

WisdomTree MINDS ON THE MARKETS



Jeff Weniger, CFA
Head of Equity Strategy



Kevin Flanagan
Head of Investment and Fixed Income Strategy

‘Warshing’ the Balance Sheet

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There’s no doubt the most important aspect to the June FOMC meeting was the fact that policymakers kept the Fed funds rate unchanged and removed its prior easing bias. But, this was not just your normal, run-of-the-mill policy gathering. It was Kevin Warsh’s first meeting as Fed Chair and instead of being a ‘rubber stamp’ for rate cuts, as some market observers were opining, the new FOMC leader put his stamp on the Fed in a different way.

With good reason, the lion’s share of attention has been given to the fact that “forward guidance is out” now as far as Warsh is concerned. But, there were other aspects of the monetary policy train that will also come under review. In fact, the new Fed Chair announced there would be five separate task forces. The task force we wanted to discuss in this installment of Minds on the Markets is the balance sheet.

Much like forward guidance, the Fed’s balance sheet has been given a good deal of attention as an area that Mr. Warsh wanted to focus on once he took the helm. Changing the policy statement, which occurred at the June FOMC meeting, was the easy part. Shrinking, changing and/or shifting the mix of the Fed’s securities holdings will more than likely be more challenging.

For our regular readers, you know that we’ve covered the Fed’s balance sheet in the past, but the new Fed Chair seems destined to make this topic headline-grabbing in the future. The natural question is just how far into the future are we talking about. First, let’s put the potential task before Warsh into perspective.

Let’s get some perspective on the size of the System Open Market Account (SOMA), or the Fed’s securities holdings. Presently, the total amount stands at about \$6.5 trillion. That’s down about \$2 trillion from its May 2022 peak, as a result of the most recent round of quantitative tightening (QT). In terms of SOMA’s make-up, the Treasury component comes in at \$4.5 trillion while its mortgage-backed securities (MBS) holdings total about \$2 trillion.

Those numbers underscore the herculean task before Warsh & Co. The Fed has already implemented a couple rounds of QT, and essentially in each instance, the policymakers discovered that reducing the balance sheet’s size can come with unwanted consequences, namely potential ‘plumbing’ issues for the funding markets. In fact, the Fed ended the latest QT operation in December, and due to these issues, is once again buying T-bills to help ameliorate any potential stresses that could crop up.

So, how if in fact Warsh wants to shrink the balance sheet, how can he achieve his goal? There are basically two ways: outright selling Treasuries and/or MBS or let maturing securities run off without replacing them. The first option is the more active or aggressive approach and could have unintended consequences on the money and bond markets. In addition, SOMA is sitting on paper losses as interest rates have risen substantially from the days of COVID-related QE buying. The second, arguably more passive, approach would seem more feasible at this stage, but even this line of policy has its risks.

The other aspect of the balance sheet debate within the Fed has been returning to a Treasuries-only SOMA, an outcome essentially all pre-Warsh members agreed on as well. Once again, how do you get rid of \$2 trillion in MBS without any unwanted, or unintended by-products? That’s where the notion of Warsh-related rate cuts came about, i.e., the Fed would cut the Fed funds rate as an offset for future tightening, which is exactly what reducing the balance sheet is.

As you can see, shrinking the FOMC policy statement is relatively easy, but shrinking the balance sheet can come with a whole host of other potential issues to consider. In other words, this is more than likely a market topic for the future, not something anytime soon.

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