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Fed balance sheet expands despite a hike in policy rate

This has cushioned the blow, resulting in a mild correction in risk assets like equity, say analysts

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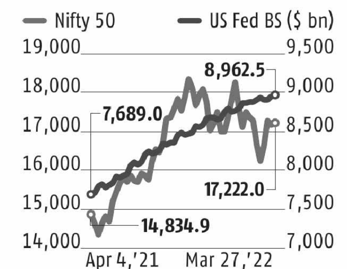
The financial markets are under pressure as the Federal Reserve has changed its course and begun to raise its policy rate in a bid to fight record-high inflation in the United States. Earlier this month, the American central bank raised the interest rate by 25 basis points — its first rate hike in more than three years (it had last raised the Fed fund rate in December 2018).

Big adjustments in asset prices are yet to come because the US central bank continues to expand its balance sheet through asset purchases that translate into greater liquidity in the financial markets, say analysts.

ILLUSTRATION: AJAYA KUMAR MOHANTY

DESPITE TURMOIL, NIFTY HASN'T TANKED



Source: Bloomberg, Federal Reserve

The Fed balance sheet has grown by nearly $58 billion since the beginning of March and around $205 billion year-to-date. Its balance sheet grew to a fresh high of $8.96 trillion on March 23, up from $8.9 trillion on March 3 and $8.76 trillion at the end of December 2021. The US Fed releases its balance sheet data every Wednesday.

The Fed balance sheet expands when it buys financial assets, such as government bonds, equity exchange-traded funds and mortgage-backed securities, and thus pumps more cash into the markets. Conversely, the Fed sells these assets and mop-up liquidity from the markets when it shrinks its balance sheet. In all, the US central bank has expanded its balance sheet by $4.8 trillion since the beginning of the 2020 calendar year.

An expansion in the balance sheet cushioned the blow from the rate hike, resulting in only a mild correction in the price of risk assets, such as equity, according to analysts. "The policy reversal by the US Fed has resulted in a sharp rise in bond yields and borrowing costs. The liquidity in the financial markets, however, remains benign, thanks to the continued expansion in the Fed balance sheet. It blunted the adverse impact of the higher interest rate on asset prices," says Dhananjay Sinha, MD and chief strategist JM Financial Institutional Equity.

India's equity benchmark Nifty 50, for example, is down just 0.4 per cent since the rate hike by the Federal Reserve. In fact, the index is up by 2.6 per cent during March, so far.

The latest hike by the Fed and its announcement of more rate hikes in the coming months to cool down inflation in the country has, however, sent tremors through the bond market. There has been a sell-off in the bond market and a sharp rise in the yields.

The yield on the benchmark 10-year US government bond is up 75 basis points in March, so far, rising from 1.72 per cent at the beginning of the month to 2.47 per cent on Monday. This is the steepest climb in bond yields in nearly a decade. There is an inverse relationship between bond yields and bond prices.

According to Sinha, the big correction in the equity markets will occur once the American central bank begins to shrink its balance sheet beginning May this year as announced earlier. "A combination of a higher bond yield and reduction in the size of Fed balance sheet would be deflationary for the asset markets and would trigger a fresh round of sell-off," he says.

Others, however, discount any adverse impact on the equity market due to a planned balance sheet reduction by the Fed. "The policy reversal by the Federal Reserve means that the US economy is getting better and hints at a good growth environment. It will translate into a better-than-expected global economic growth and strong growth in corporate earnings, which are good for the equity markets," says G Chokkalingam, founder & MD Equinomics Research & Advisory.

According to him, the domestic equity markets are likely to start recovering from April 2022. "Once the war ends in Ukraine, inflation will start moderating and therefore, FIIs are likely to return to the domestic equity markets in FY2023," he adds.