Heartwood
Investment Management

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Investment Insight

Weekly Insight

The Fed: Predictable and gradual?

Over the last few months, the US Federal Reserve has done a much better job in communicating a more consistent message to markets and getting on with the job of renormalising monetary policy. Part of this shift has been helped by the recovery in global economic conditions, as the Fed is now able to focus specifically on its mandate and avoid the distraction of external forces. A sign that the market has more confidence in the Fed's approach is that gradual interest rate increases have yet to have any real economy impact: financial conditions in the US have actually eased in recent months.

But the tricky part still lies ahead: the unwinding of a $4.5 trillion balance sheet. The latest Fed policy minutes have guided the market to expect this process to begin this year, assuming the economy and the interest rate path evolves as expected. If handled poorly and given the unprecedented nature of such an exit process, it could represent a more significant tightening of financial conditions. That is why policymakers are keen to emphasise that this unwinding should be executed in a "gradual and predictable manner" and have suggested monthly caps on the amount of repaid bonds that are allowed to roll off the balance sheet.

Time will tell how this process will evolve and if the Fed can continue to adeptly manage the bond market's expectations. We are moving into uncharted territory and expect that withdrawing years of emergency stimulus is unlikely to be all plain sailing. Investors should expect to see more bond market volatility as we enter a new era of monetary policy setting.

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Clear Thinking

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To find out more about the Heartwood strategies, visit our website or contact your local representative.

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