Federal Reserve Balance Sheet Normalization

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- In 2017, the Federal Reserve will hike the interest rate two more times and start reducing the balance sheet. Chair Janet Yellen will start discussing the balance-sheet reduction process at the June press conference. The actual shrinkage will begin sometime late this year, most likely in December. As long as the economy and inflation follow the path expected by the central bank, two more hikes---June and September---are highly likely this year.

- If the FOMC gives the economy a double whammy of higher interest-rates and sale of securities, financial markets could react negatively especially if the economic numbers are not as rosy as the Federal Reserve expects. The nation's money managers should be mindful of the fact that over-reaction by the Federal Reserve was the number one cause of recessions during the post war period.

- As the latest minutes of the FOMC showed, gradually increasing caps (most likely in dollars) will be placed on the amount of the balance-sheet reduction for each operational period. In 2018, $414.6 billion of Treasuries and $177.8 billion of MBS will mature. Most likely about two-thirds of the reduction could come from Treasuries.

- The normalization process will have impact on many parts of the economy. The U.S. Treasury will raise increasing amounts starting 2018 especially if some parts of President's economic plan is executed. Depending on the type of securities and amount the central bank purchases, the yield curve will shift. This could be especially true for MBS. The home building activity has never caught up to the pre-recession level. These changes will add to uncertainties in the financial markets.