Daiwa Capital Markets

U.S. Economic Comment

- Next step in Fed balance sheet normalization: maturity composition

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The Fed's Balance Sheet: Short-Term or Proportional?

The Federal Reserve took its first step toward normalizing its balance sheet in March by establishing a plan to end the redemption of securities and stabilize the size of the portfolio. The Fed has already trimmed the pace of Treasury redemptions (shifting from $30 billion per month to $15 billion beginning in May) and it will end the redemption of Treasuries after September. The Fed is continuing to redeem a maximum of $20 billion of mortgage-backed securities per month, but starting in October it will use principal payments on MBS to purchase Treasury securities in the open market (up to $20 billion per month).

The Fed has two more aspects of normalization to consider: the ultimate size of the balance sheet, and the maturity composition of its securities portfolio. Officials started to discuss the maturity composition of its Treasury holdings at the FOMC meeting on April 30/May 1 (minutes of this meeting were released this week).

The Fed is considering two options: a short-term portfolio, where it would limit its holdings of Treasury securities to those with maturities of three years and under; and a so-called proportional portfolio, where the Fed would invest in Treasury securities across the maturity spectrum in proportion to the outstanding volume.

The FOMC did not make any decisions regarding the maturity composition at its latest meeting, but our sense from the information presented in the minutes is that officials favor the proportional portfolio.

The short-term option has some advantages. The average maturity of the Fed's assets would be close to that of its liabilities, which would reduce the Fed's interest rate risk and the volatility of its net income. (Interest expense on reserves and reverse repurchase agreements will rise and fall with short-term interest rates, while returns on a portfolio with long-term securities will change slowly). In addition, a short-term portfolio would give the Fed flexibility to stimulate the economy in the event of a slowdown by implementing a maturity extension program (shifting to longer-term securities while holding the size of the portfolio steady).

While the short-term option has advantages, it also has less attractive features that seemed to carry the day with Fed officials. Most important, concentrating investments in short-term maturities would probably leave term premiums on long-term securities larger than they would be under a proportional portfolio, which would slow the economy. Also, heavy purchases of short-term securities by the Fed could complicate the liquidity programs of commercial banks and others.

Treasury Securities Maturity Composition*

	Fed Portfolio	Treasury Securities Outstanding
	Percent	
0 to 3 years	41.9	52.5
3 to 10 years	29.6	34.0
> than 10 years	28.5	13.5

** Calculations for the Fed's portfolio show the share of securities maturing within a certain timeframe as a share of the total Federal Reserve portfolio. Data on Treasury securities show outstandings in specified maturity ranges as a share of total outstanding marketable Treasuries.*

Source: Federal Reserve Bank of New York; U.S. Treasury Department; Daiwa Capital Markets America

Some Fed officials also downplayed the alleged advantages of the short-term portfolio. They had doubts about the effectiveness of maturity extension programs, and even if such programs were effective, the Fed could still implement one under a proportional portfolio.

Thus, although the FOMC did not make any decisions at its latest meeting, the discussion in the minutes led us to believe that the Committee will seek to establish a portfolio that matches the maturity composition of outstanding Treasury securities -- i.e. a proportional portfolio. The minutes noted that officials felt that a decision on maturity composition did not have to be made “for some time,” but they do face time constraints in a sense. Beginning in October, the Fed will be reinvesting principal repayments from mortgage-backed securities into Treasuries, and these purchases will be made in the open market. Logic might suggest that the Fed would arrange these purchases to align with its desired maturity composition. Thus, the Committee might want to have the decision on maturity composition nailed down by October. If a decision has not been made by October, the Fed indicated in March that the reinvestment of MBS principal payments would be spread across the maturity spectrum in proportion to the outstanding volume of securities. With the benefit of hindsight, this plan to buy across the maturity spectrum could be viewed as a clue that officials are leaning in the direction of a proportional portfolio.

Investors and traders are likely to be keenly interested in the nature of the Fed’s purchases to achieve a proportional portfolio. The portfolio is currently overweight in the long end of the maturity spectrum, and thus most purchases will occur in the short and intermediate portions of the maturity spectrum. As shown on the table on page 1, the Fed is overweight in the long end by approximately 15 percentage points. Boosting its share of short-term securities by approximately 10 percentage points and the intermediate term securities by five percentage points would put the Fed’s portfolio in alignment with the composition of outstanding Treasury securities. Thus, the Fed will be quiet in the long end but active in the short end; it will buy moderately in the middle portion of the maturity spectrum.

Ultimate Size

Determining the ultimate size of the balance sheet and securities portfolio represents the final decision variable in the normalization process. In a sense, the Fed has already determined the ultimate size of its portfolio. It will stop redeeming securities at the end of September, and the portfolio will then remain steady for a time. Given the current redemption schedule, the Treasury portfolio will total $2,051 billion at the end of September versus $2,115 in early May. The size of MBS holdings is uncertain because prepayments will fluctuate, but it is likely to contract by approximately $80 billion from its mid-May level.

The portfolio is likely to remain at this size for some time, but eventually it will have to increase to accommodate the natural growth of the Fed’s liabilities. The liabilities of the Fed arise because of services it provides and responsibilities it has in maintaining the smooth functioning of financial markets. The Fed must accommodate these liabilities, and thus the size of the balance sheet and portfolio in the future will depend on the growth of the Fed’s liabilities.

The key liability is currency in circulation, which comprises the bills and coins that individuals carry in their pockets (both domestically and internationally, with a large share held internationally; see the balance sheet on the next page). This liability tends to grow smoothly over time, and if growth were to be maintained at the recent pace of four to five percent, the Fed would need to begin expanding its portfolio again sometime in 2021.

The Fed’s security portfolio will again be expanding, but it should not be viewed as a new round of quantitative easing. The expected portfolio expansion in 2021 would represent a passive change -- the Fed keeping up with the growth of the economy and the need for an expanding payments system and a liquid financial system. We would not expect such action to have an effect on interest rates, especially with the Fed buying across the maturity spectrum, which would enhance the neutral nature of the Fed’s activity.

Federal Reserve Balance Sheet*

Assets				Liabilities
$ billions				
Securities		**3,684.23**	**1,732.20**	**Currency in Circulation**
U.S. Treasury Securities	2,114.50			
Mortgage-backed Securities	1,567.38			
Federal Agency Securities	2.35			
Discount Window Loans		**0.05**	**282.86**	**Treasury General Account**
Repurchase Agreements		**0.00**	**63.69**	**Deposits**
Other		**227.03**	**268.61**	**Reverse Repurchase Agreements**
			1,518.16	**Reserve Accounts**
			45.80	**Other Liabilities and Capital**
Total Federal Reserve Assets		**3,911.32**	**3,911.32**	**Total Liabilities and Capital**

* *Averages of daily figures for the week ended May 22, 2019.*

Source: H.4.1. Report, Federal Reserve Board of Governors; Daiwa Capital Markets America

Review

Week of May 20, 2019	Actual	Consensus	Comments
Existing Home Sales (April)	**5.19 Million (-0.4%)**	**5.35 Million (+2.7%)**	Sales of existing homes eased in April for the second consecutive month after a spurt in February, suggesting that the February result was a temporary burst related to the drop in interest rates in late 2018 rather than a quickening in the underlying pace of sales. The level of sales in the latest month, although better than that in Q4 (5.14 million, annual rate), was below the average in the first half of last year (5.46 million). Lower interest rates have helped, but not by much. The number of homes on the market jumped 9.6%. However, this series is not seasonally adjusted, and inventories typically increase in April. The latest increase was close to the average of 9.2% in the prior 10 years. Inventories remain tight from a longer-term perspective.
New Home Sales (April)	**0.673 Million (-6.9%)**	**0.675 Million (-2.5%)**	New home sales fell in April, but the drop occurred from an unusually firm reading in March (an already strong showing was revised upward by 4.5%, moving to the highest level of the current expansion). Sales in April compare favorably with results in the current expansion, as only spikes in November 2017 and March were higher. The firm pace of sales in April absorbed some of the inventory on the market, as the number of new homes for sale eased 0.9%, although inventories remained in the upper end of the range of the current expansion.
Durable Goods Orders (April)	**-2.1%**	**-2.0%**	A drop of 5.9% in the transportation category led the decline in durable orders in April. The volatile aircraft industry accounted for much of the softness in transportation (off 18.0%, commercial and defense combined), but the motor vehicle sector also contributed with a drop of 3.4%. The trends in both total durable orders and ex-transportation have been approximately sideways since early-to-mid 2018. Orders for nondefense capital goods excluding aircraft, a series that provides insight into capital spending plans by businesses, slipped 0.9% from a downward revised level in March (revised 0.8% lower). This series has been drifting downward since the middle of last year, with the softness also leading to declines in unfilled orders.

Source: National Association of Realtors (Existing Home Sales); U.S. Census Bureau (New Home Sales, Durable Goods Orders); Consensus forecasts are from Bloomberg

Preview

Week of May 27, 2019	Projected	Comments
Conference Board Consumer Confidence (May) (Tuesday)	**129.0 (-0.2%)**	A firm labor market should support positive attitudes, but hesitation in the equity market in May could sow doubts about the economic outlook. The offsetting influences are likely to leave the confidence index close to its level in April.
Revised GDP (2019-Q1) (Thursday)	**2.8% (-0.4 Pct. Pt. Revision)**	Inventory investment is likely to standout as contributing to a downward revision to GDP growth, although stock-building will still appear hefty in the first quarter (contributing 0.40 percentage point to GDP growth rather 0.65 pct. pt.). Three other components -- residential construction, consumer spending, and net exports -- also are likely to be revised lower. An upward revision to business outlays for new structures could provide a partial offset to these softer areas.
U.S. International Trade in Goods (April) (Thursday)	**-$72.5 Billion ($1.2 Billion Wider Deficit)**	Imports of food will probably cool after an unusual burst in March, but firm demand and attractive prices will probably lead to gains in other areas. Exports are likely to lack vigor because of slow economic growth abroad. The expected deficit is the widest of the year thus far, but it is narrower than the average of $73.2 billion from last year and well shy of $76.5 billion average in Q4.
Personal Income, Consumption, Core Price Index (April) (Friday)	**0.3%, 0.2%, 0.1%**	Job growth in April was brisk, but a shorter workweek will probably limit the growth of wages and salaries. Rental income and dividends are likely to remain firm. On the spending side, a drop in sales of new vehicles is likely to lead to a decline in outlays for durable goods, while a soft report on retail activity suggests only moderate outlays on nondurable goods. Spending on services should remain respectable. Results on the consumer price index suggest another tame month for the core price index for personal consumption expenditures.
Revised Consumer Sentiment (May) (Friday)	**101.0 (-1.4% Revision)**	Recent economic and financial developments do not argue for a revision to consumer sentiment in either direction, but the large change in the preliminary tally (5.4%) and the elevated level (the best of the current expansion by 1.0%) lead us to suspect an element of random volatility that could be revised away.

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

May/June 2019

Monday	Tuesday	Wednesday	Thursday	Friday
20	21	22	23	24
CHICAGO FED NATIONAL ACTIVITY INDEX Monthly / 3-Mo. Avg. Feb -0.57 / -0.26 Mar 0.05 / -0.24 Apr -0.45 / -0.32	**EXISTING HOME SALES** Feb 5.48 million Mar 5.21 million Apr 5.19 million	**FOMC MINUTES**	**INITIAL CLAIMS** May 04 228,000 May 11 212,000 May 18 211,000 **NEW HOME SALES** Feb 0.669 million Mar 0.723 million Apr 0.673 million	**DURABLE GOODS ORDERS** Feb -2.6% Mar 1.7% Apr -2.1%
27	28	29	30	31
MEMORIAL DAY	**FHFA HOME PRICE INDEX (9:00)** Jan 0.6% Feb 0.3% Mar -- **S&P CORELOGIC CASE-SHILLER 20-CITY HOME PRICE INDEX (9:00)** SA / NSA Jan 0.1% / -0.2% Feb 0.2% / 0.2% Mar -- / -- **CONFERENCE BOARD CONSUMER CONFIDENCE (10:00)** Mar 124.2 Apr 129.2 **May 129.0**		**INITIAL CLAIMS (8:30)** **REVISED GDP (8:30)** GDP / Chained Price 18-Q4 2.2% / 1.7% 19-Q1(a) 3.2% / 0.9% **19-Q1(p) 2.8% / 0.9%** **U.S. INTERNATIONAL TRADE IN GOODS (8:30)** Feb -\$70.8 billion Mar -\$71.3 billion **Apr -\$72.5 billion** **ADVANCE INVENTORIES REPORT (8:30)** Wholesale / Retail Feb 0.4% / 0.2% Mar -0.1% / -0.3% Apr -- / -- **PENDING HOMES SALES (10:00)** Feb -1.0% Mar 3.8% Apr --	**PERSONAL INCOME, CONSUMPTION, AND CORE PRICE INDEX (8:30)** Inc. / Cons. / Core Feb 0.2% / 0.1% / 0.1% Mar 0.1% / 0.9% / 0.0% **Apr 0.3% / 0.2% / 0.1%** **CHICAGO PURCHASING MANAGERS' INDEX (9:45)** Index / Prices Mar 58.7 / 64.5 Apr 52.6 / 50.8 May -- / -- **REVISEDCONSUMER SENTIMENT (10:00)** Mar 98.4 Apr 97.2 May(p) 102.4 **May(r) 101.0**
3	4	5	6	7
ISM INDEX **CONSTRUCTION SPEND.** **VEHICLE SALES**	**FACTORY ORDERS**	**ADP EMPLOYMENT REPORT** **ISM NON-MFG INDEX** **BEIGE BOOK**	**INITIAL CLAIMS** **TRADE BALANCE** **REVISED PRODUCTIVITY & COSTS**	**EMPLOYMENT REPORT** **WHOLESALE TRADE** **CONSUMER CREDIT**
10	11	12	13	14
JOLTS DATA	**NFIB SMALL BUSINESS OPTIMISM** **PPI**	**CPI** **FEDERAL BUDGET**	**INITIAL CLAIMS** **IMPORT/EXPORT PRICES**	**RETAIL SALES** **IP & CAP-U** **CONSUMER SENTIMENT** **BUSINESS INVENTORIES**

Forecasts in Bold. (a) = advance (1st estimate of GDP); (p) = preliminary (2nd estimate of GDP); (r) = revised

Treasury Financing

May/June 2019

Monday	Tuesday	Wednesday	Thursday	Friday
20	21	22	23	24
AUCTION RESULTS: Rate / Cover 13-week bills 2.335% 2.94 26-week bills 2.340% 2.82	**AUCTION RESULTS:** Rate / Cover 52-week bills 2.280% 2.95 **ANNOUNCE:** $45 billion 4-week bills for auction on May 23 $35 billion 8-week bills for auction on May 23 **SETTLE:** $50 billion 4-week bills $35 billion 8-week bills		**AUCTION RESULTS:** Rate / Cover 4-week bills 2.335% 2.53 8-week bills 2.330% 2.53 10-year TIPS 0.567% 3.07 **ANNOUNCE:** $72 billion 13-,26-week bills for auction on May 28 $18 billion 2-year FRNs for auction on May 29 $40 billion 2-year notes for auction on May 28 $41 billion 5-year notes for auction on May 28 $32 billion 7-year notes for auction on May 29 **SETTLE:** $72 billion 13-,26-week bills $26 billion 52-week bills	
27	28	29	30	31
MEMORIAL DAY	**AUCTION:** $72 billion 13-,26-week bills $40 billion 2-year notes $41 billion 5-year notes **ANNOUNCE:** $45 billion* 4-week bills for auction on May 30 $35 billion* 8-week bills for auction on May 30 **SETTLE:** $45 billion 4-week bills $35 billion 8-week bills	**AUCTION:** $18 billion 2-year FRNs $32 billion 7-year notes	**AUCTION:** $45 billion* 4-week bills $35 billion* 8-week bills **ANNOUNCE:** $72 billion* 13-,26-week bills for auction on June 3 **SETTLE:** $72 billion 13-,26-week bills	**SETTLE:** $11 billion 10-year TIPS $18 billion 2-year FRNs $40 billion 2-year notes $41 billion 5-year notes $32 billion 7-year notes
3	4	5	6	7
AUCTION: $72 billion* 13-,26-week bills	**ANNOUNCE:** $45 billion* 4-week bills for auction on June 6 $35 billion* 8-week bills for auction on June 6 **SETTLE:** $45 billion* 4-week bills $35 billion* 8-week bills		**AUCTION:** $45 billion* 4-week bills $35 billion* 8-week bills **ANNOUNCE:** $72 billion* 13-,26-week bills for auction on June 10 $38 billion* 3-year notes for auction on June 11 $24 billion* 10-year notes for auction on June 12 $16 billion* 30-year bonds for auction on June 13 **SETTLE:** $72 billion* 13-,26-week bills	
10	11	12	13	14
AUCTION: $72 billion* 13-,26-week bills	**AUCTION:** $38 billion* 3-year notes **ANNOUNCE:** $45 billion* 4-week bills for auction on June 13 $35 billion* 8-week bills for auction on June 13 **SETTLE:** $45 billion* 4-week bills $35 billion* 8-week bills	**AUCTION:** $24 billion* 10-year notes	**AUCTION:** $45 billion* 4-week bills $35 billion* 8-week bills $16 billion* 30-year bonds **ANNOUNCE:** $72 billion* 13-,26-week bills for auction on June 17 $26 billion* 52-week bills for auction on June 18 $15 billion* 5-year TIPS for auction on June 20 **SETTLE:** $72 billion* 13-,26-week bills	

**Estimate*