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The Fed's balance sheet has contracted as planned since October 2017...

...But bank reserves are falling more quickly, mostly for technical factors, which will partly reverse.

The faster decline in bank reserves does constitute extra tightening, but not by much.

Is the Accelerating Fall in Bank Reserves a Real Problem for the Fed?

The rundown of the Fed's balance sheet has proceeded in line with the plans laid out back in June 2017. From the initial run rate of $6B Treasuries and $4B mortgages, the Fed's holdings are now falling by $30B Treasuries per month and $20B mortgages. The cumulative decline since the run-off program began in October 2017 is now $423B. But the FOMC now says it is "prepared to adjust any of the details for completing balance sheet normalization", apparently spooked by the tightening of financial conditions in the fourth quarter—mostly due to the drop in stock prices—and the rollover in global manufacturing surveys, led by China.

That's a pretty strong hint that the pace of the run-off will soon be slowed, but remember that what's happening to the Fed's balance sheet in aggregate does not always tell the whole story. *The point of the run-off is to shrink the pool of excess reserves held at the Fed by depository institutions, mostly banks.* Excess reserves—that is, the stock of reserves above the regulatory minimum—are a measure of safe liquidity in the banking system, and were created when the Fed purchased mortgages and Treasuries during the three QE programs implemented after the crash.

The increase in the level of excess reserves tracked the increase in the Fed system's open market account, as our

EXCESS RESERVES FALLING FASTER THAN FED BALANCE SHEET

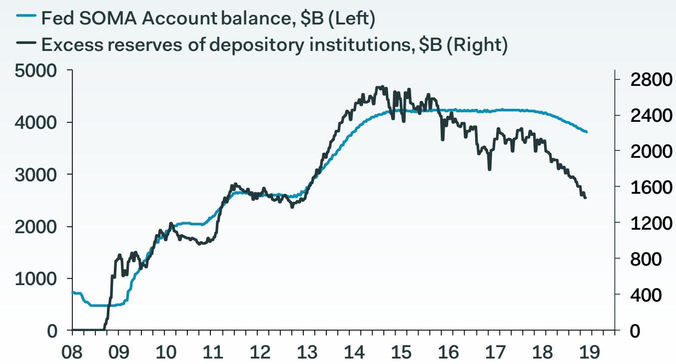
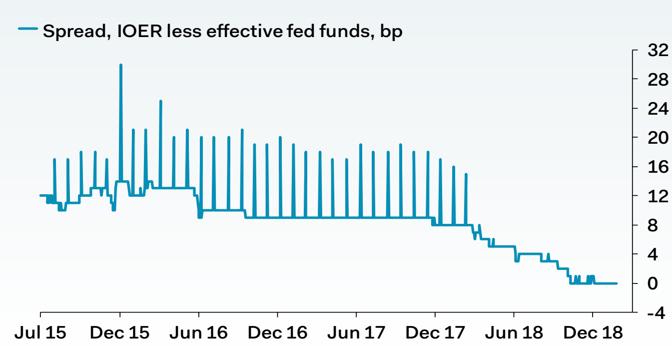


chart above shows. Excess reserves rose more quickly than implied by the increase in the SOMA balance from late 2013 through mid-2014, but this was then followed by an undershoot from early 2016 though late 2017. ***Since early 2018, though, the gap between the rate of run-down in excess reserves and the SOMA accounts has widened dramatically.*** In the 13 months since January 2018, the SOMA account balance has shrunk by $395B, but excess reserves have fallen by $516B.

Partly, this is because the effective fed funds rate has risen towards the top of the target band, squeezed by greater demands on short-term liquidity as Treasury bill issuance has risen. *As a result, the spread between the effective funds rate and the rate paid by the Fed*

THE DISAPPEARING IOER-FUNDS SPREAD IS PARTLY TO BLAME

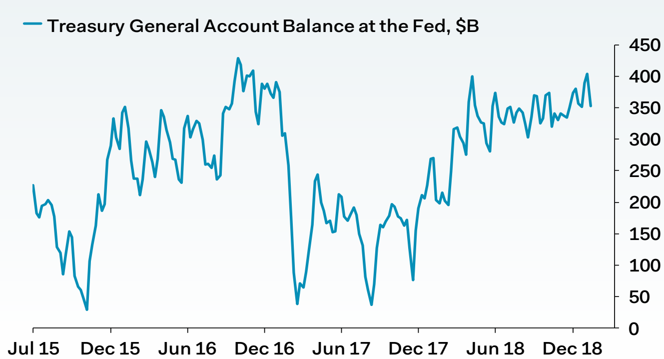


on excess reserves narrowed last year, giving banks an alternative to holding balances at the Fed.

The other key factor driving down excess reserves has been the sharp increase in the Treasury's cash deposits at the Fed. This matters because when the Fed sells Treasuries, the initial impact is to reduce bank reserves. But when the borrowed money is spent—the government is good at that, most of the time—it ends up back in the hands of banks, so reserves rise. This is an ongoing churning process so most of the time it does not leap out of the data.

Recently, though, the Treasury's cash balances at the Fed have risen sharply, as our next chart shows. Presumably, this is partly because officials want to have cash on hand in the event that Congress fails to deal with the debt ceiling, which is due to be re-imposed on March 1. The six-week government shutdown also slowed the pace of spending, allowing cash balances to rise.

RISING TREASURY CASH BALANCES DEPRESSING RESERVES TOO



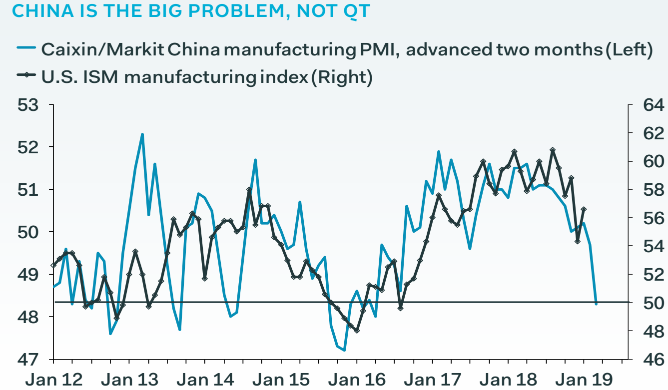
It's clear from the chart above that movements in Treasury's balances at the Fed are very erratic, but looking back over the past year they have made a material difference to banks' excess reserves. *In the year through February 6, the Treasury's balance at the Fed rose by $148B, accounting for a quarter of the $596B decline in depository institutions' reserve balances.* The bulk of the remaining $448B was due to the $371B decline in the Fed's holdings of securities.

This is all very interesting, you might think, but does it matter? ***At this point, the extra run-down in reserves probably hasn't made a material difference to the Fed's overall policy stance, but things could change if the gap shown in our first chart were to continue widening.*** Depending on whose analysis you choose, the "extra" $247B drop in reserves since the start of QT, relative to the decline in the SOMA account, is the equivalent of a 10-to-40bp increase in the fed funds rate.

That's not much, but neither is it completely trivial, and a further increase in the implied tightening via reserves could come into conflict with the Fed's intention that the balance sheet rundown should be like "watching paint dry", as former Chair Yellen said in June 2017. The Fed has made it abundantly clear, over and over, that its key policy tool is interest rates and that it does not want to pursue an policy of "active" reserve management. That makes sense because the balance sheet rundown is partly an exercise in discovery; as Fed Chair Powell said last week, "Estimates of the level of reserve demand are quite uncertain".

Equally, though, the Fed will not want to get into the business of making frequent changes to the pace and structure of the balance sheet rundown, and won't want to over-react to unexpected moves in bank reserves, unless they persist. *We remain firmly of the view that the tightening of policy via rates and QT has had little impact on the economy or markets so far; the key problems are China's slowdown and the trade war.* Major changes to the balance sheet rundown aren't needed, in our view.

CHINA IS THE BIG PROBLEM, NOT QT



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THIS WEEK IN BRIEF

Note: "**D**" prefix denotes Datanotes for these releases.

Monday, February 11

- **No significant data released.**

Tuesday, February 12

- **D: NFIB Small Business Survey (1)/6:00 EST**
The rebound in the stock market likely will filter into the economic expectations component, lifting the headline index slightly to about **105** from 104.4. **Consensus: 103.0.**

- **Redbook Chain Store Sales (2/9)/9:00 EST**
Expect little change from last week's on-trend **5.7%** year-over-year.

- **JOLTS (12)/10:00 EST**
The number of job openings appears to be levelling-off, so we look for about **6,900K,** little changed from October's 6,888K. The quits rate should be steady at 2.3%. **Consensus: 6,832.**

Wednesday, February 13

- **Mortgage Applications (2/8)/7:00 EST**
Reported purchase applications usually fall sharply in February, thanks to a persistent seasonal adjustment problem, so we expect a clear decline from last week's **254.0.**

- **D: Consumer Prices (1)/8:30 EST**
The headline index likely was **unchanged** in January, depressed by a further sharp fall in gasoline prices. The core likely rose **0.1%,** with corrections in used car prices and hotel room rates constraining the index. **Consensus: Headline 0.1%, core 0.2%.**

- **Treasury Budget (12)/14:00 EST**
The CBO reckons the deficit was **$11B**, a bit less than the $23B shortfall in December 2017. But excluding calendar effects the CBO says the deficit would have been $36B. **Consensus: $11B.**

Thursday, February 14

- **D: Jobless Claims (2/8)/8:30 EST**
Our take on the seasonals points to a modest dip to **230K** from 234K. **Consensus: 225K.**

- **D: Producer Prices (1)/8:30 EST**
Lower food prices, after a run of increases, and another dip in energy prices, mean the headline PPI likely fell **0.1%.** But we look for a **0.2%** increase in the core, mean-reverting after December's surprise 0.1% decline. **Consensus: Headline 0.1%, core 0.2%.**

- **D: Retail Sales (1)/8:30 EST**
Falling auto sales and another drop in gas prices mean total sales probably rose **0.3%,** with non-auto sales up **0.2%.** The strong chainstore numbers suggest the control measure jumped **0.8%. Consensus: Total sales +0.1%, ex-autos 0.0%, control 0.4%.**

- **Business Inventories (11)/10:00 EST**
Previously-released data suggest that total inventories rose only 0.1%, dragged down by a sharp drop in the non-durable goods component. **Consensus: 0.2%.**

Friday, February 15

- **D: Empire State Survey (2)/8:30 EST**
Downward pressure on global manufacturing emanating from China suggests that the Empire State index will be reported down to **zero,** from +3.9. **Consensus: 7.0.**

- **Import Prices (1)/8:30 EST**
The modest rebound in oil prices suggests import prices rose **0.3%,** after two steep falls. **Consensus: -0.1%.**

- **D: Industrial Production (1)/9:15 EST**
Production likely was **unchanged,** a 0.2% correction in manufacturing, following December's jump, offset by a 2% weather-driven rebound in utility output. **Consensus: 0.1%.**

- **D: Univ. of Michigan Consumer Sentiment (2p)/10:00 EST**
The end of the government shutdown and the partial reversal of the Q4 drop in stock prices should lift the headline index to about **94** from 91.2. **Consensus: 93.5.**

THIS WEEK'S FUNDING

Monday 11	Auction: $45B 3-month, $39B 6-month bills
Tuesday 12	Announcement: four-week bills, eight-week bills
Wednesday 13	Nothing
Thursday 14	Auction: four-week bills, eight-week bills Announcement: 3-month, 6-month bills (Feb. 20) Announcement: 2-year FRN (Feb. 20) Announcement: 30-year TIPS (Feb. 21)
Friday 15	Nothing

PANTHEON'S FINANCIAL FORECASTS

		End-month:			
	4:00pm Fri.	Mar	Jun	Sep	Dec
Fed funds target	2½-to-2¾	2½-to-2¾	2½-to-2¾	2¾-to-3	3-to-3¼
2-yr	2.47	2.60	2.90	3.20	3.10
10-yr	2.63	2.80	3.10	3.50	3.00
30-yr	2.98	3.10	3.20	3.40	2.75
Curve 10-2	16	20	20	30	-10
Curve 30-2	51	50	30	20	-45
S&P 500	2,708	2,700	2,750	2,750	2,650
Dollar/Yen	109.8	112	112	112	114
Euro/Dollar	1.13	1.15	1.15	1.17	1.20
Sterling/Dollar	1.29	1.35	1.36	1.38	1.40

PANTHEON'S ECONOMIC FORECASTS

GDP	Q1	2.0%	2015 year:	2.6%
	Q2	4.2%	2016 year:	1.6%
	Q3 third	3.4%	2017 year:	2.3%
	Q4 forecast	*3.3%*	*2018 year:*	*3.0%*
	Q1 forecast	*1%*	*2019 year:*	*2.2%*
	Q2 forecast	*3%*		

CPI	Dec. -0.1% (1.9% y/y); core 0.2% (2.2% y/y)
	Mar. 2019 forecast: 1.6% y/y; core 2.1% y/y
	Sep. 2019 forecast: 1.9% y/y; core 2.5% y/y

Unemployment: June 2019: 3.7%; December 2019: 3.6%.

Federal budget: FY 19 forecast: -$950B (4.5% of GDP)