A Shrinking Fed Balance Sheet is No Cause for Alarm

Key Takeaways

» Contrary to the fears of some bond investors, we do not expect the initiation of Federal Reserve (Fed) balance-sheet reduction to have a material impact on the bond market.

» The Fed intends for balance-sheet reduction to be a passive process and not a tool to implement monetary policy.

What It May Mean for Investors

» We recommend that investors refrain from making changes to their fixed-income strategy as a result of upcoming Fed balance-sheet reduction operations.

Last week’s Federal Open Market Committee (FOMC) meeting provided little additional information for investors concerning monetary policy. The Fed continues to be stymied by inflation that remains below its target levels. Despite the Fed’s inflation concerns, it appears that the FOMC is readying its next step on the road to monetary-policy normalization. Assuming that economic and market data continues to support current economic-growth trends, we look for the Fed to announce the initiation of its balance-sheet reduction plan at the September FOMC meeting.

Contrary to the fears of some bond investors, we do not expect the start of balance-sheet reduction to have a material impact on the bond market.

The Fed’s balance sheet stood near $800 billion before the initiation of quantitative easing in 2008. After the Fed announced three separate rounds of bond purchases, its balance sheet ballooned to its current size of $4.5 trillion. The balance sheet is primarily composed of Treasury and mortgage-backed securities (MBS).
We don’t believe that the Fed balance sheet will return to pre-crisis levels. Even in a normal economic state, the U.S. economy and currency in circulation have grown materially since 2008. In fact, if the Fed so desired, it could leave the balance sheet unchanged, and the economy likely would grow into the current balance sheet size in 10-15 years. We anticipate that the Fed will maintain a much larger normalized balance sheet going forward than it did before the financial crisis. Under a persistently modest economic-growth scenario, we anticipate that the Fed balance sheet will slowly decrease to a size of $2.5 to $3 trillion over the next seven years—at which point it would be considered normalized. Yet, it is likely that the current economic expansion will falter before the balance sheet can be normalized—and that balance-sheet-reduction operations will be slowed, halted or even reversed before hitting our target level.

Chart 1. Fed Balance Sheet versus U.S. Currency in Circulation

Source: Federal Reserve, Bloomberg, June 2017. SOMA = Fed System Open Market Account, which equates to the Fed balance sheet. SOMA has several purposes, one of which is to serve as collateral for U.S. currency in circulation. See disclosures for the SOMA definition.

The Fed has been fairly transparent regarding its balance-sheet normalization plans. The Fed will not sell Treasury or mortgage securities outright. Instead, it simply plans to decrease the total reinvestment of maturing positions. Initially, the Fed anticipates reducing Treasury purchases by $6 billion per month and MBS purchases by $4 billion per month. If economic and market conditions allow, the Fed anticipates that it will increase the roll-off every three months, until it reaches $30 billion in monthly Treasury security reductions and $20 billion in monthly MBS reductions.
A Shrinking Fed Balance Sheet is No Cause for Alarm

Chart 2 shows the current maturity schedule of Fed balance-sheet Treasury holdings. In 2018, maturing Treasury securities will spike to a level above $425 billion. As a result, even if the full balance-sheet-reduction plan is implemented, the Fed will buy more Treasury securities through its reinvestment program in 2018 than it did in 2017. This is hardly a situation that is likely to lead to a bond-market disruption. To put the planned balance-sheet reduction into further context, the U.S. Treasury oversees almost $600 billion in net new Treasury security issuance per year in addition to its massive refinancing operations that the market has easily absorbed.

Investment Implications

We recommend that investors refrain from making changes to their fixed-income strategy as a result of the upcoming Fed balance-sheet reduction. While periodic portfolio rebalancing and evaluation always are important, we do not expect the initiation of the Fed balance-sheet reduction to have a material impact on the bond market—and we expect the Fed to maintain a gradual approach to normalizing interest rates. We currently hold a neutral position on Treasury securities and on residential MBS. Both of these sectors offer potential advantages to a well-diversified investment portfolio strategy, and we believe that a nominal allocation to Treasury securities and residential MBS is appropriate within a globally-diversified fixed income allocation.
Stocks Aren’t Cheap

Fundamentals and earnings drive markets over the long run; and they look to be improving. Another key factor is valuation. Price-earnings (P/E) ratios, price-to-book ratios, and other valuation measures often reflect market sentiment. Greater investor confidence that growth and fundamentals will improve may be rewarded with higher valuation multiples.

Yet, simply capturing a ratio in isolation doesn’t say much. The value comes in comparing valuation metrics on a relative basis—across time periods or relative to other assets. The chart below shows that the current forward P/E ratio for the three major equity groups is above the upper end of historical ranges. Relative to history, the S&P 500 Index appears to be the most overvalued, while the MSCI EAFE Index appears to be the least overvalued. On an absolute basis, the MSCI Emerging Markets Index is the cheapest. What this all means to us is that stocks are not cheap. Looking at other measures such as price-to-sales, we found similar results.

Valuations could remain elevated or expand even more. While downside risk has increased with recent market gains, stocks can sometimes deliver euphoric upside moves. One key factor to watch will be interest rates. Warren Buffett recently commented that “the most important item in stock valuation over time is interest rates.” Historically low rates have helped to prop up equity valuations, but with the Fed looking to raise rates and other global central banks expected to tighten in the coming years, equity investors need to be mindful of the potential impact on valuations. Rate-hike cycles usually are a headwind for valuation. We believe that currently elevated valuation levels suggest higher volatility ahead.

Key Takeaways

» The current forward P/E ratio for the three major equity groups is above the upper end of historical ranges.

» Low rates have helped prop up equality valuations. Yet, with the Fed looking to raise rates and other global central banks expected to tighten in the coming years, equity investors need to be mindful of the potential impact on valuations.

Equity Valuations as Reflected in Forward P/E Ratios

Sources: Wells Fargo Investment Institute, Bloomberg; 7/25/17. Forward P/E: Price to Next Twelve Months Earnings. Calculated as the current market price over the estimated earnings for the next twelve months for the index. The MSCI EAFE (DM) and Emerging Markets (EM) indices are equity indices which capture large- and mid-cap representation across 21 DM countries and 23 EM countries around the world. The S&P 500 Index is a market capitalization-weighted index composed of 500 widely held common stocks that is generally considered representative of the US stock market. An index is unmanaged and not available for direct investment.
The Next Fed Chair—A Big Unknown

The Fed chair has more influence over the U.S. economy in the short term than any other figure in Washington, D.C., including the president. Janet Yellen’s term ends in February 2018 and, while she may be reappointed, the odds are that we will have a new leader of the Fed early next year. With the opening of such an influential position, the potential market impact could be significant. We expect President Trump to make a nomination before the end of this year.

While not probable, it is possible that the president could opt for the status quo. Chair Yellen has a strong track record and would undoubtedly be a market favorite given the continuity and certainty she would bring to the position.

Perhaps the most mentioned name for the post is Gary Cohn, the president’s chief economic advisor. He does not come from an academic background, as most Fed voting members currently do, and that could appeal to the president. We would not anticipate that he would radically alter the current path of the FOMC, and it is likely that he would maintain an accommodative stance to help propel the economy and markets forward.

Finally, the president could nominate a more rules-based proponent to lead the Fed. One of the better known examples is John Taylor—famous for the Taylor rule in which the prescribed Fed rate policy is derived from inflation and economic slack. While a prescribed rules-based approach removes political influence from the Fed’s decision-making, it also lacks the flexibility to adjust policies should economic conditions warrant a move away from a strict rules-based approach.

Key Takeaways

- Fed Chair Yellen likely would favor more dovish policies, and her reappointment could bring a relief rally to both equity and fixed-income markets.
- The appointment of a presidential loyalist runs the risk of politicizing the Fed, and we believe that many market participants would view such a development as unwelcome over the long term. In the short term, a pro-growth stance at the Fed could lift equity markets, while bond markets likely would be more mixed, with the yield curve potentially steepening—at least initially.
- While the market may potentially appreciate the transparency of a rules-based approach, it could be deemed to be more hawkish than the current approach.
Is Oil Being Pushed Higher by the U.S. Dollar?

The answer to the title is, yes. The U.S. dollar has broken down recently, while the price of oil has been heading up, now back near $50 per barrel. The typical historical relationship between commodities and the U.S. dollar is a negative one. In other words, one goes up, while the other goes down. This negative relationship has intensified in the last decade, which is emphasized in the bottom panel of the chart below. The top panel shows the U.S. Dollar Index and West Texas Intermediate (WTI) oil, while the bottom panel highlights the connection between the two, since 1967.

Why the routine negative connection? Crude oil is priced in U.S. dollars globally. When the U.S. dollar goes down, the currency of other countries often strengthens. A stronger currency for countries outside of the U.S. makes crude oil look cheaper to their consumers (they see cheaper prices at the pump). Crude-oil prices, in anticipation of this potential oil demand from being cheaper, rise globally. The U.S. may be the largest single petroleum-buying country (19 million barrels per day), but the rest of the world in total is four times larger (76 million barrels per day). There are other factors in play in this relationship, but this is the main one.

The bottom line is that the U.S. dollar has had an influence on global oil prices recently. The U.S. dollar influence, however, does not change our 2017 oil outlook. We see WTI oil finishing the year between $40 and $50 per barrel, and Brent oil between $45 and $55. Prices higher than $55, we believe, will unleash a flood of new supply.

Key Takeaways

» The weak U.S. dollar likely has been helping to push oil prices higher.

» We do not believe that oil has much upside from here, even with a weak dollar. Our year-end 2017 target range remains $40-$50 per barrel for WTI and $45-$55 for Brent.

Sources: Wells Fargo Investment Institute, Bloomberg. Monthly Data: 1/31/1967 – 6/30/2017. Top panel shown in log scale. Oil prices from 1967 to April 1983 are Bloomberg Arabian Gulf Arab Light Crude Spot prices, and prices from May 1983 to current are Bloomberg West Texas Intermediate Cushing Crude Spot price. Prices from 1951 to April 1983 are Bloomberg Arabian Gulf Arab Light Crude Spot prices, and prices from May 1983 to current are Bloomberg West Texas Intermediate Cushing Crude Spot price. West Texas Intermediate (WTI) is a grade of crude oil used as a benchmark in oil pricing. The U.S. Dollar Index is an index that measures the value of the U.S. dollar compared to other major currencies.
Option Volatility: Just Rinse and Repeat

Much of the banter surrounding volatility hasn’t changed much since the beginning of 2017. Some pundits point to the complacency of market participants in an equity market that has not only held gains since the election, but has brought the S&P 500 (SPX), Russell 2000, and NASDAQ indices to new all-time highs. Others point to the fact that equity sell-offs have been quickly met with buyers this year, giving equity hedgers little time to decide whether to sell. Combining this with the supporting recovery of developed and emerging markets, solid earnings growth, low inflation, positive economic growth, and low U.S. unemployment, we believe that it will be tough for implied volatility to rise measurably in the near term.

On the perimeter, some investors are nervous. We recently observed hedges being purchased for the period between July and October, which covers the expected announcement of the European Central Bank (ECB) quantitative easing taper and the Fed balance sheet unwind, along with the pending debt-ceiling debate. Hedging with instruments based on the S&P 500 remains popular, but it is expensive relative to other assets. We have also seen defensive trades based on the CBOE SPX Volatility Index and gold recently.

While there are catalysts on the horizon that could change the investment landscape, we expect the slow grind higher in U.S. stocks to continue—and implied volatility to remain low across many markets—essentially, “rinse and repeat.”

Key Takeaways

» Implied volatility remains subdued as stocks grind higher.

» Beware of the approaching catalysts that could change the investment landscape.

VIX versus S&P 500 Index

Sources: Wells Fargo Investment Institute, Bloomberg; 7/26/17. The CBOE Volatility Index® (VIX®) is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices. The VIX projects “implied” volatility 30 days in the future. Changes in the level, up or down are expressed as percentages. The S&P 500 Index is a market capitalization-weighted index composed of 500 widely held common stocks that is generally considered representative of the US stock market. The VIX and the S&P 500 typically move in opposite directions. An index is unmanaged and not available for direct investment.
Risks Considerations

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets**, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Foreign investing** has additional risks including those associated with currency fluctuation, political and economic instability, and different accounting standards. These risks are heightened in emerging markets. **Small- and mid-cap stocks** are generally more volatile, subject to greater risks and are less liquid than large company stocks. **Bonds** are subject to market, interest rate, price, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates. Although U.S. government securities are considered free from credit risk, they are subject to interest rate risk. **High yield (junk) bonds** have lower credit ratings and are subject to greater risk of default and greater principal risk. **MBS** are subject to the risks associated with investment in debt securities and also to prepayment and call risks. **Commodities** are considered speculative, carry substantial risks, and have experienced periods of extreme volatility. Investing in a volatile and uncertain commodities market may cause a portfolio to rapidly increase or decrease in value which may result in greater share price volatility. **Real estate** has special risks including the possible illiquidity of underlying properties, credit risk, interest rate fluctuations and the impact of varied economic conditions.

Alternative investments, such as hedge funds, private equity/private debt and private real estate funds, are speculative and involve a high degree of risk that is suitable only for those investors who have the financial sophistication and expertise to evaluate the merits and risks of an investment in a fund and for which the fund does not represent a complete investment program. They entail significant risks that can include losses due to leveraging or other speculative investment practices, lack of liquidity, volatility of returns, restrictions on transferring interests in a fund, potential lack of diversification, absence and/or delay of information regarding valuations and pricing, complex tax structures and delays in tax reporting, less regulation and higher fees than mutual funds. Hedge fund, private equity, private debt and private real estate fund investing involves other material risks including capital loss and the loss of the entire amount invested. A fund’s offering documents should be carefully reviewed prior to investing.

Hedge fund strategies, such as Equity Hedge, Event Driven, Macro and Relative Value, may expose investors to the risks associated with the use of short selling, leverage, derivatives and arbitrage methodologies. Short sales involve leverage and theoretically unlimited loss potential since the market price of securities sold short may continuously increase. The use of leverage in a portfolio varies by strategy. Leverage can significantly increase return potential but create greater risk of loss. Derivatives generally have implied leverage which can magnify volatility and may entail other risks such as market, interest rate, credit, counterparty and management risks. Arbitrage strategies expose a fund to the risk that the anticipated arbitrage opportunities will not develop as anticipated, resulting in potentially reduced returns or losses to the fund.

Definitions

The **Federal Reserve System Open Market Account (SOMA)** is a portfolio of U.S. Treasury and federal agency (mortgage-backed) securities, foreign currency investments and reciprocal currency arrangements. The SOMA is managed by the Federal Reserve Bank of New York and contains dollar-denominated assets acquired through open-market operations. These securities serve as collateral for U.S. currency and other reserve factors that are liabilities on the Federal Reserve (Fed) balance sheet, a tool for the Fed to manage reserve balances, and a source of liquidity in the event of an emergency.

General Disclosures

Global Investment Strategy (GIS) is a division of Wells Fargo Investment Institute, Inc. (WFII). WFII is a registered investment adviser and wholly-owned subsidiary of Wells Fargo Bank, N.A., a bank affiliate of Wells Fargo & Company.

The information in this report was prepared by Global Investment Strategy. Opinions represent GIS’ opinion as of the date of this report and are for general information purposes only and are not intended to predict or guarantee the future performance of any individual security, market sector or the markets generally. GIS does not undertake to advise you of any change in its opinions or the information contained in this report. Wells Fargo & Company affiliates may issue reports or have opinions that are inconsistent with, and reach different conclusions from, this report.

The information contained herein constitutes general information and is not directed to, designed for, or individually tailored to, any particular investor or potential investor. This report is not intended to be a client-specific suitability analysis or recommendation, an offer to participate in any investment, or a recommendation to buy, hold or sell securities. Do not use this report as the sole basis for investment decisions. Do not select an asset class or investment product based on performance alone. Consider all relevant information, including your existing portfolio, investment objectives, risk tolerance, liquidity needs and investment time horizon.

Wells Fargo Advisors is registered with the U.S. Securities and Exchange Commission and the Financial Industry Regulatory Authority, but is not licensed or registered with any financial services regulatory authority outside of the U.S. Non-U.S. residents who maintain U.S.-based financial services account(s) with Wells Fargo Advisors may not be afforded certain protections conferred by legislation and regulations in their country of residence in respect of any investments, investment transactions or communications made with Wells Fargo Advisors.

Wells Fargo Advisors is a trade name used by Wells Fargo Clearing Services, LLC and Wells Fargo Advisors Financial Network, LLC, Members SIPC, separate registered broker-dealers and non-bank affiliates of Wells Fargo & Company. CAR 0717-04555