Focal Point

US yields capped as Fed takes note of limited market tolerance

February 22, 2019

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- In the January meeting the Fed not only put rate hikes on hold, but also signaled an earlier end to balance sheet unwinding, acknowledging financial market volatility and the risks to growth. We now expect the run-off to end already at the end of the year, leaving the Fed's assets at around 3.7 US$ tn.
- The Fed will then likely tilt the portfolio composition toward shorter-dated Treasuries in order to enhance its power as a crisis-fighting tool. The Fed also announced its readiness to adjust the runoff process in case of a serious downturn.
- While Quantitative Easing had a clear impact on asset prices, the effect of tightening appears at present more muted. A key reason is that the balance will shrink from a peak of 25% of GDP to 18%, still three times the pre-crisis level.
- The remaining balance sheeting tightening is expected to contribute up to 15 bps to higher 10-year US yields. However, the dominant factors for US Treasury yields in the medium term are seen to be the slowing of the US economy and the expected end of the Fed hiking cycle.

More than one year since its inception, the unwinding of the Fed balance sheet has has come to the forefront for financial markets. In December fears of too strong an impact on financial conditions contributed to the market rout, and the following decision by the Fed to envisage a more flexible approach to the balance sheet runoff provided a visible relief. In this paper we sketch the likely evolution of the runoff and assess the quantitative effect on yields, which is likely to be much less than formerly feared. Finally, we consider its impact together with other factors shaping our forecast for Treasury yields.

Balance sheet runoff less boring than expected

In June 2017 chair Yellen announced the beginning of the shrinking of the balance sheet and stated that the process would be as interesting as "watching paint dry". The reduction of the amount of bond holdings being reinvested was meant to follow a schedule communicated in advance.

After a first negative reaction to the prospects of tighter financial conditions, financial markets largely ignored the balance sheet for most of last year. As the cycle matured, markets became increasingly concerned by the automatic nature of the balance sheet tightening in the face of the visible deterioration of the economic outlook. Chair Powell's claim that the runoff was to continue on "autopilot" was one of the trigger of the large selloff in December. The Fed was then forced to admit that more flexibility on the pace of the balance sheet reduction may be needed, should economic activity deteriorate sizably. This shift, together with the pledge of a long pause in rate hiking, was warmly welcomed by markets.

Market reactions to Fed's annoucements on the balance sheet runoff

Date		Comment	Impact (%) on S&P500*
1/4/2017	Minutes	Implication of stronger outlook on Balance sheet	0.1
1/12/2017	Harker	Time to consider stop to reinvesting	-0.5
4/5/2017	Minutes	Change in reinvestment policy is soon appropriate	-0.3
9/20/2017	Statement	Normalization to begin in October	-0.4
12/19/2018	Powell	Runoff is on autopilot	-2.6
12/21/2018	Williams	Changes policy possible to meet goals	1.5
1/4/2019	Powell	Will not hesitate to change policy to meet goals	1.1
1/30/2019	Statement	Prepared to adjust normalization if needed	0.9

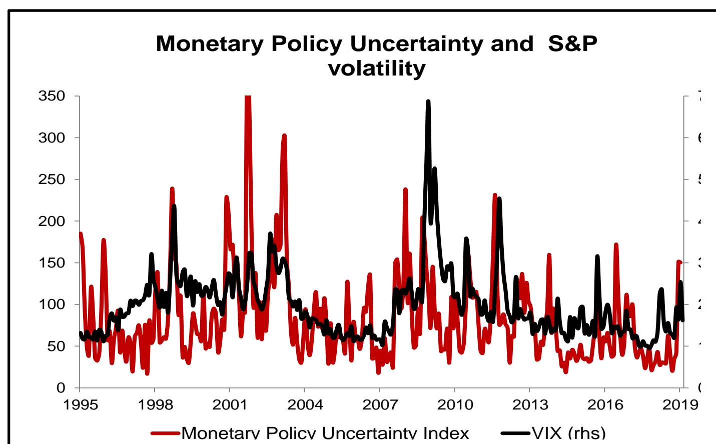
*Price chg. from 30 mins. Before the comment to peak reaction. Source: Goldman Sachs

The minutes of the January meeting showed that most members are in favor to stop the unwinding at the end of the year. Moreover the need to communicate clearly on the issue was underlined. Therefore the March meeting will bring more information on both the final size of the balance sheet and the speed at which it will be reached.

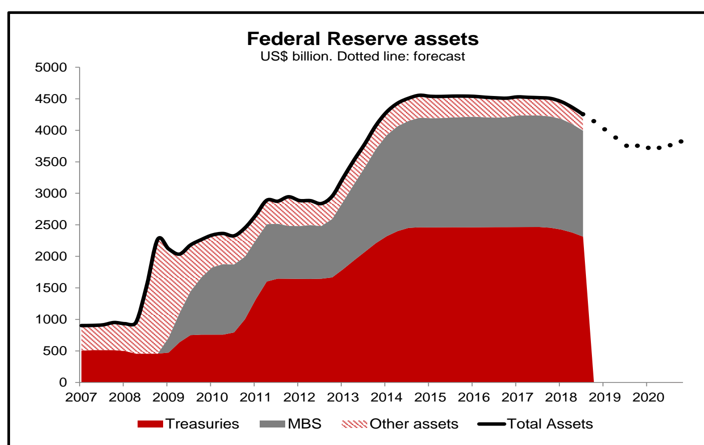
The Fed is keen to reduce the overall uncertainty over monetary policy, as the end of forward guidance contributed to higher volatility.

A much larger size of the balance sheet

The optimal size of the Fed's asset portfolio is determined by the evolution on the liability side, and in particular by that of currency and bank reserves. This includes the regulatory requirements plus a sizeable discretionary buffer aimed at preventing liquidity shortages.



Given what was hinted in the minutes, the final size of the balance sheet would be around $ 3.7 tn, The terminal size of the portfolio would therefore be, in dollar terms, more than three times larger than the one prevailing before the crisis, as regulation has increased the demand for reserves. In the second half of next year, the balance sheet will start expanding again to accommodate the ongoing increase in currency and reserves demand.



The other key issue is whether and how the portfolio composition will be reshuffled.

Since the December meeting the Fed has explicitly given the balance sheet a larger role in crisis-fighting. Fed funds rate will peak at much lower rate than in past tightening cycles (2.50%-2.75% according to our forecast) and therefore, in case of a sharp slowdown, the scope for cutting rates to boost the economy will be more limited. This would require a bigger role for what were previously considered nonstandard measures, such as asset purchases.

After the optimal portfolio size is reached, the Fed will have to adjust its composition in order to be able to provide the biggest possible stimulus to the economy. This entails reducing the holding of Mortgage Backed Security (MBS) in favor of more liquid assets like Treasuries. Secondly, the overall maturity of the portfolio will be reduced, in order to have more room for tilting the composition towards longer maturities (and therefore reducing long term borrowing costs) in case of a downturn. The early termination of the runoff and the expected rebalancing of the portfolio imply that the Fed will be again a net purchaser of Treasury from the final months of the year.

The risks to this outlook are tilted towards an earlier end of the balance sheet reduction in case growth disappoints. However, we give a fairly small probability to the Fed being forced to put an early end to the runoff.

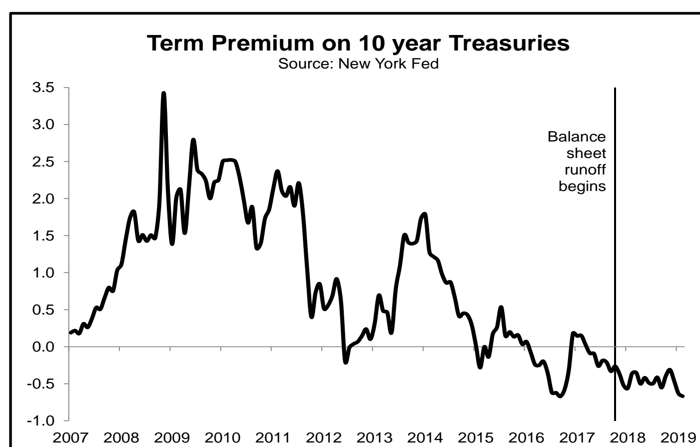
The Fed is faced with an asymmetric balance of risk. It will have to tighten again policy only if core inflation rises higher than the mild overshooting the Fed likely tolerates (roughly to a core PCE rate just above 2.2%), which at the moment appears quite a remote possibility. On the contrary, the probability of deterioration in economic activity and/or prolonged market turbulence is much bigger. However, the magnitude of the adverse shock is likely to be much lower than in 2007-8 and the current level of the Fed funds rate allows for sizeable cuts that should be enough to prevent a deep crisis.

A small positive impact on yield, in theory

The gradual end of reinvestment has added to the increase in net supply resulting from the higher budget deficit: according to our estimates, the net supply of Treasury is set to increase by around 8% this year, to US$985 bn.

All this would in principle lift yields, via changes to the term premium, i.e. the part of the yield not directly related to the expected path for policy rates.

Yet, while the three rounds of Quantitative Easying (QE) have reduced the term premium by around 100 bps, according to Fed estimates, Quantitative Tightening (QT) does not seem to have the sharp impact market feared.



There are three main reasons for that:

- The size of tightening is much lower than that of the easying. QE brought the Fed balance sheet from 6% of GDP to 25%. QT will lower it to 18%. While during QE Fed holdings of secutries grew by more than $50 bn per month, the reduction so far has averaged less than a half of that
- It has been estimated that around one half of the impact from QE was due to the fact that bond purchases reinforced confidence that the Fed was not going to hike rates. This signaling effect is absent in QT, as the runoff and rate hikes are actually substitutes in tightening financial conditions.
- Moreover, QE operates by altering the net supply of assets. These effects were priced in on the announcement of the measures and, according to the academic literature, had a more powerful effect than the actual flows of asset purchases. Given the predictable path of runoff, the announce-

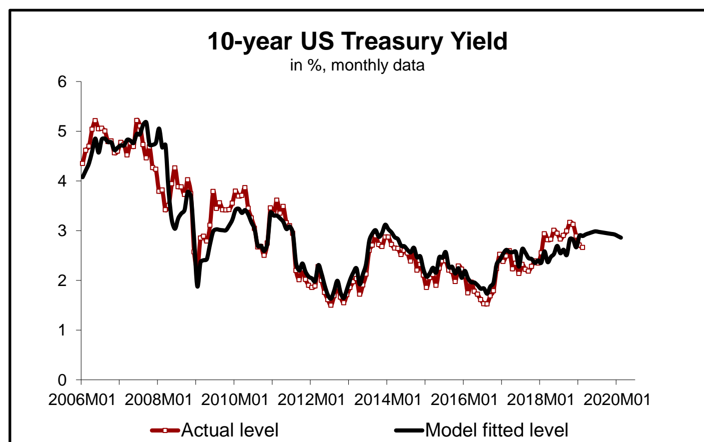
ment effect of QT has already vanished, and what is left is the much more muted impact of flows.

Looking at a broad range of estimates, we think that overall QT as a whole will contribute by no more than 30 bps to the term premium. About one half of this effect has already occurred.

The likely decomposition of the balance sheet will matter once the runoff is completed. The shift away from MBS, at a time when the Fed will become a net bond purchaser again, will reduce the pressure on government securities yields, and the preference for shorted dated Treasuries would support the long end of the curve.

Fed hike to drive US yields upwards

The more flexible approach by the Fed in combination with the weaker economic releases has already left its mark on US government bond markets. Since the peak at the beginning of November, 10-year Treasury yields have already fallen by more than 50 bps to less than 2.70%. This is due to both lower inflation expectations and a more pessimistic growth outlook which triggered a softer Fed stance. 10-year US inflation swaps fell by 40 bps during the last five months (and have recovered by 10 bps recently) and 10-year US real yields decreased by up to 40 bps during the last months (and have rebounded slightly).

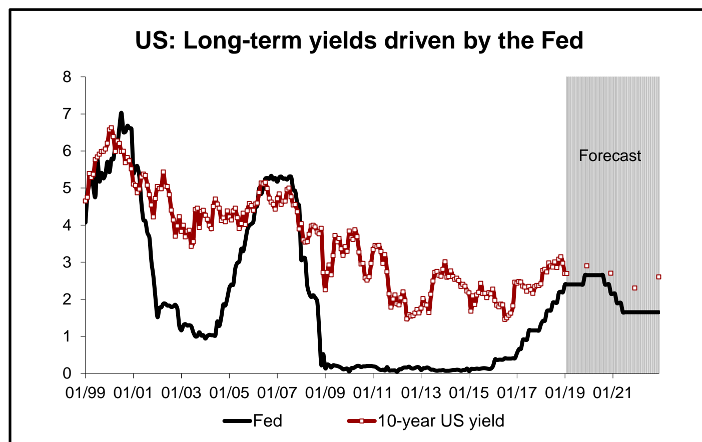


Beside the upward pressure by the QT outlined above, we regard the slightly too cautious key rate expectations by financial markets as one driver that is likely to trigger somewhat higher US yields. Currently, no key rate hikes are priced over the course of the year and there are even speculations about a first key rate cut already in 2019. In contrast, as mentioned above, we expect another key rate hike by 25 bps to an upper bound of 2.75% in H2 2019. While it is difficult to determine the exact time when financial markets will start to price this hike, the tight labor market which is supportive for higher wages and core inflation, growth above potential (although weakening) and the strong rebound of oil prices (up by more than 30% since the trough in December) are forecast to pave the way for moderately higher US yields in the course of 2019. This is mirrored by our fair value model as well. According to that, there is scope for 10-year US yields to rise by around 30 bps (see chart above, year-end forecast: 2.90%).

This will impact the whole US yield curve. Particularly shorter-dated tenors will be impacted be the forecast repricing of the Fed. While an inversion of the 2-year/10-year curve is rather unlikely, it is seen to flatten going forward (in contrast to the currently priced curve steepening).

Way is paved for lower yields in the medium term

Afterwards, however, the slowing of the US economy is likely to bite and to trigger lower US yields. While financial markets still expect the US to grow by nearly 2% in the years 2020 and 2021, we expect a more pronounced slowing as the fiscal impulse will turn into a fiscal drag and investments will slow (growth forecasts 2020/2021: 1.6%/1.4%). Even a short and mild recession cannot be excluded further down the road.



This is expected to induce a change in the monetary policy stance. The Fed is likely to cut key rates over the course of 2020. Given the even at that time still rather robust labor market and inflation still close to 2%, however, the central bank is seen to follow initially a rather cautious course and is not expected to do so aggressively. Still, US yields are forecast to drop over the course of 2020.

However, US government bonds are not expected to rally strongly. This applies even more as – although the yield-increasing effect of QT is expected to peter out in early 2020 – supply will remain on a high level. Already in 2019 gross supply will reach the highest level ever and a lasting relieve is not in sight in the years to come. Moroever, non-domestic investors are unlikely to increase their exposure considerably going forward (they have not done it in recent years). In addition, the re-allocation needs by pension funds are seen to remain low given the meagre outlook for equity returns. Hence, the ex-ante imbalance between demand and supply is expected to prevent a strong drop in US yields in the medium term.

All in, while QT will continue to exert a moderate upward pressure in the months to come, this is unlikely to determine the outlook for US sovereign yields medium term. In contrast, the slowing economy and the approaching key rate cuts by the Fed are seen to trigger a moderate bull steepening of the US yield curve.

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Sources for charts and tables: Thomson Reuters Datastream, Bloomberg, own calculations

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