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US central bank will start reducing bond holdings in October

Gerhard Winzer

The most important central bank in the world, the Federal Reserve of the USA, has announced a historic decision as a result of its FOMC meeting on 20 September: the central bank balance sheet, hugely inflated in the wake of the bond purchase programme, will be gradually reduced from October onwards. Generally speaking this is a good sign, as the decision can be seen as further testimony to the normalisation of the economic environment.

Central bank balance sheet had increased to USD 4,500bn by 2014

Prior to the Great Recession at the beginning of 2007, the central bank balance sheet totalled USD 900bn. From Q3 2008 to Q3 2014, an enormous volume of liquidity was being pumped into the market. This measure was probably how the USA and the global economy managed to avoid slipping into depression and stagflation. Since the beginning of 2015, the central bank's balance sheet total has remained steady at a sizeable USD 4,500bn. A further expansion has not been necessary due to the economic recovery. From coming October, this volume will be subject to a gradual reduction. More specifically, in a first step, the expiring bonds and the coupon payments up to an upper limit of USD 10bn will not be reinvested anymore. The economic environment has therefore been deemed sufficiently self-supporting to absorb a gradual reduction of the central bank balance sheet.

Increase in Fed funds rate planned as next step

The bandwidth of the Fed funds rate has been left unchanged at 1%-1.25%. On the basis of the core rate for personal consumer spending of 1.4% as published for July, the real Fed funds rate is -0.28%. This is roughly in line with the real neutral interest rate of -0.22% as estimated by Fed economists. "Neutral" in this context means that it has neither a supporting nor dampening effect on the economy. The forecasts by the Fed suggest a gradual increase of inflation to 2% by 2019. This would theoretically require two and a half Fed funds rate hikes to 1.8% in order for the real Fed funds rate to remain unchanged. In fact, the Fed is even more optimistic: for the end of 2017, it still predicts 1.4% (one interest rate hike), and for the end of 2018 already 2.1% (three further hikes). This implies the assumption that the neutral interest rate will also rise a bit (from currently -0.22% to 0%).

The key facts of the central bank policy

- US economic growth becomes gradually more self-supporting and sustainable. According to the Fed forecasts, it will fall from 2.4% this year to its estimated potential growth rate of 1.8% in 2020.
- Increase of the currently low inflation towards central bank target (2%) by 2019.
- Reduction of the central bank balance sheet.
- Increase in the neutral Fed funds rate to 2.8% (long-term); neutral interest rate: 0.8%.
- Fed funds rate increases in line with the economic improvement to the long-term neutral Fed funds rate level: the extent will be determined by a) the estimated increase in inflation and b) by the implied assumption of a rise in the neutral interest rate.

This scenario is generally positive for equities and disadvantageous for credit-safe government bonds. NB. In the coming months, some Fed members' (including Chairwoman Yellen's) positions will be newly appointed. This could of course change the aforementioned scenario.

Legal note:
Prognoses are no reliable indicator for future performance.

Gerhard Winzer

Gerhard Winzer has worked at Erste Asset Management since March 2008. Up until March 2009, he was Senior Fund Manager in Fixed Income Asset Allocation; he has been Head Economist since April 2009.

He holds a degree from a polytechnical college and studied economics and business at Vienna University with a special focus on financial markets. He holds a CFA charter and participated from 2001 to 2003 in the doctoral programme for finance at the Center for Central European Financial Markets in Vienna.

From July 1997 to June 2007, he worked in research at CAIB, Bank Austria Creditanstalt, and UniCredit Markets & Investment Banking. His last position was as Executive Director for Fixed Income / FX Research and Strategy. He was responsible for research on asset allocation at Raiffeisen Zentralbank (RZB) in Vienna from July 2007 to February 2008.