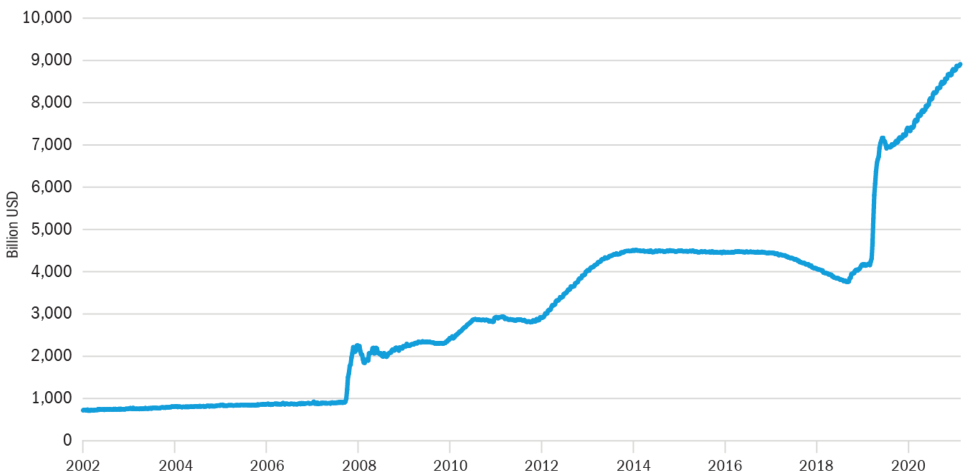
Demystifying Fed speak: How shrinking the balance sheet could (not) impact markets

March 8, 2022

One of the ways the Fed may tighten financial conditions is by reducing its balance sheet. Here's what investors should know about it.

At the height of the pandemic, the Fed pumped trillions of dollars into the financial system through asset purchases to support markets and the broader economy. Consequently, its balance sheet ballooned to unprecedented levels, totaling nearly $9 trillion. And it continues to grow. As the Fed considers how it begins to normalize monetary policy, it is likely to begin reducing its balance sheet this year.

The Fed balance sheet has soared to nearly $9 trillion



Source: Federal Reserve Board of Governors via FRED

Edward Al-Hussainy
Senior Interest Rates Strategist

The Fed has several options for unwinding its portfolio:

- **Doing nothing (technically).** Instead of buying more or replacing securities coming due, the Fed would be shifting its policy position by doing nothing when securities reach maturity. In other words, with about one quarter of the balance sheet coming due within two and a half years, it would reduce the balance sheet by just allowing holdings to roll off organically as the debt matures.
- **Changing the composition of the balance sheet.** The Fed bought both agency mortgage-backed securities (MBS) and Treasuries at the height of the pandemic in 2020. The Fed would very much like to get out of the agency MBS market altogether and would welcome the opportunity to reduce its exposure to agency MBS over time.
- **Actively selling longer term bonds.** The Fed could sell off different parts of the balance sheet. For example, it could sell long-dated Treasuries (e.g., seven to 20 years) and in turn buy short-dated Treasuries, which would have the effect of steepening the yield curve. It could also sell agency MBS, as mentioned above, which have 15- to 30-year maturities. Any of these moves would be considered quite disruptive (the Fed owns around half of the agency MBS market) and not something the Fed has done in the past.

In considering these options, it's important to remember that the Fed's balance sheet is a bit of a mysterious animal. We have a good idea of how expanding the balance sheet works when the economy is in distress. In a recession, for example, the Fed uses its balance sheet to purchase bonds, creating a "floor" under risk assets. The liquidity that it provides both for Treasuries and equities is a significant tailwind for the market. But our understanding of what happens when the Fed draws down its balance sheet is less clear, because it generally takes place at the same time the economy is stronger.

The clearest impact of unwinding the balance sheet is that doing so sends a signal to markets that the Fed intends to raise the fed funds rate. For longer term rates (e.g., 10-year, 30-year), the balance sheet impact is more ambiguous. This is because the balance sheet is composed predominantly of short-term securities that don't impact longer term interest rates. Risk assets, like equities, could be the least affected. There's no strong evidence to support the idea that removing Fed liquidity from the system will cause equities, which previously benefited from this liquidity, to underperform.

While we think investors will hear a lot about the Fed balance sheet in the coming months, it will be more important to focus on what the Fed is saying about the fed funds rate, which would have the most direct impact on fixed-income assets. Investors should monitor their fixed-income allocations to make sure they are flexible and able to respond effectively.

To find out more, call 800.426.3750
or visit columbiathreadneedle.com

Not Federally Insured	No Financial Institution Guarantee	May Lose Value

The views expressed are as of the date given, may change as market or other conditions change and may differ from views expressed by other Columbia Management Investment Advisers, LLC (CMIA) associates or affiliates. Actual investments or investment decisions made by CMIA and its affiliates, whether for its own account or on behalf of clients, may not necessarily reflect the views expressed. This information is not intended to provide investment advice and does not take into consideration individual investor circumstances. Investment decisions should always be made based on an investor's specific financial needs, objectives, goals, time horizon and risk tolerance. Asset classes described may not be appropriate for all investors. Past performance does not guarantee future results, and no forecast should be considered a guarantee either. Since economic and market conditions change frequently, there can be no assurance that the trends described here will continue or that any forecasts are accurate.

Securities products offered through Columbia Management Investment Distributors, Inc., member FINRA. Advisory services provided by Columbia Management Investment Advisers, LLC.

Columbia Threadneedle Investments (Columbia Threadneedle) is the global brand name of the Columbia and Threadneedle group of companies.

CTBPM25 (03/22) 4367055