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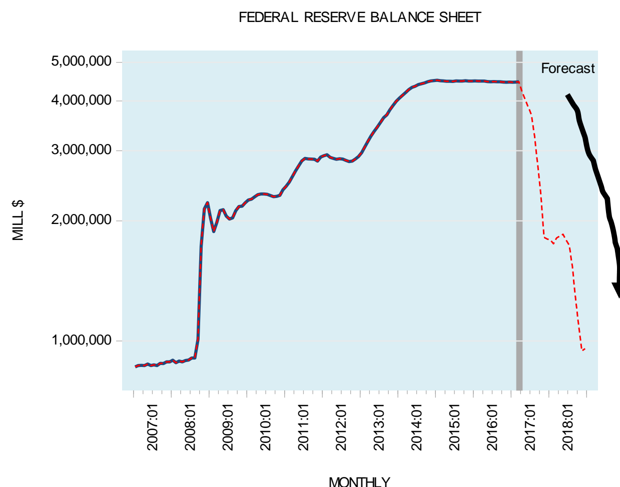
ECONOMIC INSIGHTS

COMMENTARY

The impact of Fed's shrinking its balance sheet on markets

Most Federal Reserve officials said that they backed a policy change that would begin shrinking the central bank's $**4.5** trillion balance sheet, according to minutes of the Federal Open Market Committee's (FOMC) March 14-15 meeting released on April 5, 2017. The FOMC members generally preferred to phase out or cease reinvestments of both Treasury securities and agency mortgage-backed securities at the same time. To assess the effect of the possible shrinkage of the Fed's balance sheet we have employed our large-scale model of 276 equations. We have assumed that by December this year the balance sheet will shrink to $**1.8** trillion. By December next year we are assuming that the balance sheet will settle at around $**1** trillion.



The results of the model are compared to the base case situation where the Fed's balance sheet doesn't change a lot during the 2017-2018 period.

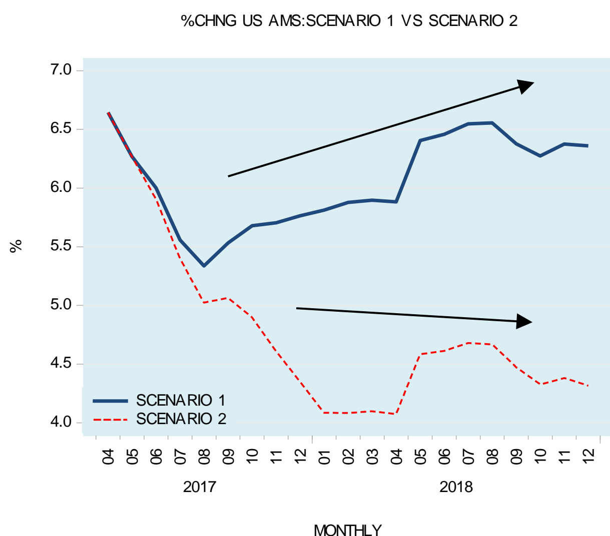
In this report Scenario 1 is the base case where the Fed does not shrink the balance sheet. Scenario 2 is the situation where the Fed reduces its balance sheet.

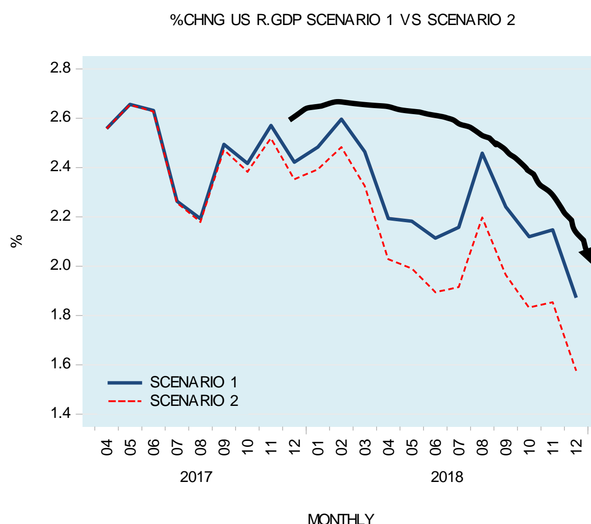
According to the model, with Scenario 2 the yearly growth rate of AMS (our measure of money supply) is forecast to close at **4.4**% by December 2017 versus **5.8**% in Scenario 1.

By December 2018, the yearly growth rate of AMS is forecast to settle at **4.3**% in Scenario 2 versus **6.4**% in the Scenario 1.

Thus a reduction in the Fed's balance sheet is expected to reduce (our measure of) money supply growth. In our framework, this would be mildly contractionary as far as measured economic aggregates are concerned.

Therefore, under Scenario 2 the growth rate of real GDP is forecast to be **1.6**% p.a. in December next year compared to **1.9**% in Scenario 1.

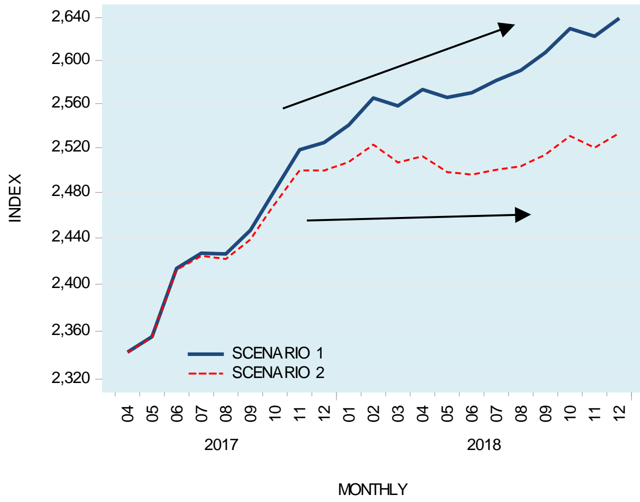


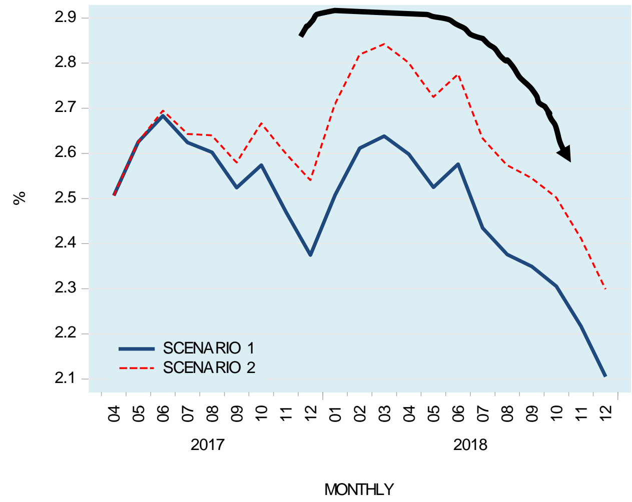


Following our model we forecast that in the framework of Scenario 1 the S&P500 will close at **2,525** by December 2017 – an increase of **10.4**% from January. In Scenario 2 we forecast a figure of 2,500 by December – an increase of **9.3**%.

By December next year, under Scenario 1 the stock index is forecast to increase by a further **4.5**% to **2,639**. In Scenario 2, the S&P500 is forecast to increase by **1.3**% to **2,533** by December next year.

Under Scenario 1, the yield on the 10 year US T-Note is forecast to close at **2.37**% in December 2017 compared to **2.46**% in January. This compares with the Scenario 2 figure of **2.54**%. By December 2018, we forecast a figure of **2.1**% for Scenario 1 against **2.3**% for Scenario 2.





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