specific targeting to support a given agent) according to the types of shocks suffered by the economy. At the current programme's close, the Fed will not withdraw from the market, selling no securities, and reinvesting maturing ones. Paper absorption requirements will be reduced with the cyclical reduction in the federal deficit. In any case, the Fed is likely to keep some pressure on long-term rates. Maintaining a large portfolio of securities is supposed to weigh on their absolute level.

1 Carlson & al (2020), *Issues in the Use of the Balance Sheet Tool*

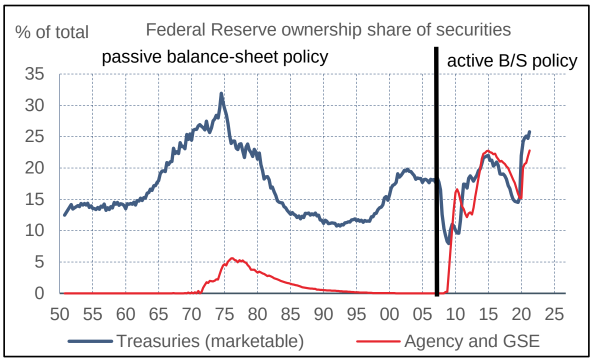
Fed's simplified balance sheet

Federal reserve banks consolidated statement (bn$)

Assets	1 Jan.2020	14 Oct.2021	Liabilities	1 Jan.2020	14 Oct.2021
Gold/FX Reserves	18	17	Banknotes	1759	2155
Loans	0	55	Deposits	2032	4593
- o/w PD credit facility	0	0	- o/w held by banks	1549	4205
- o/w MMMF liq.facility	0	0	- o/w T'sy account	404	72
- o/w PPP liq.facility	0	55			
Repo	256	0	Reverse repo	337	1658
Central bank swap	4	0			
Securities	3740	7963			
- o/w Treasuries	2329	5466			
- o/w MBS	1409	2495			
Other assets	156	445	Other liabilities	46	75
TOTAL	**4174**	**8481**	**TOTAL**	**4174**	**8481**

PD: primary dealer , MMMF: money market mutual fund, PPP: Paycheck Protection Program

Weight of the Fed in the bond market



Sources: Fed, ODDO BHF Securities

Economy

- On the surface, the **September** labour market report was uninspiring, in all events disappointing compared to expectations (+194k jobs created, 500k expected). Below the surface, though, the details were more robust. Firstly, the data for July and August were revised upwards by 169k. Next, the number of positions in the education sector fell to quite an unusual extent (-123k), which probably reflects the disruptions to the back-to-school period during the pandemic. This is not a factor which is likely to be repeated. Lastly, the BLS survey with households gives a much stronger estimate of job gains (+526k), which points to a decline in the jobless rate of 0.4 points to 4.8%. The hourly wage rate has accelerated further (+0.6% m-o-m, +4.6% y-o-y), confirming the tensions at the bottom of the wage scale. This movement also partly reflects composition effects. The supplementary JOLTS report on labour market flows indicates a fresh increase in the quit rate to 2.9% of employees in **August**, a new record (the series starts in 2000, its historical average is 1.9%). In catering, this rate has literally soared, rising by 1.2 pt to 6.8%, again a new record (average = 4.1%).
- In **September**, the CPI advanced by 0.4% m-o-m, pushing the annual rate somewhat higher 5.4%. A good chunk of this stems from soaring energy prices (+25% y-o-y). Regarding prices distorted by the pandemic, we note a slight easing in used car prices (-0.7%, +24.4% y-o-y). For the second month in a row, air fares are down, which is probably a Delta variant effect. We can expect a recovery out to the end of the year. Housing services prices (rents and owners' equivalent rents) have firmed up. This trend is likely to continue as a delayed effect of the real estate overheating. All told, inflation remains high by recent standards, although the pace of price increase eased in Q3 (0.39% per month) compared to Q2 (0.77% per month). Core inflation has stabilised at 4.0% y-o-y.
- In the latest *World Economic Outlook* published this week, the IMF substantially revised down its real GDP growth forecast for 2021, with -1pt vs July at 6.0%, but raised its outlook for 2022, with +0.3pt to 5.2%. The consensus is more conservative (rightly, in our view), at respectively 5.7% and 4.1%.

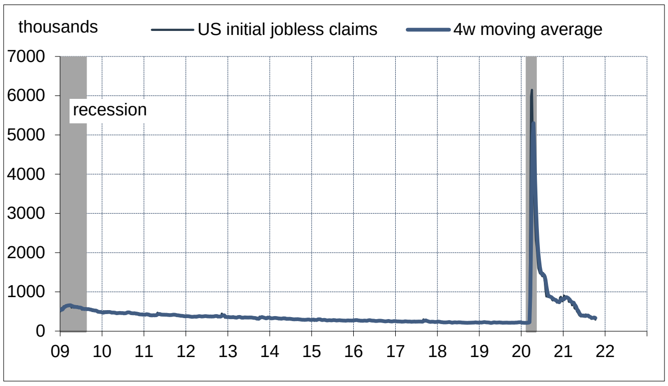
Monetary and fiscal policy

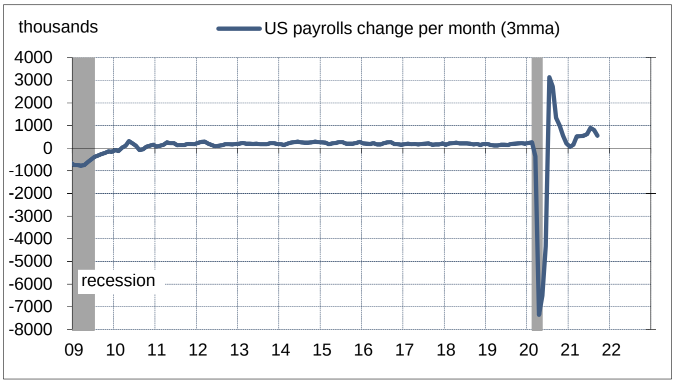
- If there were any lingering doubts as to whether the Fed would reduce the pace of its asset purchases at its next meeting, they were dispelled by several recent speeches by members of the FOMC, for example those by **Richard Clarida** (Board) and **Raphael Bostic** (Atlanta). Both acknowledged that inflation risks still tilted to the upside and, therefore, that the risk of expectations becoming unanchored needed to be heeded. Richard Clarida admitted that the current situation had the flavour of the stagflation in the 1970s but refuted the idea that it had the same substance. The Fed has learned the lessons from the mistakes made during that period, he said, and will not make them again. Raphael Bostic does not believe that the conditions for a lasting surge in inflation are in place either, but he now refuses to use the word "*transitory*" to describe the rise in inflation. Some of the supply chain disruptions began more than a year ago, and they are not about to be corrected imminently. Mr Bostic prefers to speak of an episodic surge as these extreme variations in relative prices are almost all tied to the pandemic, which deformed the structure of consumer spending and created bottlenecks. Beyond this quibbling over language, it is clear that the Fed does not plan to remain passive. Reducing the emergency measures (asset purchases) without delay is the least it can do.
- The minutes of the **22 September** meeting of the FOMC merely confirmed that tapering is imminent. The decision will be official at the next meeting, but it has yet to be announced whether the reduction in asset purchases will begin mid-November or mid-December. The pathway being considered is a reduction of $ 10bn in Treasuries and $ 5bn in MBS each month. Starting from respective rates of $ 80bn and $ 40bn, it would take exactly eight months at this pace to complete the process.

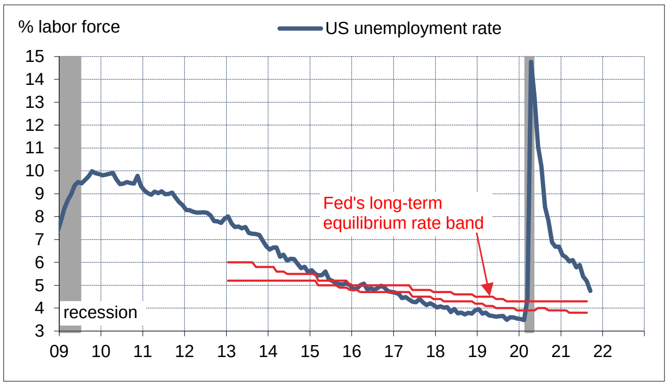
The week ahead

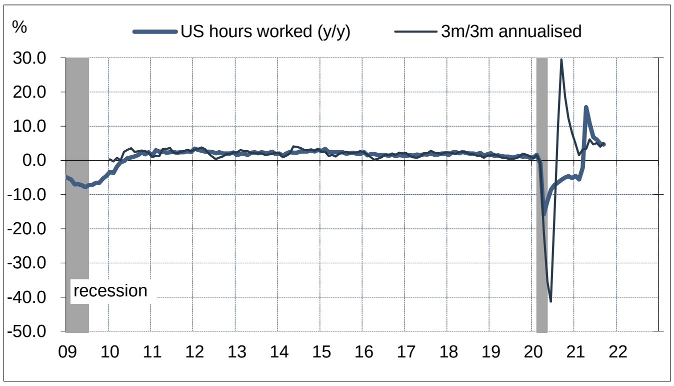
- The Beige Book, prepared ahead of the FOMC on **3 November**, is to be published on **20 October**. The key data for release are industrial production (**18 October**), housing starts and building permits (**19**) and existing home sales (**21**). With regards to survey data for October, there will be the NAHB homebuilders' confidence index (**18**), the Philly Fed index for the manufacturing sector (**21**) and preliminary PMI estimates (**22**).

Appendix 1 - Labour market

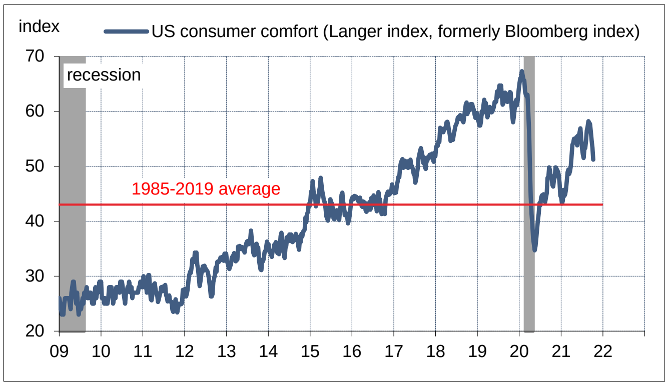


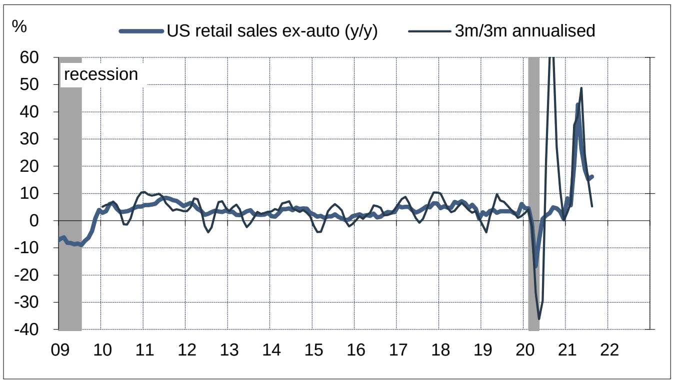


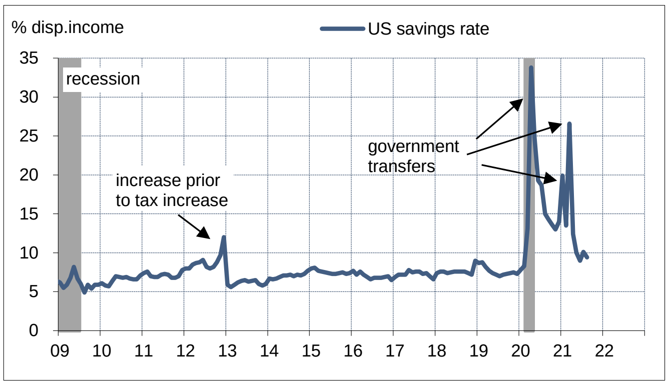


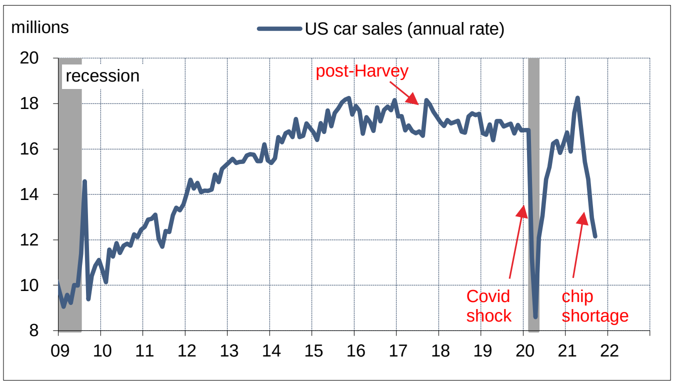


Appendix 2 - Consumer



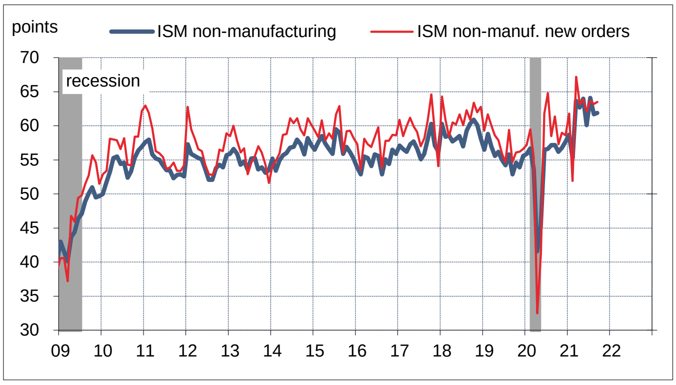


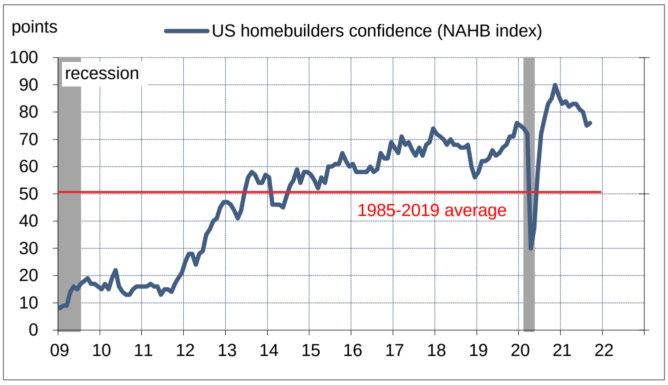


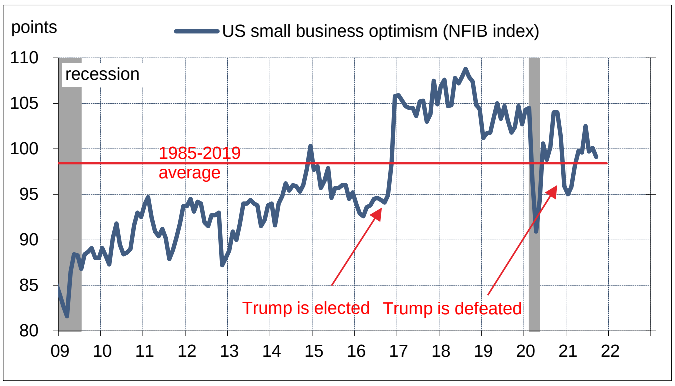


Sources: Thomson Reuters, Bloomberg, ODDO BHF Securities

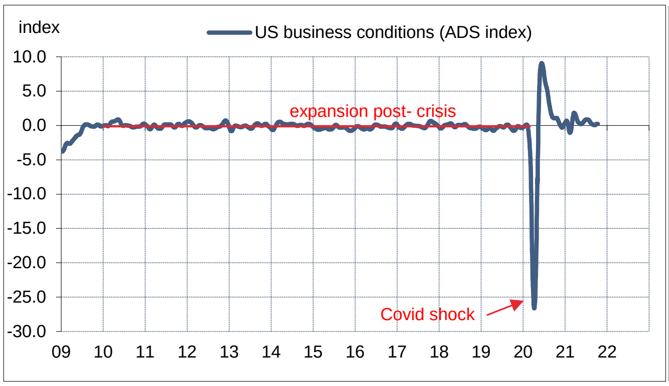
Appendix 3 - Business climate

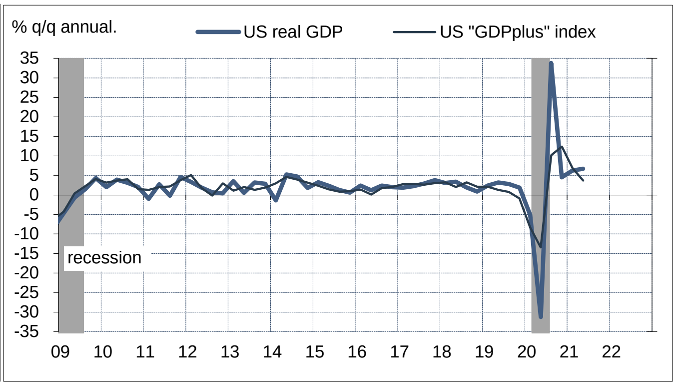


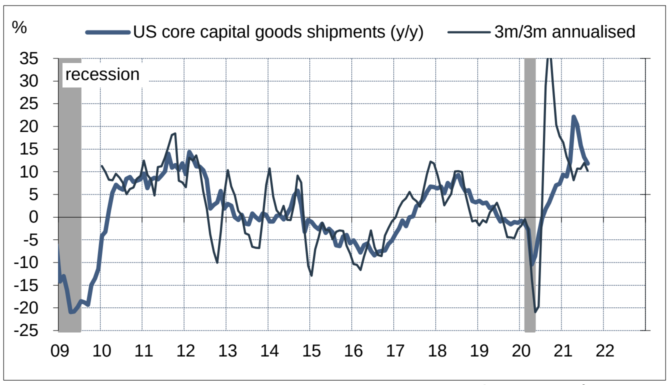


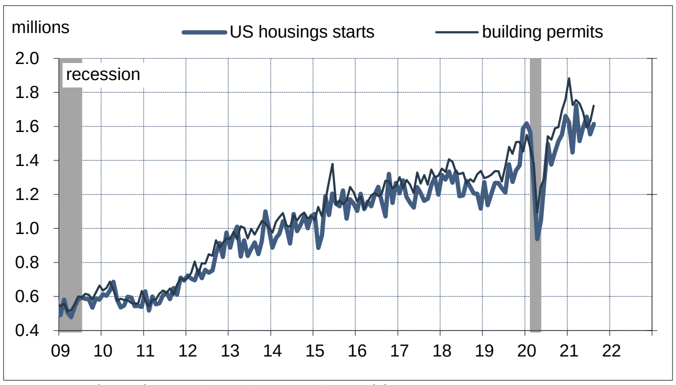


Appendix 4 - Conditions of economic activity



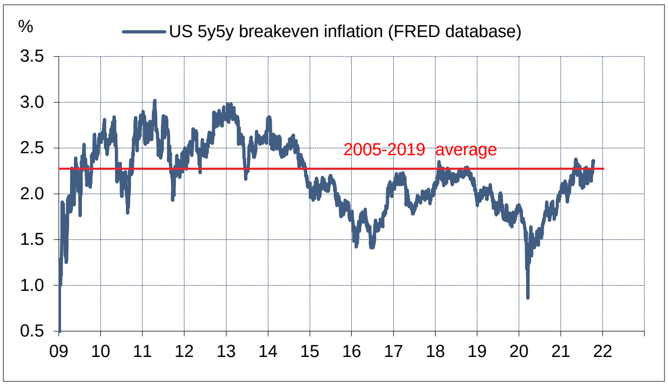


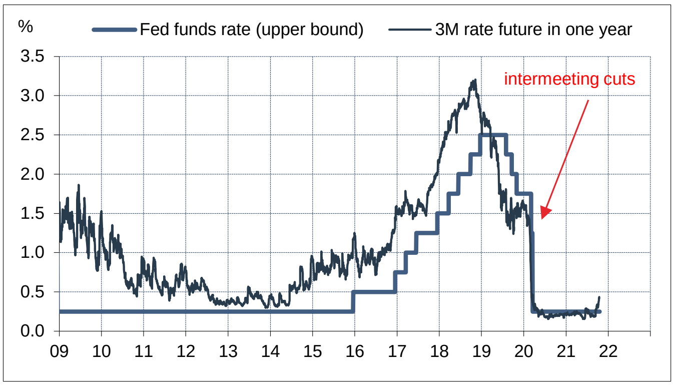


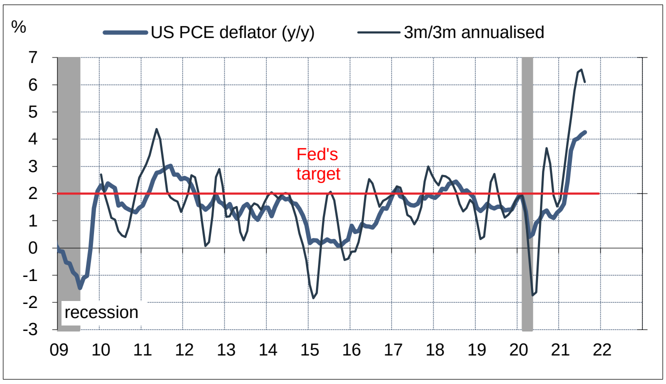


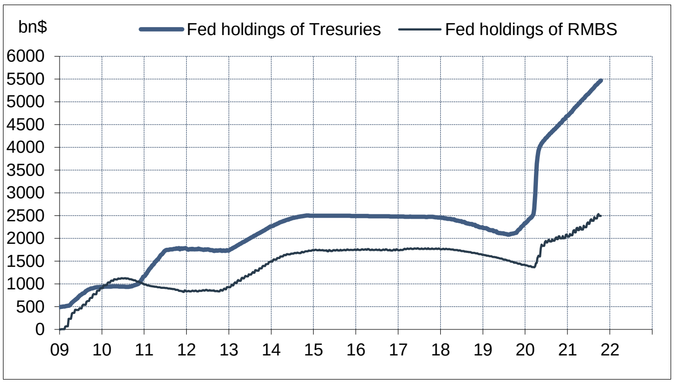
Sources: Thomson Reuters, Bloomberg, ODDO BHF Securities

Appendix 5 - Inflation and monetary policy

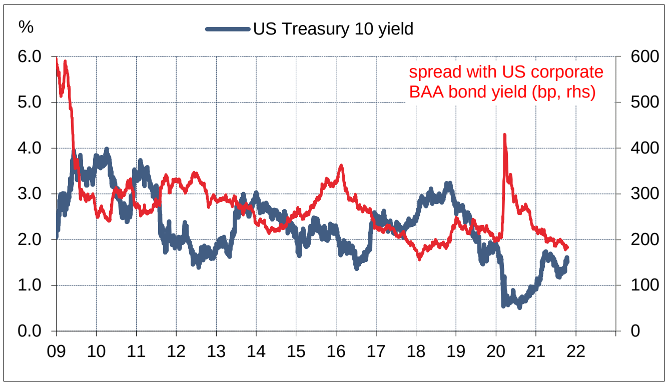


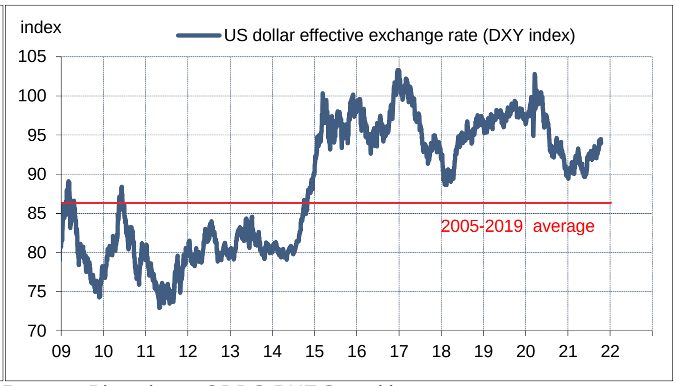






Appendix 6 - Financial markets





Sources: Thomson Reuters, Bloomberg, ODDO BHF Securities

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