First Trust
Monday Morning OUTLOOK

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WSJ Leak: Fed May Shrink Balance Sheet

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If you read us regularly, and we hope you do, you know that we write each week about a topic we think is both important and timely. Last week, we were either clairvoyant, or extremely persuasive.

We argued that unless and until the Federal Reserve reduced the size of its balance sheet (and unwound quantitative easing), it would not be in control of inflation. Rate hikes alone wouldn't be effective. Last week, it didn't seem like the Fed shared our concern. But, this week is a different story.

Last week, all anyone talked about was whether the Fed would hike interest rates two or three more times in 2017, after hiking them by a quarter-point in mid-March. As we argued, as long as there are excess reserves in the financial system, higher inflation will remain a threat, even if the Fed hiked rates.

This week the world has changed. Fed Chair Janet Yellen apparently allowed a leak to the Wall Street Journal, published on March 31st, suggesting the Fed understands the problem. The Fed is taking off the table the idea there might be four rate hikes this year, but is putting on the table the idea that it will eventually pause on rate hikes and start reducing the size of its balance sheet as the normalization process continues.

At this point, the Fed is being slow and cautious and only planning on doing one thing at a time – rate hikes or bond sales. Later, it might do both at the same time.

So what should investors expect? Before the leak, it looked like the Fed would raise rates two or three more times this year, once in June and another time in either September or December, with some possibility of hiking rates in both September *and* December.

Now we think the Fed will raise rates in June and September and then take the following six months to start the "Great Unwinding" of the balance sheet. To begin, the Fed will take baby steps. It's not outright and actively going into the financial markets selling bonds from its balance sheet. Instead, it will take a portion (but not all) of maturing principal payments on its bond portfolio (Treasury or mortgage-backed securities) and not reinvest them into new securities, instead using that portion to extinguish excess reserves.

This cautious approach will not disrupt the bond market, but it will allow inflation to become more entrenched. As we argued last week, as long as excess reserves exist, rate hikes will make it more profitable for banks to lend those excess reserves. This expands the money supply and creates inflation.

In other words, the Fed has a long way to go. But like any government entity, unwinding its actions always proceeds at a much slower pace than the speed of its interference. This is why monetary policy is almost always biased toward inflation.

What this means for the economy and financial markets is that the Fed is highly unlikely to become a drag on growth anytime in the near future. And since the number one cause of recession is an excessively tight Fed, we think investors should watch this process carefully, but not be alarmed by it.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
4-3 / 9:00 am	ISM Index – Mar	57.2	**57.5**	57.2	57.7
9:00 am	Construction Spending – Feb	+1.0%	**+0.8%**	+0.8%	-1.0%
afternoon	Total Car/Truck Sales – Mar	17.3 Mil	**17.2 Mil**		17.5 Mil
afternoon	Domestic Car/Truck Sales - Mar	13.6 Mil	**13.4 Mil**		13.7 Mil
4-4 / 7:30 am	Int'l Trade Balance – Feb	-$44.5 Bil	**-$44.1 Bil**		-$48.5 Bil
9:00 am	Factory Orders – Feb	+1.0%	**+0.9%**		+1.2%
4-5 / 9:00 am	ISM Non Mfg Index – Mar	57.0	**57.2**		57.6
4-6 / 7:30 am	Initial Claims – Apr 1	250K	**254K**		258K
4-7 / 7:30 am	Non-Farm Payrolls - Mar	175K	**178K**		235K
7:30 am	Private Payrolls – Mar	175K	**178K**		227K
7:30 am	Manufacturing Payrolls – Mar	17K	**7K**		28K
7:30 am	Unemployment Rate – Mar	4.7%	**4.7%**		4.7%
7:30 am	Average Hourly Earnings – Mar	+0.2%	**+0.2%**		+0.2%
7:30 am	Average Weekly Hours – Mar	34.4	**34.4**		34.4
2:00 pm	Consumer Credit– Feb	$15.0 Bil	**$16.3 Bil**		$8.8 Bil

Consensus forecasts come from Bloomberg. This report was prepared by First Trust Advisors L. P., and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.