Comerica Economic Alert

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Fed Slows Balance Sheet Runoff and Holds Interest Rates Steady; Forward Guidance Pushes Back the Timing of an Initial Rate Cut to Later in 2024

- **The Fed announced a change to their balance sheet reduction policy at the May 1 decision, also called a taper of the Quantitative Tightening program.**
- **Beginning in June, the Fed will reduce the monthly limit on runoff of their bond holdings to a maximum of $25 billion in Treasuries and $35 billion in mortgage-backed securities.**
- **The Fed also held interest rates steady, as expected, and modified their forward guidance to indicate rate cuts are further off than they had been thinking. This came as no surprise after inflation ran hotter-than-expected in the first quarter of 2024.**
- **Comerica forecasts for the Fed to make two quarter percentage point interest rate cuts in 2024, at their September and December decisions.**
- **The Fed will likely end balance sheet runoff in the spring or summer of 2025.**

The Federal Reserve's Federal Open Market Committee (FOMC) changed the policy managing the runoff of their balance sheet at the May 1 monetary policy decision, also called a taper of the Quantitative Tightening program or just QT. Beginning in June, the Fed will lower the cap on the amount of Treasuries that they allow to roll off of their balance sheet to $25 billion per month, down from $60 billion previously.

For context, the Fed bought trillions of dollars of Treasuries and government-backed mortgage-backed securities (MBS) between 2020 and 2022 to support the economic recovery. Those purchases pushed down long-term interest rates and supercharged housing, car sales, and other parts of the economy that use a lot of credit. The Fed has been unwinding those bond purchases since mid-2022 by accepting repayment on a portion of the bonds as they mature. The Fed zeroes out the cash they receive in those repayments, reducing the amount of money in the financial system and economy. This is called Quantitative Tightening or QT because it reverses the Fed's Quantitative Easing program, which is the nickname for the Fed's purchases of these bonds.

In addition to slowing the runoff of their Treasury holdings, the Fed changed the cap on runoff of their holdings of government-backed mortgage-backed securities (MBS). The Fed will still allow up to $35 billion of MBS to run off their balance sheet each month, as was true previously. But the Fed will start reallocating monthly MBS runoff over $35 billion to purchases of more Treasuries, instead of reinvesting in MBS as they used to do. In principle, this could run off the Fed's MBS holdings faster. But MBS are long-maturity bonds, and the Fed usually sees well under $35 billion per month in repayments. So the change to the MBS runoff cap would only affect financial conditions if repayments accelerate substantially. In the near-term, the biggest driver of MBS maturities will be existing home sales: When a homeowner sells, they pre-pay their mortgage, and that prepayment funds a

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prepayment of the MBS that financed the mortgage. As a result, faster existing home sales will lead to a faster runoff of the Fed's MBS holdings, and put upward pressure on mortgage interest rates. This will likely impose a speed limit on the recovery of existing home sales.

Financial markets will likely interpret the taper of the Fed's QT program as bullish for riskier investments like stocks and corporate bonds, but the effect is mostly psychological. Since mid-2022, the Fed's balance sheet reduction has put downward pressure on bond prices and upward pressure on bond yields. This is because private investors have to buy more government bonds as the Fed reduces their holdings. When the quantity of government debt sold to the public goes up, the price the public is willing to pay falls, meaning higher yields on the bonds. So in theory, as the Fed slows the pace of QT, they should exert less upward pressure on long-term interest rates, and those rates should be lower than if QT continued at the old, faster pace. But in practice, other developments in the financial system are likely to outweigh the effect of QT's taper. Interest rates on longer-maturity government bonds are exceptionally low relative to shorter-maturity bonds considering that the economy is growing solidly, so there is likely limited scope for longer-term interest rates to fall before the Fed gets closer to cutting short-term interest rates. Also, the big federal fiscal deficit pushes in the opposite direction as the taper, putting upward pressure on long-term interest rates.

Separate from tapering the QT program, the FOMC also held unchanged the target for the federal funds rate at a range of 5.25% to 5.50%. May marks ten months since the Fed last changed the fed funds rate with a quarter percentage point increase in July 2023.

The Fed revised their assessment of the economy and their forward guidance to imply they will likely wait longer to start cutting interest rates than they expected a few months ago. Regarding inflation, the FOMC's monetary policy statement reads, "Inflation has eased over the past year but remains elevated," a line unchanged from the March statement, but adds a new sentence, "In recent months, there has been a lack of further progress toward the Committee's 2 percent inflation objective." Core CPI inflation was higher than the consensus forecast in January, February, and March, and other measures of inflation were stronger than expected in the first quarter as well. Where the prior statement issued March 20 read, "the risks to achieving its employment and inflation goals **are moving into better balance**," the latest statement says, "The Committee judges that the risks to achieving its employment and inflation goals **have moved toward better balance over the past year**" (emphasis ours on both quotes). The FOMC is saying that inflation is still trending lower when viewed over a longer time horizon, but the process is moving two steps forward, one step back. The Fed did not release an update to their Dot Plot (economic and interest rate projections) in May. The Fed publishes the Dot Plot quarterly, with the next release scheduled for the June 12 decision.

These changes mean that the Fed will likely wait until September to start reducing the fed funds rate, and will likely make two quarter percentage point rate cuts by the end of 2024. That is less than seemed likely when the Fed met in March. Separately, the Fed will likely continue to reduce their balance sheet at the new, slower pace through the turn of the year, and eventually end balance sheet reductions in the spring of 2025.

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