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The Fed is looking for the exit

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- **The US Fed has started talking about its exit strategy again. Perhaps it does not need to reduce its Treasury holdings by much**
- **Global economic conditions remain firm, though some data disappoints**
- **Chinese FX reserves stable in March, suggesting improved efficiency of capital flows or less pressure to move money out of the country**

The minutes of the March FOMC meeting show that the Fed is drawing up plans to reduce the size of its balance sheet. That can be done in various ways, of course. Until now, the Fed has reinvested maturing securities it had bought during its QE programmes, keeping its holdings of Treasury securities and Mortgage Backed Securities (MBS) constant at USD 2.5 trn and USD 1.8 trn, respectively. The Fed must now decide if it wants actively to sell securities, simply stop reinvesting monies received from all maturing securities or stop reinvesting, but put a ceiling at how much it wishes to reduce its balance sheet by per month. It must also decide which securities it wants to reduce its holdings of.

Fed will be cautious

It seems to me most likely that a passive, cautious approach makes most sense as the Fed will surely not wish to disrupt markets. Caution and communication are of the essence. As to the type of securities, I would imagine that a reduction of MBS holdings would have priority over reducing Treasury securities and the latter would be a more natural holding for a central bank.

Financial market participants are subject to some anxiety over this issue. Will this reduction of the Fed's balance sheet affect markets strongly? In order to assess this, it is important to have an idea of the size of the reduction of the balance sheet.

Required reduction of holdings less than feared

I think the potential problems for the market may be less than feared. It is correct that the Fed is currently holding USD 4.3 trn of these securities. That does not mean it needs to get rid of them all. Even before the crisis, the Fed owned Treasury securities. At the end of 2007, their holdings amounted to USD 750 bn.

The balance sheet of the Fed grows over time, in line with economic activity. Its balance sheet total is now some USD 4.5 trn, while before the crisis, at the end of 2007, it was USD 900bn. But it would be wrong to assume that the balance sheet must be brought back to that level. The balance sheet total excluding excess reserves of the commercial banks is currently USD 2.2 trn, so more than twice the size of the balance sheet in 2007. Currency in circulation alone has risen by over USD 700 bn.

USD 25 bn a month?

So my guess would be that the Fed needs to reduce its balance sheet by a maximum of the amount of excess reserves: USD 2.3 trn. The securities were bought between 2009 and 2016, so over a seven year period. If they choose to spread the reduction of the balance sheet over a similar period, the reduction of the balance sheet per year would amount to some USD 300 bn, or USD 25 bn a month. This is probably even an overestimation as the underlying growth of the Fed's balance sheet will continue. All in all, therefore, it does not sound too onerous.

There is another aspect. Treasuries would appear to be a more natural holding for the Fed than MBSes. If the Fed were to completely let their MBS holdings run off, they would need to reduce their Treasury holdings only by some USD 500 bn. Again, that would not be too onerous. Of course, in such a scenario, the MBS market would bear the brunt.

The bottom line for me is that the Fed should be able to reduce their balance sheet while maintaining orderly market conditions and without putting undue pressure on borrowing costs throughout the economy. Communication and a cautious approach will be key, but I also think that the size of the reduction of the balance sheet is very manageable.

German orders and output zigzagging higher

Cyclical global indicators remained positive in recent days, though there were some areas of surprising weakness. Factory orders and industrial production in Germany were strong in February, Orders rose 3.4% mom and output gained 2.2% after several months of significant volatility.

The important Tankan survey in Japan, measuring business confidence rose convincingly in Q1, improving over a wide front, suggesting the cyclical upturn is hitting Japan.

Chinese FX reserves rise again in March

Also positive was the modest rise in FX reserves in China in March (USD 3,009 bn, versus 3,005 bn in February). Chinese reserves have recently stabilised after they had fallen significantly for a long period. As China is running a sizeable trade surplus, falling reserves indicated an even larger capital outflow, which was seen as a negative sign of a lack of confidence. It is not entirely clear why capital outflows have been reduced. This could be the result of more efficient enforcement of the restrictions on capital outflows or of less demand for bringing money out of the country as confidence in the domestic economy has risen.

US data mixed

The recent crop of US cyclical data has been mixed. All published nationwide business confidence indices fell back modestly in March, but remained at an unusually high level. The labour market sent very contradictory signals. The ADP numbers were very strong, indicating strong hiring by companies. And the household survey showed an increase of 472,000 jobs in March. On the other hand, the establishment survey of the March payroll report showed a gain of only 98,000 jobs in March. I think that number is a bit of a blip. It happens. Don't worry.

US Markit PMI and ISM

Index – 50 is neutral

Source: Bloomberg

Next Weekly will be published on Friday 21 April 2017

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Main economic/financial forecasts

GDP growth (%)	2015	2016e	2017e	2018e
United States	2.6	1.6	↓ 2.3	↓ 2.5
Eurozone	1.9	1.7	1.8	1.6
Japan	1.2	1.0	0.9	0.7
United Kingdom	2.2	1.8	1.7	1.6
China	6.9	6.7	6.5	6.0
World	3.4	3.1	3.5	3.6
Inflation (%)	**2015**	**2016e**	**2017e**	**2018e**
United States	0.1	1.3	↓ 2.5	↑ 2.5
Eurozone	0.0	0.2	1.6	1.5
Japan	0.8	-0.1	0.8	1.0
United Kingdom	0.0	0.7	2.7	2.5
China	1.4	2.0	2.5	2.5
World	2.9	2.9	3.5	3.2
Key policy rate	**06/04/2017**	**+3M**	**2017e**	**2018e**
Federal Reserve	1.00	1.25	1.50	↑ 2.25
European Central Bank	-0.40	-0.40	-0.40	-0.30
Bank of Japan	-0.10	-0.10	-0.10	-0.10
Bank of England	0.25	0.25	0.25	0.25
People's Bank of China	4.35	4.35	4.35	4.35

3M interbank rate	30/03/2017	06/04/2017	+3M	2017e	+12M	2018e
United States	1.15	1.16	↑ 1.40	↑ 1.70	↑ 1.95	↑ 2.40
Eurozone	-0.33	-0.33	-0.35	-0.35	-0.35	-0.20
Japan	0.06	0.06	0.00	-0.10	-0.10	-0.10
United Kingdom	0.34	0.34	0.40	0.40	0.40	0.40
10Y interest rate	**30/03/2017**	**06/04/2017**	**+3M**	**2017e**	**+12M**	**2018e**
US Treasury	2.42	2.34	↓ 2.5	2.90	3.00	↑ 2.80
German Bund	0.33	0.26	0.5	↑ 1.00	↑ 1.10	↑ 1.40
Euro swap rate	0.78	0.74	↑ 1.0	↑ 1.30	↑ 1.40	↑ 1.60
Japanese gov. bonds	0.06	0.06	0.0	0.00	0.00	0.00
UK gilts	1.12	1.10	↓ 1.2	↓ 1.70	↓ 1.80	1.90
Currencies	**30/03/2017**	**06/04/2017**	**+3M**	**2017e**	**+12M**	**2018e**
EUR/USD	1.07	1.07	1.05	1.10	1.15	1.20
USD/JPY	111.9	110.8	117	110	110	105
GBP/USD	1.25	1.25	1.25	1.25	1.30	1.35
EUR/GBP	0.86	0.85	0.84	0.88	0.88	0.89
USD/CNY	6.89	6.90	6.95	7.00	7.05	7.10

Source: Thomson Reuters Datastream, ABN AMRO Group Economics.

Key macro events 10-14 April

Day	Date	Time	Country	Key Economic Indicators and Events	Period	Latest outcome	Consensus	ABN AMRO
Monday	10/04/2017	15/04/2017	CN	M2 money supply - % yoy	Mar	11.1	11.1	
Monday	10/04/2017	15/04/2017	CN	New Yuan Loans - CNY bn	Mar	1170.0	1200.0	
Monday	10/04/2017	15/04/2017	CN	Aggregate financing - CNY bn	Mar	1147.9	1500	
Monday	10/04/2017	08:00:00	NO	CPI - % yoy	Mar	2.5		
Monday	10/04/2017	08:00:00	NO	CPI Underlying - % yoy	Mar	1.6		
Tuesday	11/04/2017	10:30:00	GB	CPI - % yoy	Mar	2.3	2.2	
Tuesday	11/04/2017	11:00:00	EC	Industrial production - % mom	Feb	0.9	0.1	**0.0**
Tuesday	11/04/2017	11:00:00	DE	ZEW index (expectation economic growth)	Apr	12.8	13.0	**18.0**
Tuesday	11/04/2017	12:00:00	US	NFIB small business optimisme - index	Mar	105.3		
Tuesday	11/04/2017	16:00:00	US	US Job Openings by Industry	Feb	5626		
Tuesday	11/04/2017	19:45:00	US	Fed's Kashkari participates Q&A Minneapolis				
Wednesday	12/04/2017	01:50:00	JP	Machinery orders private sector - % mom	Feb	-3.2	3.8	
Wednesday	12/04/2017	03:30:00	CN	CPI - % yoy	Mar	0.8	1.0	
Wednesday	12/04/2017	03:30:00	CN	PPI - % yoy	Mar	7.8	7.4	
Wednesday	12/04/2017	09:30:00	SW	CPI - % yoy	Mar	1.8		
Wednesday	12/04/2017	09:30:00	SW	CPI CPIF - % yoy	Mar	2.0		
Wednesday	12/04/2017	10:30:00	GB	Change in claimant count - thousands	Mar	-11.3		
Wednesday	12/04/2017	10:30:00	GB	Claimant count unemployment rate - %	Mar	2.1		
Wednesday	12/04/2017	16:00:00	CA	Policy rate - %	Apr 12	0.5	0.5	**0.5**
Wednesday	12/04/2017		BR	Policy rate - %	Apr 12	12.3	11.3	
Thursday	13/04/2017	08:00:00	DE	CPI - % yoy	Mar F	1.6	1.6	
Thursday	13/04/2017	14:30:00	US	Prod. prices index excl food and energy - % mom	Mar	0.3	0.2	
Thursday	13/04/2017	14:30:00	US	Prod. prices index - % mom	Mar	0.3	0.0	
Thursday	13/04/2017	16:00:00	US	Univ. of Michigan cons. confidence - index	Apr P	96.9	96.7	**96.2**
Thursday	13/04/2017		CN	Imports - % yoy	Mar	38.1	17.0	
Thursday	13/04/2017		CN	Exports - % yoy	Mar	-1.3	4.0	
Thursday	13/04/2017		KR	Policy rate - %	Apr 13	1.25		**1.25**
Friday	14/04/2017		JP	Industrial production - % mom	Feb F	2.0		
Friday	14/04/2017	14:30:00	US	Retail sales - % mom	Mar	0.1	0.1	**0.0**
Friday	14/04/2017	14:30:00	US	Inflation excl food and energy - % mom	Mar	0.2	0.2	**0.2**
Friday	14/04/2017	14:30:00	US	Inflation excl food and energy - % yoy	Mar	2.2	2.3	**2.3**
Friday	14/04/2017	14:30:00	US	Inflation (CPI) - % mom	Mar	0.1	0.0	**0.0**
Friday	14/04/2017	14:30:00	US	Inflation (CPI) - % yoy	Mar	2.7	2.6	**2.6**
Friday	14/04/2017	16:00:00	US	Business inventories - % mom	Feb	0.3	0.3	

Source: Bloomberg, Reuters, ABN AMRO Group Economics (we provide own forecasts only for selected key variables and events)

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