September 18, 2017

Deflating the Fed’s Balance Sheet Balloon

Fed Leads the Charge to Normalization

- **Fed Set to Kick Off Balance Sheet Unwind.** The Federal Reserve is largely expected to announce the beginning of its balance sheet unwind at its September meeting, keeping the committee true to its previous communication of initiation of the tightening cycle by the end of this year.

- **A Gradual Pace Is Essential.** While the Fed’s unwind plan appears gradual at the start, it quickly ramps up to $50 billion in assets each month. For those who believe that the Fed’s stimulus since 2008 have helped boost markets, a balance sheet unwind of similar magnitude could provide market headwinds if done too quickly. Further rate hikes may also be delayed so as not to compound the effect of the bond sales.

- **European Central Bank (ECB) Takes Hawkish Tone.** The ECB did not make any changes to monetary policy at its September meeting, but speakers following the meeting appeared hawkish, signaling the coming tightening. Members mentioned that it would be important to remove stimulus “gradually but clearly”.

Our Take: After growing their balance sheets in sync, global central banks must begin gradually shrinking them.

Economic Expansion – 8 Years And Counting

- **Global business surveys point to an ongoing expansion.** Markit’s Eurozone composite purchasing managers’ index (PMI) for August remained at 55.7, suggesting economic activity remains robust in the region. In the U.S., the Institute of Supply Management’s manufacturing PMI accelerated to 58.8, well above estimates at 56.5.

- **Mortgage applications surge to highest level in almost a year.** MBA mortgage application volume grew 9.9% week over week, to its highest overall reading since November 2016. The wave of new applications is likely spurred by cheap borrowing costs, which fell to 4.0%, another low since last November.

- **Mixed inflation data a lingering headwind for another 2017 rate hike.** US PPI reported marginally below consensus (2.4% vs. 2.5% Y/Y). On the other hand, CPI was marginally stronger at 1.9% Y/Y vs. 1.8% consensus. Inflation’s middling trend as of late has been cited as a headwind for another rate hike in 2017.

Our Take: The macroeconomic expansion remains intact, both in the U.S. and abroad.

Dealing With Disagreements...

- **The (Potential) Clash.** Early last week, the United Nations approved tougher sanctions on North Korea. North Korea retaliated by firing another missile over a Japanese island. Investors should be wary that tensions remain high. Our base case is that cooler heads should prevail, but potential for further escalation remains.

- **Legislation Appears to Progress.** House Ways and Means Chairman Kevin Brady will release a tax reform framework a week from now – which hopefully addresses corporate rates and interest deductibility. However, House and Senate proposals will likely diverge, and mortgage interest rate deduction’s status is ambiguous.

- **“Repeal and Replace” – Weakened.** Bernie Sanders introduced “Medicare-For-All”, a single payer bill, backed by 15 Democratic Party co-sponsors. Divisions with the GOP have emerged, with some Senators working to shore up the Affordable Care Act.

Our Take: Markets face near-term geopolitical risks, but continue to plod ahead along with the ongoing expansion.

OPEC: Not the Monopoly it Once Was

- **Extension of Production Cuts on the Table.** OPEC members have been discussing extending supply production cuts into the second half of next year, well past their current March 2018 end date.

- **Saudi Arabia “Losing Credibility”.** Saudi Arabia will push to monitor oil exports alongside production. Saudi Arabia’s energy minister told other OPEC ministers he is “losing credibility” as oil continues facing pressure.

- **Demand Strengthens.** Helping to act as a counterbalance to over-supply, Q2 demand grew 2.4%, leading the International Energy Agency (IEA) to increase its demand growth estimate to 1.7% for 2017 and 1.4% for 2018.

Our Take: Saudi Arabia continues its attempts to bring the oil market into balance, but must fight the surge of U.S. shale.
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**Chart of the Week:**

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Fed’s Balance Sheet as a % of GDP

The Fed’s plan:
- Sell $10B/M
- Increase gradually
- Eventual $50B/M run-rate

Back to “normal” by June 2023.

Source: FactSet, International Monetary Fund (IMF), Glenmede. Graph represents the Fed’s balance sheet as a percentage of U.S. GDP. Chart assumes the Fed begins trimming their balance sheet according to the plan outlined at the June meeting, starting in December, 2017. Future GDP is represented as projected by the IMF.

**Dates of interest:**

- **9/18:** US NAHB Housing Market Index, EUZ CPI
- **9/19:** US Goldman Retail Sales, Housing Starts/Completions, Building Permits, Japan Trade Balance
- **9/20:** US FOMC Meeting, EIA Crude Oil Stocks, Total Fuel Inventory, Japan BOJ Meeting, Germany PPI
- **9/21:** US Philadelphia Fed Index, FHFA Home Price Index, Jobless Claims, EUZ Flash Consumer Confidence
- **9/22:** US Flash Markit PMI, Baker Hughes U.S. Rig Count, EUZ Markit Flash PMI