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In this week's recap: The Fed signals more aggressive action on interest rates.

Weekly Economic Update

Presented by Ed Papier, April 11, 2022

THE WEEK ON WALL STREET

Stock prices fell last week in response to the Fed's plan to combat inflation, which staked out a more aggressive stance than investors had anticipated.

The Dow Jones Industrial Average slipped 0.28%, while the Standard & Poor's 500 fell 1.27%. The Nasdaq Composite index dropped 3.86% for the week. The MSCI EAFE index, which tracks developed overseas stock markets, slid 2.05%. [1,2,3]

FED ROILS MARKETS

After a positive start to the week, stock prices turned lower on a more hawkish tone from Fed officials. On Tuesday, investors were surprised by comments from Fed governor Lael Brainard, one of the Fed's more dovish members, who suggested the Fed could take a more aggressive approach with interest rates.

The unease extended into Wednesday when minutes of the last Federal Open Market Committee (FOMC) meeting were released, signaling a potentially faster pace in both interest rate hikes and the wind-down of the Fed's balance sheet. Yields climbed steadily throughout the week as the bond market digested this new information. Particularly hard hit were high valuation stocks, as reflected in the 4% drop in the Nasdaq.

FED MINUTES

After raising the federal funds rate by 0.25% last month, the minutes from the March FOMC meeting made it clear the Fed is serious about fighting inflation with higher interest rates.

Fed officials indicated they might have hiked rates by a half percentage point in March had it not been for the uncertainty created by the invasion of Ukraine. Multiple Fed officials suggested that future rate hikes may reach 0.5%. Fed officials also discussed allowing up to a $95 billion monthly run off the Fed's balance sheet, a faster pace than the market expected. [4]

THE WEEK AHEAD: KEY ECONOMIC DATA

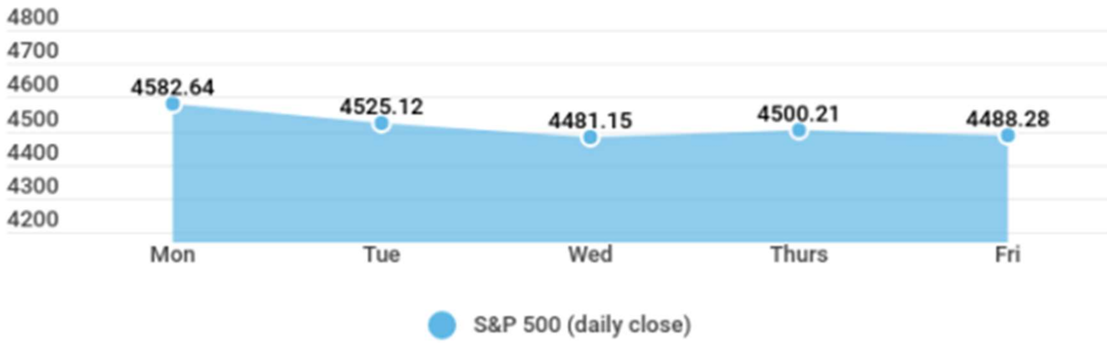
Tuesday: Consumer Price Index (CPI).
Wednesday: Producer Price Index (PPI).
Thursday: Jobless Claims. Retail Sales. Consumer Sentiment.
Friday: Industrial Production.

QUOTE OF THE WEEK

"Don't cry because it's over. Smile because it happened"

DR. SEUSS

Market Index	Close	Week	Y-T-D
DJIA	34,721.12	-0.28%	-4.45%
NASDAQ	13,711.00	-3.86%	-12.36%
MSCI-EAFE	2,126.57	-2.05%	-8.97%
S&P 500	4,488.28	-1.27%	-5.83%



	Treasury	Close	Week	Y-T-D
	10-Year Note	2.72%	+0.34%	+1.20%

Sources: The Wall Street Journal, April 8, 2022; Treasury.gov, April 8, 2022
Weekly performance for the Dow Jones Industrial Average, Standard & Poor's 500 Index, and NASDAQ Composite Index is measured from the close of trading on Friday, April 1, to Friday, April 8, close. Weekly performance for the MSCI-EAFE is measured from Friday, April 1, open to Thursday, April 7, close. Weekly and year-to-date 10-year Treasury note yield are expressed in basis points.

OF NOTE

Earlier this week, Federal Reserve governor and vice-chair nominee Lael Brainard indicated the central bank will shrink its balance sheet at a "considerably" more rapid pace than it did during the previous cycle. Some commentators have claimed the Fed won't be able to do this. Why not?

The Fed first expanded its balance sheet in the wake of the 2008 financial crisis. Through three rounds of quantitative easing (QE), the Fed expanded its balance sheet from under $1 trillion to $4.5 trillion. When the central bank started QE, then-Fed Chair Ben Bernanke swore the central bank wasn't monetizing federal government debt. He said the balance sheet expansion was an emergency measure and that the Fed would eventually sell the bonds it was buying.

The Fed didn't get around to balance sheet reduction until 2018, and it did so at a relatively slow pace. By the time it ended tightening in August 2019, the balance sheet was just below $3.8 trillion. In all, the Fed shed about $700 billion from its balance sheet in a little more than 18 months.

Why did the Fed abandon tightening in 2019? Because in the fall of 2018, the stock market tanked, and the economy went wobbly. The markets and the economy couldn't handle even the modest monetary tightening the Fed managed to implement.

It's important to remember that the Fed resumed QE months before the pandemic — although it didn't call it QE. By the time the Fed launched QE 4 in 2020, the balance sheet had already expanded back to just over $4 trillion. Over the last two years, the Fed has added another $5 trillion to the balance sheet expanding it to nearly $9 trillion.

Brainard indicated that the upcoming balance sheet runoff will be "considerably" faster than last time. She did not say what that actually means, but the Fed minutes from the March meeting shed a little bit of light on the nuts and bolts of the plan.

According to the minutes, the plan is to reduce the balance sheet by about $3 trillion over a three-year period. This would leave the balance sheet at $6 trillion – up by $2 trillion from its pre-pandemic level and more than $5 trillion above the pre-2008 financial crisis level.

Looking at the big picture, the Fed's plan is relatively modest. If it sticks to this plan, it will shrink the balance sheet by about $1 trillion per year. The process of balance sheet reduction makes it extremely unlikely that the Fed can accomplish its goal.

If the central bank couldn't run off $700 billion in 2018 without popping the bubbles and shaking up the economy, what makes them think they can decrease its balance sheet holdings by $3 trillion this time around with even bigger bubbles and more debt in the economy?

First, you have to understand how and why the Fed expanded its balance sheet to begin with.
Through quantitative easing, the Fed buys US Treasury bonds and mortgage-backed securities with money created out of thin air on the open market.

QE accomplishes two important things for the US government. First, it injects currency and liquidity to juice the economy (inflate bubbles?) Second, it reduces the supply of bonds on the market and holds bond prices artificially high. Bond yields are inversely correlated with bond prices. When the price of a bond rises, the yield falls. Propping bond prices up through its artificial demand keeps interest rates low.

So, QE benefits the federal government in two ways. It allows the US Treasury to sell more bonds to finance its deficits because the Fed is absorbing some of the supply and keeping demand higher than it otherwise would be. And it keeps the government's borrowing costs low by artificially suppressing interest rates.

Balance sheet reduction, or quantitative tightening (QT), reverses this process. The Fed can shrink its balance sheet in two ways.

1. Typically, the Fed rolls over the bonds on its balance sheet as they mature. In other words, it takes the money the government pays for the mature bond and buys a new one to replace it. The Fed can shrink its balance sheet simply by letting the old bonds roll off the books without replacing them. This is a relatively slow way to shrink the balance sheet.
2. The Fed can decrease its bond holding more quickly by selling them on the open market.

Either way, it creates a big problem for the federal government. If the Fed sheds $1 trillion in bonds from its balance sheet over the next year, the US Treasury will have to find buyers for $1 trillion in additional bonds, on top of the $1 trillion or so in new bonds it will have to sell to finance the annual deficit. And it will also have to sell new bonds to replace maturing bonds that are currently out there in the market. That's how a government Ponzi scheme works. It pays off old debt with money borrowed from new lenders.

We're talking about $3 to $4 trillion in bonds that will need buyers over the next year. This conundrum raises a very important question: who is going to buy all of these bonds? The Fed ranks as the second-largest holder of US debt behind US individuals and institutions. If the Fed is out of the market, and shedding some of its holdings, who is going to fill that gap? Where will the Fed find buyers for an additional $1 trillion in Treasuries every year for the next three years, on top of all the new bonds it needs to sell to finance its massive deficits? The Fed was in the QE game to prop up the bond market. What happens when it pulls out those props?

Supply and demand dictate that as the Fed dumps bonds onto the market, supply will rise, and the price will fall. That means yields will rise, creating another big problem for the US government. Rising interest rates mean Uncle Sam's borrowing costs rise. It's the same problem you would have if the bank started raising your mortgage rate, or your credit card company raised your interest rate. The US government will have to pay more to finance its debt. That means it will have to borrow more. And that means even more bonds on the market. This borrowing will ripple through the entire financial system and the broader economy. We saw the impacts of tightening in 2018. There is no reason to think it will be any different this time around.

The Fed can talk about balance sheet reduction all it wants. But talking and doing are two different things. [5]

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Know someone who could use information like this?

Please feel free to send us their contact information via phone or email. (Don't worry – we'll request their permission before adding them to our mailing list.)

CITATIONS:

1. The Wall Street Journal, April 8, 2022
2. The Wall Street Journal, April 8, 2022
3. The Wall Street Journal, April 8, 2022
4. CNBC, April 6, 2022
5. zerohedge.com/economics/why-wont-fed-be-able-shrink-its-balance-sheet