The Fed Is 'Normalizing.' Here's What Public Financiers Need to Know.

To combat inflation, the central bank will be raising interest rates and shedding a big chunk of its $8 trillion bond portfolio. Its actions will ripple through the world of state and local finance.

After two years of stimulating the economy to head off a crash that just about everybody thought the pandemic would usher in, the Federal Reserve now is preparing to move to curb inflation and "normalize" interest rates. As the central bank acts on several fronts, state and local treasurers, cash managers, finance directors, budget officials and pension trustees will need to remain alert and adjust their strategies dynamically to preserve and protect the public's money.

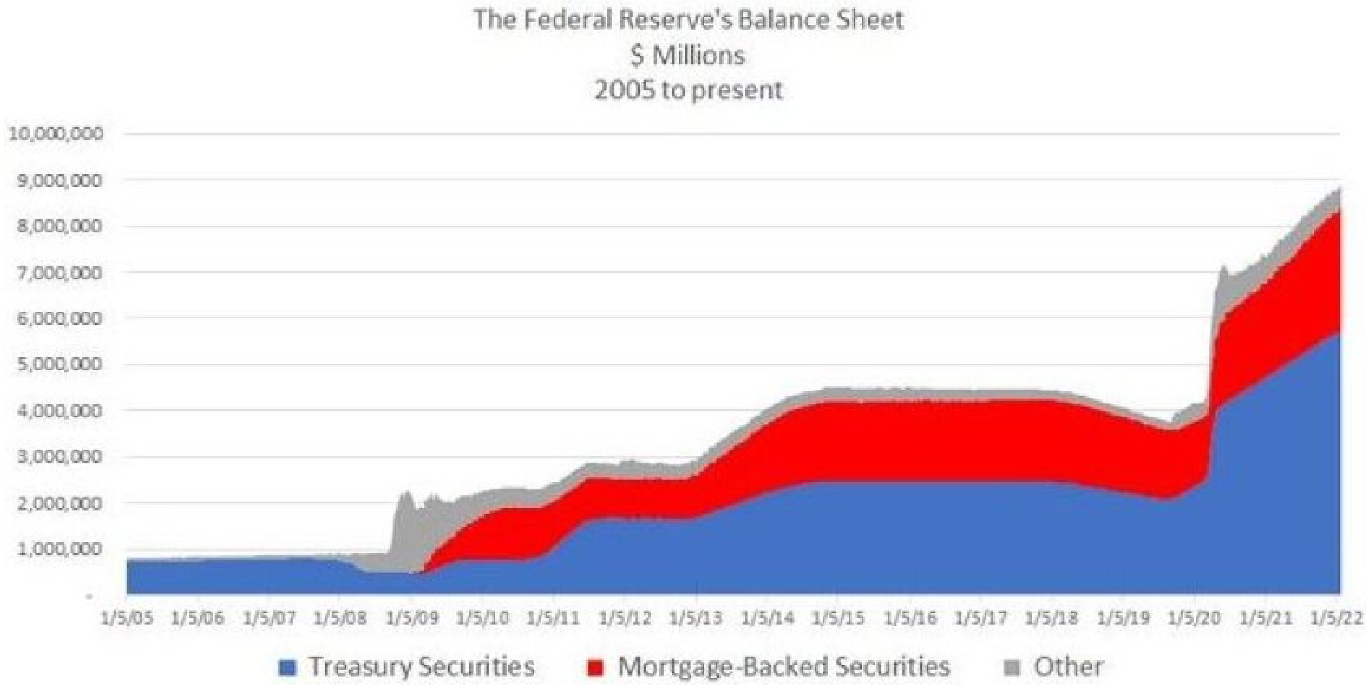
To control short-term interest rates, the Fed's primary active policy tool is the overnight fed funds rate. Our central bank, like all others, dictates those interest rates by flooding the market with buy or sell orders for overnight loans with its primary dealers, which instantly changes money market rates. Right now, those rates are still near zero, but if inflation is to be reined in they likely need to increase systematically to two or even three percent by sometime in 2023. I personally would favor sooner and faster rather than slower and later, to show markets and consumers that the Fed will not tolerate abnormal inflation beyond this year, even as kinks in the supply chain are worked out.

Beyond that, the most important and misunderstood aspect of the Fed's toolkit is the now-essential "runoff" of its bloated bond portfolio. During the first two years of the pandemic, the Fed engaged in unprecedented levels of "quantitative easing" by purchasing a walloping $4 trillion worth of government bonds and notes. That doubled its portfolio holdings and exploded our banking system's "high-powered" money supply — the sum of banks' cash reserves and currency in circulation.

The Fed must now shrink that overgrown part of the monetary base by allowing its portfolio holdings to shrink over time. That way, the monetary pig can work its way out of the U.S. economic python without fueling persistent inflation. The Fed doesn't need to aggressively sell those bonds to push yields higher; without new Fed purchases, interest rates will go up as the Treasury auctions more new bonds to fewer buyers. The Fed just needs to stand back and collect principal repayments as scheduled without buying any more, until inflation subsides. Those bond repayments in turn reduce Fed system credits at member banks, and thereby shrink the money supply along with its balance sheet. This is Washington's least painful way to curb inflation. Politicians just need to get out of the way and let the Fed do its work.

Of the $8.3 trillion of liquid marketable securities in the Fed's portfolio (see the chart below), 37 percent are overnight repos and Treasury securities maturing in one year or less, 26 percent are T-notes maturing in one to five years, and another 30 percent are mortgage-backed securities issued by Fannie Mae and Freddie Mac, which pay down principal and interest monthly. So all it takes to pull back the excessive monetary stimulus left over from the COVID-relief era is to let such holdings roll off in 2022-24 without replacing them with new purchases. Operationally, it's really not rocket science — it's just a matter of conviction and messaging. Unlike the rising stairstep expected in the

Fed's overnight rates, its bond portfolio runoff won't make nightly news headlines; it's like watching paint dry. In this regard, doing nothing is actually doing something quite constructive on the inflation front, despite the lack of fanfare.



Source: American Action Forum, from St. Louis Federal Reserve data

What would be the impact on interest rates? Little doubt they must go higher, barring an exogenous shock like a global virus lockdown or a Ukraine-war flight-to-safety. The key question is really how much higher, and how fast. My best guess is that markets have recently discounted about one-third of the potential move higher in long-term rates.

The Impact of Rising Mortgage Rates

One way to think about this is to ask what level of mortgage interest rates would snuff out the housing market, making starter homeownership unaffordable. Obviously, this has a direct bearing on local governments that rely on property taxes as a principal revenue source. The answer is that the Fed is not mindless or cavalier: It must stop short of provoking a housing crash like 2008's and will keep a keen eye on mortgage rates and residential property prices. By increasing buyers' monthly interest payments, mortgage rates above five percent would take something like 10 percent off the market price for a starter home. That would unsettle but not crush the broader housing market.

Beyond that point, the Fed may have to replace at least some of its mortgage securities as they mature to avert a housing recession. If so, that puts more upward pressure on short-term rates as the remaining policy tool, should the CPI keep running hot. If mortgage rates do hit five percent, then money market rates must rise well above levels that traders now anticipate, potentially to around four percent before the banking sector's foundations start to shake and traders smell a recession coming. By then, I suspect that inflation can normalize as markets, consumers and producers pull in their horns just enough for prices to stabilize.

As for the short-term rates that are the focus of public treasurers and cash managers, there is little reason to believe that money market rates will skate through the year 2023 below two or even three percent. The latter becomes more likely if CPI inflation remains above four percent this December. Futures markets have the direction right, although they remain [short-sighted on magnitude](). Over decades of market history, the three-month T-bill rate has typically traded at levels much closer to the prevailing inflation rate. A monetary hardhead would say that anything less falls short of “normalization.” Budget officers who include cash management interest income in their forecasts can realistically expect higher revenues from their jurisdictions’ 2023 cash balances, though hardly enough to offset the payroll cost inflation they can expect this year and next.

In coming months, public cash managers will increasingly yank cash from money market funds and ultra-short investment pools and begin investing in higher-yielding paper directly. State investment pools could see outflows unless they are able to load up on higher-yielding paper by stretching their underlying maturities into the second half of this year. But that invites underperformance should they jump the gun on rising rates. If short rates rise more abruptly than traders have already priced in, expect to hear chatter about who’s in and out of sync with SEC rules and other controversial changes to money market fund regulations.

Higher Costs for Muni Bond Issuers

In the municipal bond market, the yields paid to investors unfortunately must go higher, as I explained in my 2022 new-year outlook. Tax-exempt yields for all maturities are still too low, and issuers will face higher costs as the year progresses; the recent uptick in yields is just a prelude of more to come. AAA-rated muni yields below three percent are just not sustainable when the economy is running this hot, and ultimately interest compensation must exceed investor expectations of long-term inflation rates.

Fortunately, for most bond issuers, this will not shut their projects out of the market — it just increases their debt-service costs for general infrastructure, which will slow spending elsewhere. Most revenue-based projects should see tolls and other user fees escalating sufficiently to cover their higher interest costs, at least for now.

Meanwhile, more headwinds are on the way for public pension funds in 2022. Markets are already spooked by higher rates, with many stocks down 20 percent or more. The single best thing the Fed can do for the stock market is to signal that it now considers inflation control to be Job 1. Prompt action causing a short-term swoon in stock and bond prices is ultimately less harmful to pension funds in the long run than runaway inflation, especially when actuaries smooth out asset prices in their reports and calculate the present value of inflated future benefits payouts.

Significant stock appreciation remains unlikely until inflation shifts decisively lower on a credible path to three percent or less. Meanwhile, a rate-normalization washout of naïve speculators in 2022 will not itself cause a recession; assets will simply shift from weak hands to strong ones. Better to tap the brakes now than to slam on them later.

Just as with American politics, investors are yearning for “normal” economics. On the inflation front, that won’t be achieved by just blaming the supply chain. The limitless spenders’ Modern Monetary Theory fad has now been shown to be an inflationary pipe dream, especially given that tax hikes and balanced budgets are politically unachievable on Capitol Hill.

The Fed must — and will — step in. Hopefully, the central bank’s officials and the White House will both start using the word “normalization” persistently. Public financiers and their elected bosses should be prepared for the Fed’s portfolio runoff scenario outlined here, and both understand and appreciate why it’s happening.

governing.com

Feb. 15, 2022 | Girard Miller