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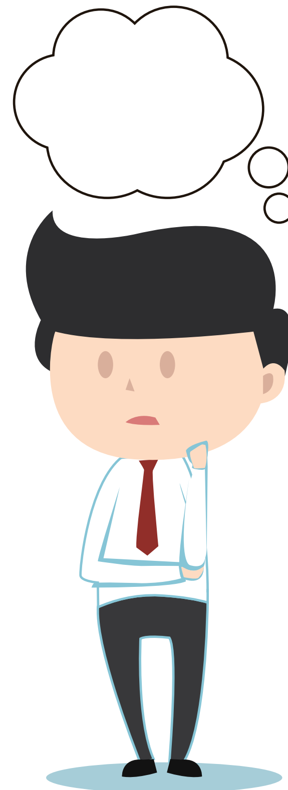
VIEWPOINT

5 Macro Thoughts

BRIAN SMITH | JULY 14, 2017



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1 If Fed and other central bank balance sheet expansion was the true catalyst for risk assets decoupling from fundamentals, then the eventual shrinking of these balance sheets back to pre-crisis levels should coincide with a return of asset prices to fundamentals.

The timing of this balance sheet reduction will be very gradual. The Fed's balance sheet ballooned from $900 billion pre-financial crisis to $4.5 trillion currently. The Fed has forecast tapering reinvestments by a scaled pace that will eventually reach $50 billion a month (60%/40% split between Treasuries & MBS). If the central bank eventually tapers at that pace, it will shrink its balance sheet by $600 billion a year. At that pace it would take approximately three years just to get the balance sheet down to $3 trillion. Chair Yellen described this slow schedule of balance sheet reduction as purposely being as boring as "watching paint dry." The Fed wants to buy time for fundamentals to improve before pushing asset prices back to them. Furthermore, if there were a downturn in the economy, the Fed could halt reduction or even look to expand the balance sheet again, depending on who the next FOMC Chair is.

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Given Yellen's focus on her legacy, and with the Fed having hiked three times in the last seven months, expect the FOMC to enact a balance sheet reduction plan before hiking again.

Yellen is looking to support her legacy, with Gary Cohn now the favored successor to her seat. The difference between a 1.25% and 1.5% fed funds rate will not be remembered five years into the future. Being able to say she started the process of normalizing the balance sheet (albeit late), addresses a significant criticism of her tenure. It would take a significant weakening of economic data for the Fed not to implement its slow balance sheet reduction program.

3

While the curve has flattened significantly, curve levels should be normalized for the overall level of rates.

Large curve flattening raises red flags because it usually foretells of an imminent end to the business cycle. As the curve flattens, forward rate expectations are being lowered relative to near-term rate forecasts. Said differently, the more the Fed hikes now, the less likely they will be able to keep hiking in the future as they may be approaching the end of the hiking cycle if economic growth starts to falter. Yet, a 2s10s curve spread of 100 bps when 10-year Treasury yields are 2.25% is very different than a 2s10s curve spread of 100 bps when 10-year Treasury yields are at 5%. Assuming a constant 100 bps 2s10s curve, at 2.25% in 10-years, the 2-year yield is 55% of the 10-year yield (1.25% / 2.25%), whereas at 5% in 10-years, the 2-year yield is 80% of the 10-year yield (4% / 5%). After normalizing the curve level for the overall level of rates, today's 2s10s curve at 100 bps with 10yrs at 2.25% does not seem as flat as it does in absolute terms.

4

Financial conditions have not tightened materially despite the Fed's three recent rate hikes. This is largely due to a weaker dollar and the strong performance of risk assets.

The Goldman Sachs Financial Conditions Index has continued to drift lower, indicating that business conditions remain accommodative. While many would have thought that three Fed hikes at consecutive press conference meetings would tighten financial conditions materially, this has not proven to be the case. The dollar has not strengthened materially, as expectations for stronger global growth have grown and other global central banks have turned more hawkish. Furthermore, risk assets remain partially buoyed by deregulation hopes and the conundrum that there are no attractive alternative investments. While there is obviously some circular feedback loop implicit in having the dollar and risk asset pricing as inputs in the index, the Fed does actively watch this index and its accommodative showing is perceived as a green light to continue tightening policy if inflation pressures emerge.

5

Inflation data is now the most important data.

The nonfarm payroll number is traditionally the biggest economic data release of the month on trading floors across the country. Yet, with the unemployment rate at 4.4% and job growth continuing to trend around +200,000 a month, it is no secret that the economy is approaching full employment. Inflation data may therefore be more important going forward. The last four Consumer Price Index prints have all disappointed to the downside, refuting the traditional Phillips Curve notion that full employment leads to inflation. If inflation is not picking up materially, then there is little reason for the Fed to keep aggressively hiking rates, given that growth is not overheating. Watch the inflation data closely going forward!

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