Fed exit may be bumpy ride for investors

By Ben Eisen and Greg Robb

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NEW YORK (MarketWatch) — The Federal Reserve's next tightening cycle won't look like anything investors have seen before.

The central bank has never attempted to hike interest rates with a $4.4 trillion balance sheet. To do so, the Fed is counting on a slew of new instruments — and the liftoff still might not function properly at first.

"They will be experimenting with new tools. Any time you do that, there are uncertainties and there are risks. We expect them to be able to manage it, but it could be a bumpy ride," said Kim Schoenholtz, a professor in New York University's Stern School of Business.

With the Fed eyeing the first rate hike sometime in 2015, key decisions still need to be made and communicated to investors.

The Fed may unveil the blueprint for its exit strategy at the conclusion of its policy meeting on Wednesday.

Robert Eisenbeis, a former Fed official and now chief monetary economist at Cumberland Advisors, said he doesn't think the Fed has settled on a strategy and does not think the exit plan will be released at this meeting. If not, then the strategy will come in October or December.

Many believe that instead of targeting a specific rate, the central bank will set a corridor of potential rates, within which the benchmark rate would trade. That may mean more volatility for stock and bond investors.

While the outlines of a plan are taking shape, there's still a lot of uncertainty, and much is likely to change along the way as the central bank learns from its successes and failures.

"I don't know how anyone can look at this and not say we're in somewhat uncharted territory," said Mark Calabria, an economist at the CATO Institute, a libertarian think tank.

“Nobody has got a silver bullet for an exit,” he said.

MarketWatch delved into the four key policy tools that many market participants believe will be crucial to the exit, looking at how they will function, the market and policy implications, and what questions remain unanswered.

Fed funds rate

The tool: This is the interest rate at which depository institutions lend to each other overnight, and it currently serves as the key policy rate upon which lending costs take their cue across the globe. For nearly six years, the rate has been targeted at near zero, creating loose monetary conditions meant to stimulate economic growth. As the economy improves, the Fed is preparing to raise this rate. But the central bank suggested a key shift: it wants to target a range within which the rate would trade, rather than its current method of targeting a specific rate. The funds rate would be wedged between two other rates: the reverse repo rate would serve as a floor, and the interest on excess reserves could be a ceiling.

The unanswered questions: One issue is whether the funds rate still has the firepower to communicate key rate levels to the market, given that the banking system has $2.5 trillion in excess reserves floating around that could obscure the signaling mechanism of a single funds rate. With so much cash, trading of fed funds has decreased to a fraction of its former size. Economists at Jefferies said controlling the funds rate would “pose a significant challenge.”

The investor impact: The market cacophony around the timing and pace of a rate hike is reaching a fevered pitch because it will set the market tone for the rest of the economic cycle. But investors shouldn’t be paying attention to the specific rate — it’s now going to be all about the “corridor” within which the rate trades, which implies more variation in the day-to-date rate, according to Jerome Schneider, head of the short-term and funding desk at Pimco. That may translate into more volatility for stock and bond investors who take their queues from the rate. “We have to be very mindful that we are entering into a different period where it is not going to be as subdued in terms of market participation,” he said.

Setting the floor: reverse repos

The tool: The reverse repo rate, which the Fed began testing last year, is thought to be the lower bound of the corridor where the fed funds rate can trade. There was speculation that it would become the key tool in the Fed’s kit, but the Fed has since said it wants to limit the rate to a supporting role. Financial institutions use the repo market to borrow cash on a short-term basis in exchange for posting collateral of high-quality securities like Treasurys. Reversing that, the Fed lends out its own securities in exchange for cash. Money market funds and other institutions earn a small amount of interest by lending their cash to the Fed overnight, thereby establishing a rate that serves as the bottom of the corridor.

The unanswered questions: During the financial crisis, Lehman Brothers lost access to the repo market to finance its cash needs, helping push it toward demise. The Fed saw what can happen when financial institutions rely too heavily on the repo market, so it’s worried about making

reverse repos too prominent a part of the monetary machine in the event that financial conditions weaken again. It's still an open question how much the Fed will want to rely on this rate. Another issue: the Fed's reverse repos are currently doled out in limited quantities. For it serve as an effective floor, the repo rate needs to be unlimited in quantity, or else other lending rates could dip lower, said Schoenholtz, of NYU.

The investor impact: The reverse repo rate provides another destination for eligible money market mutual funds to park their cash. While the Federal Reserve serves as a safe counterparty, it provides a lower rate of return than other short-term markets. While each fund invests according to its own mandate, the migration toward using the reverse repo tool, means "rates are going to remain lower for money market funds," even after the Fed lifts rates, according to Schneider, of Pimco, who expects the funds rate to trade relatively closer to the bottom of the rate corridor than the top.

The policy impact: Sheila Bair, former chairwoman of the Federal Deposit Insurance Corp, noted in a recent opinion story in the Wall Street Journal that the new reverse repo program will give money funds a "de facto insurance program" at the same time the central bank is expressing worry about the systemic risks to the financial sector from the sector.

Setting the ceiling: interest on excess reserves

The tool: The Fed began paying banks interest on excess reserves to help calm financial markets during the credit crisis. It continues to pay out a rate of 0.25% to banks that park their reserves there. This represents the upper bound of potential short-term rates, because if banks can earn more through IOER, they won't lend into the market at a lower rate. In effect, raising that rate "should pull all the market interest rates up," write economists at Morgan Stanley.

The unanswered questions: Banks have new leverage rules in place that may make it more difficult for the IOER to serve as the ceiling at all times, economists at RBC Capital contend. When smaller banks face month-end leverage tests, they may stop borrowing using the fed funds rate. Larger banks also have tests that question the cost effectiveness of investing of borrowing in that market. This lack of demand for fed funds could push the rate above the interest on excess reserves, upending its role as the ceiling, according to the RBC economists, led by Tom Porcelli.

The investor impact: Since the IOER may serve as the upper end of the corridor, investors will want to pay attention to this rate to get a sense of the upper end of the rate corridor.

The policy impact: When interest rates go up, the Fed will be transferring billion of dollars to banks, including many branches of foreign banks. If interest rates rise, this bill could top $40 billion per year, Calabria of CATO noted. This is not expected to sit well with populist Republicans and Democrats in Congress. "Politically it seems a hard stretch to me," Calabria said.

Managing the balance sheet

The tool: Throughout the Fed's rounds of post-crisis bond buying, the central bank has built up a sizeable pile of long-term bonds. As those bonds accrue interest and mature, the Fed uses that cash to buy more bonds, in what's known as reinvestment. As some point, the Fed will stop reinvesting those proceeds as it begins to pare the size of its balance sheet. That will serve as a key part of the tightening process because it means the central bank will no longer be adding to its holdings of securities. Eventually, the Fed may outright sell some of its holdings.

The unanswered questions: As Vince Reinhart of Morgan Stanley writes, the Fed hasn't agreed on the key issue of what size the balance sheet should be going forward. There are still a lot of unanswered questions, not least of which is when the Fed will begin to shrink the balance sheet. Most officials don't expect it to happen until after the first rate hike, but the Fed eventually wants its balance sheet to match what's needed for monetary purposes. As such, it's still unclear what securities it would tinker with, when and how fast it would make those changes. But once it does, there will be a lot more bond securities up for sale.

The market impact: A sizeable roll-off will start to occur at the beginning of 2016, and if the Fed doesn't reinvest the proceeds, that extra supply would flow into the broader market. Unless investor need for Treasurys increases in lockstep with the amount of Treasurys rolling off the Fed's balance sheet, the supply-demand imbalance is likely to push Treasury yields higher, according to Laura Rosner at BNP Paribas Corporate and Investment Banking. "These changes should put upward pressure on term premia and Treasury yields," she said in a note earlier this month.

The policy impact: Treasury officials are watching the issue of reinvestment closely. If the Fed decides to redeem its securities, the Treasury would have to issue $675 billion more securities to the market between 2016 and 2018.