FUND MANAGEMENT DIARY

Meeting held on 11th September 2018

Will the Fed change its balance sheet plans?

- Nearly eight years after the Federal Reserve started quantitative easing, the central bank started scaling back its balance sheet in October 2017

- Although the normalisation process has just started, it may already be putting some upward pressure on interest rates

- The United States' economy could start to slow sharply next year forcing the Federal Reserve to lower interest rates and halt its balance sheet normalisation plans

The Federal Reserve started normalising its balance sheet last year

The Federal Reserve started its tightening cycle at the end of 2015. Since then it has raised the target range for the federal funds rate seven times from between 0.00-0.25 per cent to 1.75-2.00 per cent. However, it has been slower to roll-back the unconventional monetary stimulus provided following the financial crisis.

The Federal Reserve started scaling back its balance sheet in October last year, nearly eight years after it started quantitative easing. This was a major milestone and came after the four major central banks in the developed world had collectively purchased around $10.6 trillion of assets since 2008 – equivalent to around nine per cent of global gross domestic product. This massive volume of central bank purchases since the financial crisis helped to supress bond yields, boost equity prices and, in some cases, cause sharp exchange rate movements.

No other major central bank has followed the Federal Reserve's path and started to reduce the size of their balance sheet. The Bank of England is most likely to be next but it is still probably a couple of years away from doing so – it has said that it will maintain assets at their current level of £445 billion until Bank Rate has reached a level from which it can be "materially" cut. Meanwhile, the European Central Bank is only set to stop increasing its net assets in December this year and it is likely that the Bank of Japan's balance sheet will continue to expand throughout 2019.

Balance sheet normalisation may be putting upward pressure on interest rates

While the balance sheet run-off has only just got going in the United States, with assets worth only $200 billion rolled off so far ($135 billion of Treasuries and $65 billion of mortgage backed securities), it might not be going as smoothly as hoped.

The Federal Reserve has lost some control over short-term interest rates, with the effective fed funds rate drifting to the upper end of its target range. In part that reflects a surge in repo rates, which was also a factor when the effective rate drifted higher in 2016.

There isn't a definitive explanation for the upward pressure on short-term money market rates, but the Federal Reserve is pointing the figure at the spike in the issuance of Treasuries earlier this year. That may be part of the explanation, but rates remained high in the second quarter even as net issuance fell back. It may be that, by draining reserves from the system, the Federal Reserve's balance sheet is putting upward pressure on interest rates.

With excess reserves still above $2 trillion, that is unlikely to have a big impact yet. But simulations from the New York Federal Reserve Bank of New York suggest that the effective fed funds rate may rise above the interest rate on excess reserves even with a large amount of reserves in the system. This is because the unequal distribution of reserves means that minimum requirements may become binding for some institutions.

Whatever the explanation, the Federal Reserve would probably respond to any further upward pressure on the effective fed funds rate by making "technical adjustments". This could include raising the interest rate on excess reserves by less than 25 basis points, to keep the effective rate close to the mid-point of the target range. If that failed, the Federal Reserve could lower its existing discount window rate, currently set 50 basis points above the target range. This would put a tighter ceiling on the fed funds rate. That would allow the Federal Reserve to continue winding down its balance sheet gradually.

An economic slowdown could force the Fed to halt normalising its balance sheet in 2020

However, should the United States economy slow as the effects of the fiscal stimulus fade, tighter monetary policy begins to bite and jobs growth slows then the Federal Reserve would have to call time on its tightening cycle and start easing monetary policy.

In those circumstances, the Federal Reserve would decrease interest rates and probably halt its balance sheet normalisation process by resuming reinvestment of all the proceeds from maturing assets. By then, the central bank's balance sheet would be around $3.5 trillion, which may not be far off its longer-run level anyway. On the liabilities side of the balance sheet, currency in circulation would be $2 trillion and reserve balances would be close to $1 trillion.

Even if $3.5 trillion marked the terminal size of the balance sheet, the composition of the Federal Reserve's asset holdings would still need to change. By 2020, the central bank will hold $2 trillion of Treasury bonds and $1.5 trillion of mortgage-backed securities. The Federal Reserve would prefer to get rid of its mortgage-backed securities holdings entirely, so it may run down these holdings beyond 2020 and purchase offsetting amounts of Treasury securities.

Overall, declining short term interest rates and a halt to the balance sheet normalisation process could well put downward pressure on longer-term government bond yields, meaning that yield levels in the US need to be carefully monitored.

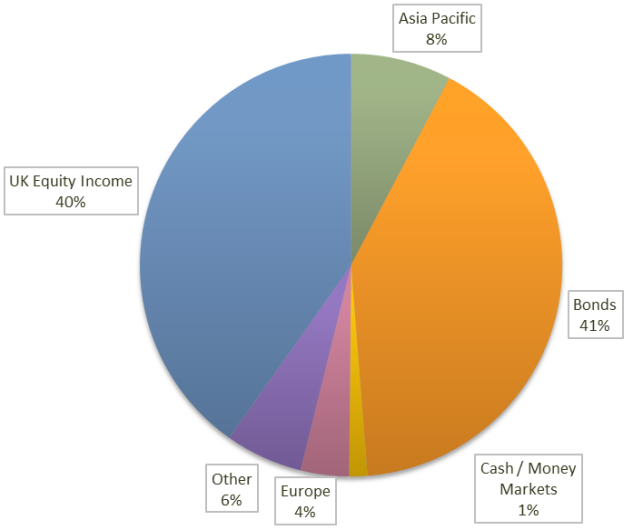
Strategy

The US is, for the moment, in a rate rising cycle. As other central banks begin to follow the Fed's lead and interest rates begin to rise globally, Future Money think that bond markets will experience downward pressure. Conventional market mechanics suggest that bonds with a shorter duration are likely to outperform bonds with longer durations in these conditions.

Future Money are conscious that rising yields in bond markets could spill over into a wider sell off of all asset classes, which could be triggered by interest rates rising too quickly or a geopolitical event. We consider this a material risk and it is an area we are actively monitoring and discussing.

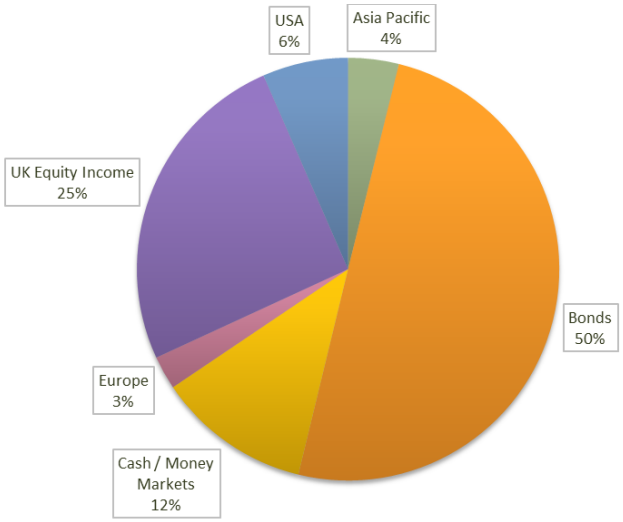
Income

The final tranche of trades away from Smith & Williamson Short Dated Corporate Bond and towards M&G Emerging Markets bond will be completed this week. The gradual move out of Majedie UK Income and into Man GLG UK Income continues. These changes have been made on a gradual basis given heightened volatility currently present, which can increase the costs of trading.



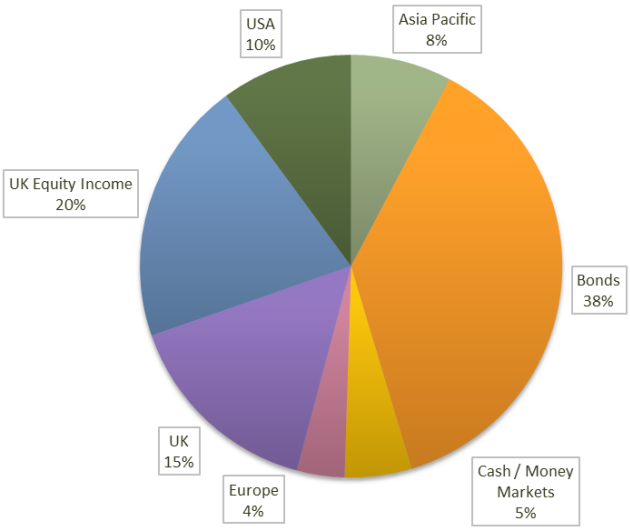
Real Value

The gradual move from Majedie UK Income towards Man GLG UK Income continues. No further trades are currently being considered.



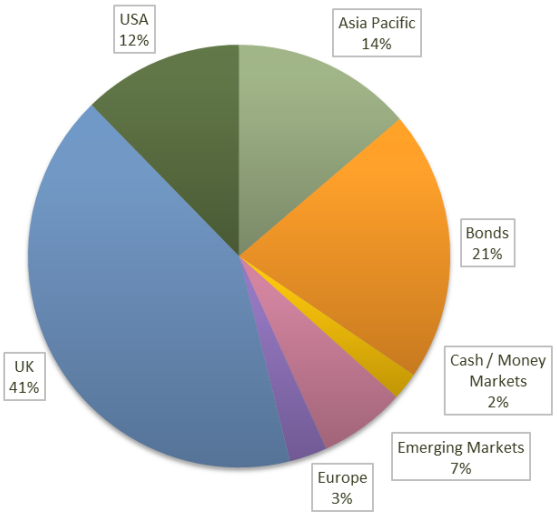
Real Growth

The gradual move from Majedie UK Income towards Man GLG UK Income continues. No further trades are currently being considered.



Dynamic Growth

No changes will be made to Dynamic Growth this week. The portfolio remains in line with target allocations and the funds selection is performing in line with expectations. One topic currently being considered is that of value in the Kames Investment Grade Corporate Bond fund, with cost in the context of future returns being considered.



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Any research is for information only, does not constitute financial advice or necessarily reflect the views of the author and is subject to change.

It remains the responsibility of the financial adviser to verify the accuracy of the information and assess whether the fund is suitable and appropriate for their customer.

Past performance is not a reliable indicator of future performance. The value of investments and the income derived from them can fall as well as rise and investors may get back less than they invested.

Important information about the funds can be found in the Supplementary Information Document and NURS-KII Document which are available on our website or on request.

For any information about the Future Money funds please contact the authorised corporate director, Margetts Fund Management Ltd, on 0121 236 2380, admin@margetts.com or at 1 Sovereign Court, Graham Street, Birmingham B1 3JR. A copy of their Terms of Business which relates to investments into the funds can also be obtained using these contact details.

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