Economics 101 with Scott Colbert – Watching the Paint Dry at the Federal Reserve

By Scott Colbert

"Federal Reserve-speak" is a language that remains a mystery to many Americans and we have an army of analysts that attempt to interpret Federal Reserve Chair Janet Yellen's every utterance on economic policy.

Commerce Brokerage Services, Inc.
A Subsidiary of Commerce Bank

Yellen said earlier this month that the Federal Reserve (Fed) is now starting to focus on undoing the "Quantitative Easing" that occurred after the Great Recession by shrinking its balance sheet. It's worth stepping back for a moment to explain this concept and how it's likely to affect investors and borrowers alike.

This country was in uncharted territory when the Fed went on a bond buying spree from late 2008 to 2014 as it purchased nearly $3.5 trillion of government securities to initially help shore up our sinking economy, lower longer-term interest rates and eventually propel a feeble recovery forward.

And now that the economy is relatively healthy, the Fed believes it would be good practice to offload some of those bonds tucked furtively away on its balance sheet and give them back to the world's financial markets. If they do it right, according to Yellen, it should be like "watching paint dry."

What does this really mean? When the economy went into a financial tailspin in 2008, our Federal Reserve Bank reacted first by pushing short-term interest rates quickly to zero. But they were (rightfully we think) worried that this might not provide enough thrust to bring us back to a level flight path. They wanted to lower longer-term interest rates as well. So they began this Quantitative Easing program, otherwise known as QE.

In three rather massive waves over six years, the Fed began purchasing both Treasury bonds and U.S. government-guaranteed mortgage-backed securities primarily for two reasons. First, they believed this new, additional demand for bonds was likely to help lower longer-term rates (and it likely did). In addition, since the Fed in effect “created” the money to buy these bonds, it would also boost the money supply as the proceeds from its purchases flowed to whatever financial institution sold them the bonds. And, in turn, that new money would hopefully be providing fresh capital to the banking system and be put back to work buying other assets (driving those values higher), or providing fuel for lenders to make new loans. In essence, this additional liquidity might help businesses or consumers who were still gasping for monetary oxygen.

The Fed liked QE so much, they continued the process through 2014. And in hindsight, it would certainly appear to have helped our recovery along. We’ve had eight years of expansion since the end of the Great Recession, and it’s hard to quarrel with QE’s positive impact. At least that is from those borrowers’ or investors’ perspective who were able to take advantage of these ultra-low interest rates, refinance their loans, hold onto their businesses and houses and watch their financial assets grow again.

But of course, there is no absolutely free lunch. Risk-averse savers saw their money market and CD rates collapse, and bond investors earned the smallest coupon payments ever. And of course the Fed's balance sheet remains bloated as it grew from $1 trillion to roughly $4.5 trillion today. And that's a lot of fixed rate bonds to finance with short-term deposits now that rates are slowly starting to rise. So as a good steward, the Fed is about to start to reverse what was set in place while we are healthy enough to withstand this dose of possibly bad-tasting medicine.

While it is hard to prove conclusively how much all this additional bond buying lowered longer-term rates, Fed studies think it was likely in the neighborhood of 1% or so. Now the Fed wants to go in reverse – and has suggested it wants to reduce its $4.5 trillion stockpile of bonds down to about $2 trillion. And rather than an outright sale of securities, the Fed plans to shrink its stockpile of assets simply by not replacing bonds as they mature.

So where does the money go once these bonds mature? Here is the dark art of monetary policy. Amazingly it will simply vanish into thin air, exactly the opposite of how it was conjured up in the first place, in effect reducing the money supply. While people always talk about the government having the capability to "print money," this is a rare example of its ability to metaphorically burn it as well.

Increasing the overall supply of government bonds on the open market should have some very real effects – namely longer-term interest rates should continue to move modestly upward. And this of course is where Yellen hopes that the process will unwind so slowly, so smoothly and take so long that it will be relatively unnoticeable, or like “watching paint dry.”

Can they do it? We believe the economic recovery has enough steam and momentum to last for quite a while. Expansions simply don’t die of old age, but usually of some shock or rapid rise in inflation that forces the Fed to raise rates aggressively. None of that is in place today, with inflation low and what appears to be a relatively unobstructed runway to continue our slow but steady lift off.

So let the painting begin at the Fed. And while they are at it, let’s also take a moment to say “Happy Birthday” to our economic expansion that just marked its July 1st eighth anniversary. As QE ends, blow out those birthday candles and wish our recovery a long life and a strong future to afford the Fed time to wean us all off the “Quantitative” elixir we’ve grown accustomed to consuming.

TAKEAWAYS

- The Fed went on a bond buying spree from late 2008 to 2014 as it purchased nearly $3.5 trillion of government securities to initially help shore up our sinking economy, lower longer-term interest rates and eventually propel a feeble recovery forward.
- In three rather massive waves over six years, the Fed began purchasing both Treasury bonds and U.S. government-guaranteed mortgage-backed securities.
- Risk-averse savers saw their money market and CD rates collapse, and bond investors earned the smallest coupon payments ever.

Commerce Brokerage Services, Inc.
A Subsidiary of Commerce Bank

The 2017 investment commentary is a special report designed to provide investment information on economic markets for Commerce Brokerage clients. It is intended to provide general information only and reflects the opinions of Commerce Trust Company's Investment Policy Committee.

Commerce Trust Company is a division of Commerce Bank. Commerce Brokerage Services, Inc., member FINRA and SIPC, and an SEC registered investment advisor, is a subsidiary of Commerce Bank.

This material is not a recommendation of any particular security, is not based on any particular financial situation or need, and is not intended to replace the advice of a qualified attorney, tax advisor or investment professional. The information in this commentary should not be construed as an individual recommendation of any kind. Strategies discussed here in a general manner may not be appropriate for everyone. Diversification does not guarantee a profit or protect against all risk. Past performance is no guarantee of future results, and the opinions and other information in the investment commentary are as of July 26, 2017.

Commerce does not provide tax advice or legal advice to customers. Consult a tax specialist regarding tax implications related to any product or specific financial situation. Data contained herein from third-party providers is obtained from what are considered reliable sources. However, its accuracy, completeness or reliability cannot be guaranteed. All expressions of opinion are subject to change without notice depending upon worldwide market, economic or political conditions.

Commerce Brokerage Services, Inc.
A Subsidiary of Commerce Bank

SCOTT M. COLBERT, CFA®

Executive Vice President,

Chief Economist and Director of Fixed Income

The Commerce Trust Company

Scott is the chief economist and director of fixed income management with Commerce Trust Company. He joined Commerce in 1993 and has investment responsibilities for over $19 billion in fixed income assets. Scott directly manages the Commerce Short-Term Government and the flagship Commerce Bond strategies.

Scott received his bachelor of science degree in nuclear engineering from the University of Cincinnati in 1986 and received his master of business administration from Xavier University in 1988. He has been both a director and president of the Chartered Financial Analyst Society of St. Louis.