ECONOMIC NEWS

Another type of monetary firming: The Federal Reserve tapers its portfolio duration

In 2007, the Federal Reserve (Fed) held about US$900B in assets, including US$800B in Treasuries—almost half of which had maturities of less than one year.

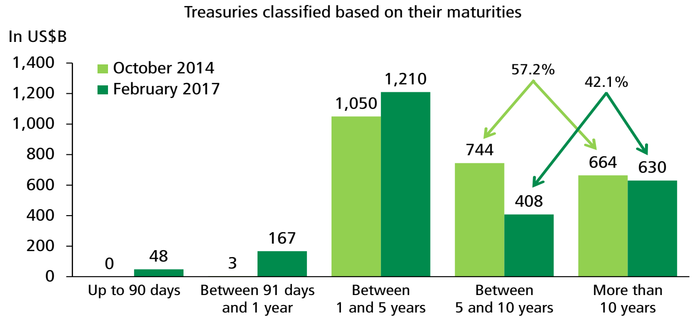
From 2008 to 2014, the Fed made several interventions which boosted the quantity and diversity of assets held and extended their average duration. One such intervention, titled Operation Twist, took specific aim at the duration of the Treasuries held. The first announcement on this initiative was made on September 21, 2011, and addressed the US$400B purchase of government bonds with maturities from 6 to 30 years, at the same time as the sale of Treasuries with maturities of less than 3 years for an equivalent amount. In June 2012, this intervention was increased by US$267B.

Operation Twist ended in December 2012, but the Fed continued to purchase long-term Treasuries until October 2014 as part of another program that also included the purchase of mortgage-backed securities (MBS). In the end, the Fed's assets totalled US$4,500B, including US$2,500B in Treasuries and US$1,750B in MBS. At the time, most of these securities had longer than 5-year maturities while 99% of the MBS had maturities that extended beyond 10 years.

The Fed then agreed to consistently maintain the size of its portfolio, but this did not prevent the average maturities of the securities held from starting to normalize, especially for Treasuries. Today, more than three years after the easing programs ended, almost 10% of the Treasuries held have maturities of less than one year and close to 50% have maturities ranging between one and five years, meaning that about 40% of the Treasuries have maturities longer than five years.

GRAPH

The distribution of securities held by the Federal Reserve has changed since the end of easing measures



Sources: Datastream and Desjardins, Economic Studies

IMPLICATIONS

In the same way that Operation Twist was viewed as monetary easing, the tapering of the duration of the Treasuries held by the Fed must be seen as firming, combined with the increase in key interest rates and the rise in the U.S. dollar. The process is nevertheless very slow and is unlikely to spur the Fed to further moderate its interest rate increases.

Selling off assets to reduce the size of its balance sheet may justify fewer interest rate increases, but the Fed does not seem to be considering this option in the short term. The first step on this score will probably call for no reinvestments of maturing securities. That said, if this approach were applied to Treasuries, it could rein in the accumulation of short-term securities and delay the return to a distribution similar to what we saw in 2007. As a result, the wind-down of reinvestments could target MBS only. Each month, between US$30B and US$40B of these securities mature prematurely due to early payments on the mortgages that make up these securities.

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