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## Fed set to shrink balance sheet

**Fed view: The delicate task of reducing the Fed's balance sheet** - The minutes of the March FOMC meeting suggest that policymakers discussed the potential benefits and costs of approaches for reducing the balance sheet of the Fed. The minutes suggested that communication of policy normalisation will be critical to reduce the risks of misleading signals that could trigger financial market volatility. Although discussions will continue, participants generally preferred to phase out or cease reinvestments of Treasury Securities and agency MBS. An approach that ended reinvestments all at once, however, was generally viewed as easier to communicate while allowing a swifter normalisation of the balance sheet. To promote rapid normalisation, one participant suggested to set a minimum pace for reductions in MBS holdings and when necessary to sell MBS to maintain such a pace. Nearly all participants agreed to communicate the decisions well in advance, and several suggested to also provide more information about "the size and compositions of the Fed's assets and liabilities in the longer run.

The Fed's balance sheet now amounts to around USD 4.5 trillion dollars. The Fed has maintained its policy of reinvesting principal payments from its holdings of US Treasury securities (USD 2.5 trillion) and mortgaged-backed securities (USD 1.8 trillion), as well as rolling over maturing Treasuries. As a result, total liabilities in the balance sheet remain unchanged. Most participants judged that if the economy continued to perform as expected a change in reinvestment policy would be appropriate this year. Critical aspects related to this policy are the size of the tax cuts and the pace at which the economy continues to improve. We remain positive about the economic outlook and we expect tax measures to be implemented next year. Overall, the minutes are unclear whether the FOMC will opt to phase out reinvestment or end it all at once. We think a phasing strategy would be smoother and likely to start once there is more clarity about the timing and size of fiscal stimulus. (Maritza Cabezas)

**US Macro: Labour market ends first quarter on strong note** - The ADP employment report for March showed that private payrolls increased by 263K, above the consensus estimate (185K) and higher than the revised February figure of 245K the previous month. This first quarter is showing a more broad based improvement of job gains. Goods-producing activities, including construction and manufacturing added jobs at a faster pace in this first quarter after having been subdued for quite some time (81K in Q1 was 9K in the previous quarter). Meanwhile, the service-providing sector remains strong (181K in Q1 was 156K in the previous quarter). The expansion in jobs was driven by professional business services. We are cautious in placing too much weight on the ADP employment report given the frequent revisions to the time series, this morning's report points to ongoing solid nonfarm payroll growth in Friday's report. We look for an increase of 160K in the private nonfarm payrolls and unemployment remaining at 4.7%. This is a slowdown compared to

the 227K reported in February. We expect job gains to cool down a bit as a result of the severe weather conditions in some parts of the country. Job growth should also moderate as the supply of labour in certain activities becomes tighter. However, the ADP report points to upside risks to our forecasts. (Maritza Cabezas)

**Global FX: No change in US dollar and EUR/USD forecasts** - Recently we have adjusted our US macro-economic forecasts as well as our global government bond yield forecasts. Taking into account these changes we decided not to change our US dollar and EUR/USD views. We keep our year-end forecasts for EUR/USD at 1.10 (2017) and 1.20 (2018), respectively. For a start, we only expect a modest rise in US real yields in 2017. Therefore, the upside of the US dollar in 2017 is limited in our view. Moreover, speculative net-long positions in the US dollar are quite sizeable. Investors are well positioned for US dollar strength but if this fails to materialise they will slowly but surely close part of these positions. This will result in downward pressure on the US dollar. Even though investors have downscaled their expectations about Trump's fiscal stimulus, they are still giving him the benefit of the doubt. As we now expect that the fiscal stimulus will take longer to arrive and the overall size of the stimulus will be smaller, this will probably weigh on the US dollar going forward. We expect that the euro will continue to receive support as market expectations build and the ECB monetary policy will gradually become less accommodative. We expect two more rate hikes of 25bp by the Fed in 2017 and three more in 2018. Financial markets have almost priced our scenario for this year, but only two hikes for 2018. If markets move in our direction the US dollar should get some support in 2017 (also anticipation for 2018 rate hikes). But this will unlikely be enough to cause a major US dollar rally mainly because investors are already positioned for this. Next year we expect the US dollar to weaken across the board because of lower US real yields, a deterioration in the growth inflation mix and other central banks moving towards more restrictive or less accommodative monetary policy (Georgette Boele).

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