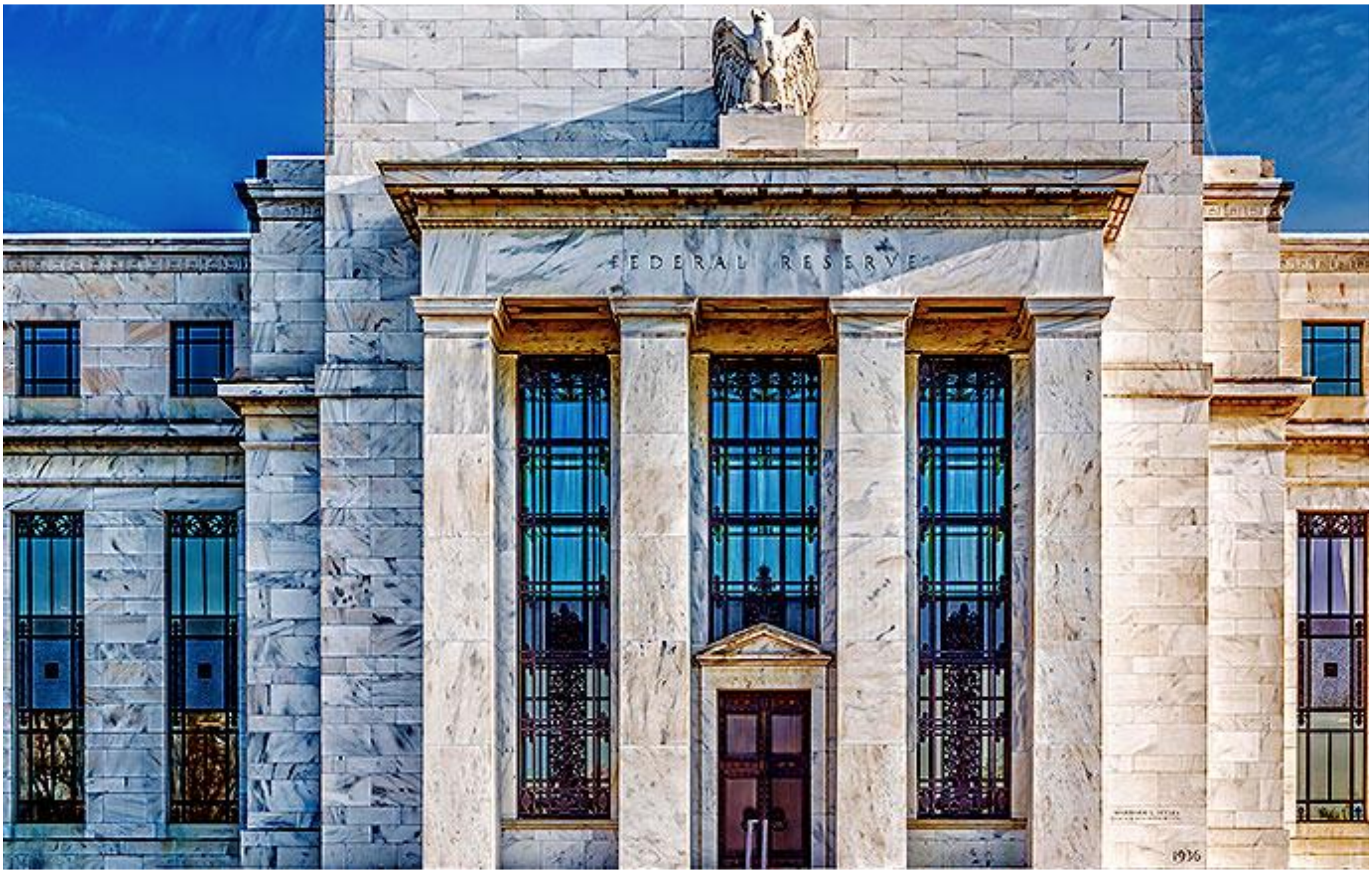
BlueBay
Asset Management




# Fed prepares for quantitative tightening and so should investors

*At its meeting on March 14-15, the Fed's monetary policy committee (the FOMC) agreed that it would likely announce a path for reducing the size of its balance sheet later this year. It would be the first and most important major central bank to begin to reverse the impact of quantitative easing (QE) by shrinking its balance sheet. QE raised cross-asset correlations and suppressed asset price dispersion as well as 'risk-free' bond yields. Quantitative tightening (QT) has important implications for asset markets and investment strategies.*

Market Insight

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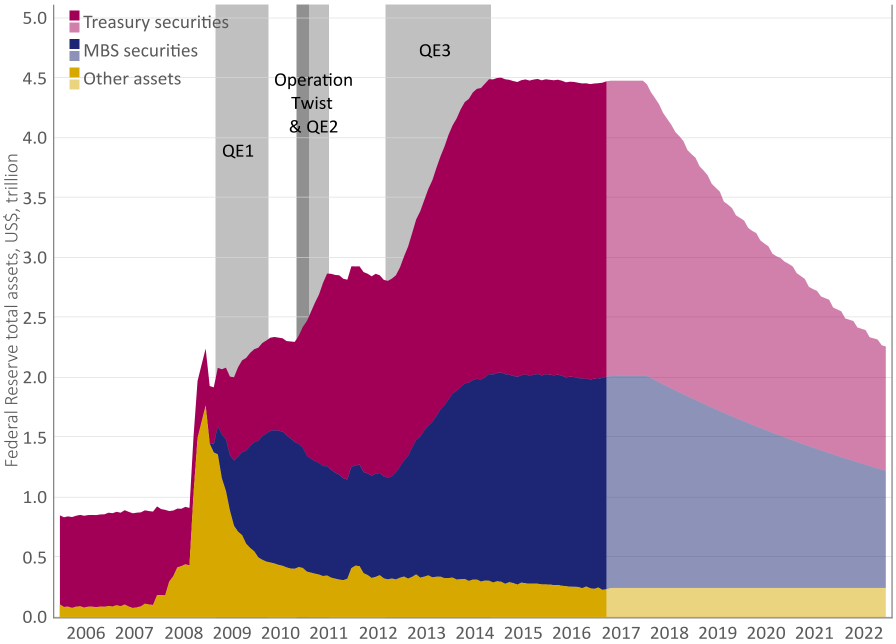
The balance sheet of the US Federal Reserve exploded in size in response to the financial crisis of 2008-09. As a consequence of QE, the Fed currently holds US$1.8 trillion of mortgage-backed securities (MBS) and US$2.5 trillion of US Treasury bonds and its balance sheet totals US$4.5 trillion (equivalent to 24% of GDP) compared to just US$1 trillion (6% GDP) in 2007. Net asset purchases were gradually reduced to zero – tapering – in October 2014 but that was not the end of QE. The Fed continues to re-invest maturing principal – around US$400 billion last year – as the stock, as well as the flow of asset purchases, influences financial conditions by suppressing long bond yields.

In the minutes of the March meeting of the FOMC, many participants emphasised that reducing the size of the balance sheet should be conducted in a passive and predictable manner. The FOMC could decide to 'taper' its reinvestment of principal or if it wished to more rapidly reduce the size of the Fed balance sheet, it could choose to sell down its securities holdings. However, the most passive and predictable option for running down the balance sheet is simply not to reinvest principal as the Fed's securities holdings mature.

The chart below projects the evolution of the Fed balance sheet if the Fed simply stops reinvesting principal from January 2018. The decline in Treasury holdings is based on the reported maturity profile of its holdings of Treasury securities while it is assumed that MBS runoff at a 12% annualised rate reflecting prepayments and amortisation (the final maturities of MBS are 15 to 30 years hence). Simply allowing securities to run-off as they mature would half the size of the balance sheet in dollar terms by the end of 2022.

**Federal Reserve balance sheet if it stops re-investing principal from January 2018**




Note: reduction in Treasury securities based on reported maturities; for MBS assuming a 12% annualised rate of prepayments and amortisations; shaded area indicate episodes of quantitative easing (QE).
Source: Macrobond; NY Federal Reserve; BlueBay calculations; latest data at 31 March 2017

The magnitude of the 'stock effect' of QE is highly uncertain, but Fed estimates in 2015 suggested that its balance sheet programmes were depressing 10-year Treasury yields by about 110bps.[1] Term premium – the compensation for the interest rate risk associated with holding 10-year bonds rather than rolling over short-dated securities – is currently zero compared to a 20-year average of 120bps. QE also suppressed asset price dispersion and elevated cross-asset correlations as the ebb and flow of central bank liquidity was the overwhelming common macro

[1] Conducting monetary policy with a large balance sheet, Stanley Fischer Vice-Chairman Federal Reserve, February 27 2015

factor driving global asset prices.

Quantitative tightening - shrinking the balance sheet to a more 'normal' size - as well as raising short-term interest rates above inflation are both integral to the 'normalisation' of monetary policy as the US sheds the legacy of the financial crisis and 'great recession'. Investors should prepare for the era of quantitative tightening that in our opinion will be characterised by higher interest rates and greater dispersion in asset price performance.