The Fed's exit strategy

Dr Robert Gay | Fenwick Advisers | 07 April 2014

The Fed’s published policy on how it will exit QE is fairly old and is likely to be updated at some point once the market has got more used to the Yellen regime. And the new FOMC members are not likely to change much.

The key paragraph about the exit from QE from Bernanke in 2010 was:

> “I currently do not anticipate that the Federal Reserve will sell any of its security holdings in the near term, at least until after policy tightening has gotten under way and the economy is clearly in a sustainable recovery. However, to help reduce the size of our balance sheet and the quantity of reserves, we are allowing agency debt and MBS to run off as they mature or are prepaid. The Federal Reserve is currently rolling over all maturing Treasury securities, but in the future it may choose not to do so in all cases. In the long run, the Federal Reserve anticipates that its balance sheet will shrink toward more historically normal levels and that most or all of its security holdings will be Treasury securities. Although passively redeeming agency debt and MBS as they mature or are prepaid will move us in that direction, the Federal Reserve may also choose to sell securities in the future when the economic recovery is sufficiently advanced and the FOMC has determined that the associated financial tightening is warranted. Any such sales would be at a gradual pace, would be clearly communicated to market participants, and would entail appropriate consideration of economic conditions.”

A look at the current composition of the Fed's portfolio, which is available on the website of the New York Federal Reserve Bank, gives some additional clues on what the Fed is likely to do.

About 36% of the Treasury securities are under five years in maturity, and that is where most of the remaining purchases are slated. Two-thirds of recent purchases have been under five years, while one-third are over ten years, with no net purchases in the five- to 10-year bracket since the beginning of 2013. So, switching to a policy of not reinvesting maturing securities would mean that in five years' time, all of these would be gone – at which point, 60% of the remaining Treasury securities would then be under five years in maturity. With the ongoing tightening in fiscal policy and, hence, a reduced supply of new Treasury issuance, the Fed might find there is demand for the securities it holds, and it has already started increasing the size of the reverse repo facility which provides them as collateral. So, it might end up selling where there is market demand. In any event, a strategy of just letting their Treasury securities mature will shrink the balance sheet pretty successfully.

Agency securities are a very small holding, and 95% are under five years in maturity anyway.

The really big long maturity chunk is the US$1.6tn in mortgages, almost all over ten years. It's much larger than the US$615bn in Treasury bonds over ten years (which is in itself less than the size of the Fed balance sheet at the start of 2008). Mortgages mature because people move or refinance, so there is some attrition, especially as economic activity picks up and housing markets improve so people become more mobile. The standard prepayment period is usually modeled at about 6% per year - so, in five years, we would expect around a third of the Fed MBS portfolio to mature, or US$530bn, without any sales.

Overall, there is not a huge overhang of securities that the Fed needs to sell. We should only expect Treasury sales if there is a strong bid in the market, long rates are falling and hence the Fed finds an opportunity to sell. Selling large quantities of mortgages would be politically difficult, as it is seen as hurting the ordinary voter. Besides, the Fed has cherry-picked these mortgages to have little default risk, so letting them mature is a much more likely option.

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