

# Daiwa's View

## An underlying theme in the market in 2022

- Expansion of the Fed's balance sheet is likely to stop at around \$8.96tn

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Daiwa Securities Co. Ltd.

### Expansion of the Fed's balance sheet is likely to stop at around \$8.96tn

#### An underlying theme in the market in 2022

◆ Expansion of the Fed's balance sheet is likely to stop at around \$8.96tn (Y1,033tn). The minutes of the November FOMC meeting make clear that the Fed has become less patient regarding inflation pressure. In addition, even San Francisco Fed President Mary Daly, who is positioned as the most dovish member, has changed her stance and agreed with faster tapering. For this reason, the Fed's faster tapering ('double-speed tapering') has suddenly emerged as a base case.

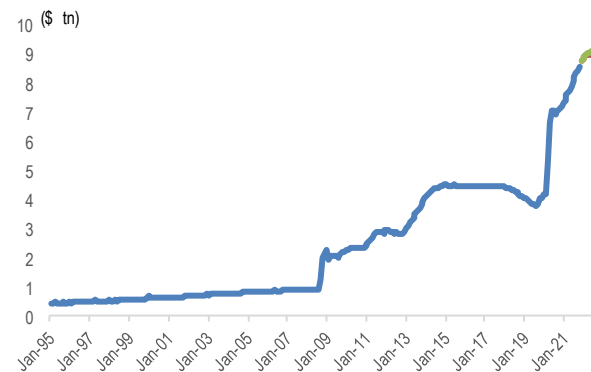
Once the pace of tapering has been decided, a clearer idea of the size of the Fed's balance sheet naturally comes into view. As of 17 November 2021, the Fed's total assets stood at \$8.67tn (around Y1,000tn, Y115.3/\$). Adding an estimated purchase amount worth \$285bn with the new base case (double-speed tapering) puts the Fed's total assets after tapering is completed at around \$8.96tn (Y1,033tn). For reference, the Fed's total assets as of 15 November 2019, before the pandemic, stood at \$4.05tn (around Y440tn, Y108.8/\$).

#### Asset Purchase Amount During Tapering (\$ bn)

Reserve maintenance period	Base case (Double-speed tapering)	Previous base case (-\$15bn/month)	Change
Oct-21	120	120	
Nov-21	105	105	
Dec-21	90	90	
Jan-22	60	75	-15
Feb-22	30	60	-30
Mar-22	0	45	-45
Apr-22		30	-30
May-22		15	-15
Jun-22		0	0
<b>Total</b>	<b>285</b>	<b>420</b>	<b>-135</b>

Source: Bloomberg; compiled by Daiwa Securities.

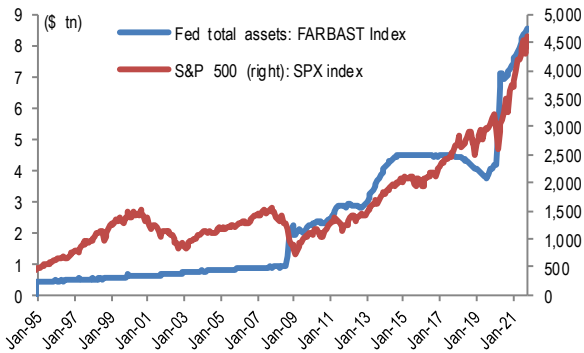
#### Fed's Total Assets (FARBAST Index)



Source: Bloomberg; compiled by Daiwa Securities.

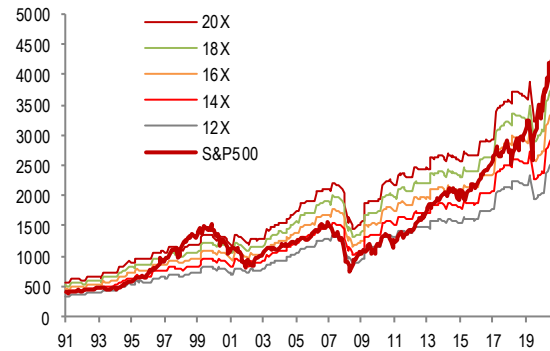
- ◆ The Fed's balance sheet and valuations  
As is well known, there is a relatively strong correlation between stock price indices and the size of the Fed's total assets, which has expanded due to QE. In the process of stock prices soaring since the outset of the pandemic, stretched valuations have played a leading role (charts on next page).

**Fed's Total Assets, S&P 500 Index**



Source: Bloomberg; compiled by Daiwa Securities.

**Valuations of S&P 500 Index (EPS based on profit forecasts)**

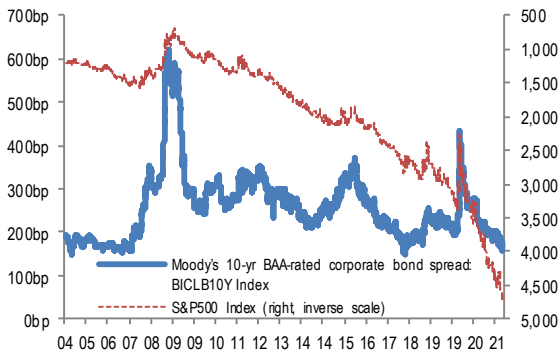


Source: Bloomberg; compiled by Daiwa Securities.

As tapering is simply a process of ceasing purchases of assets, it does not lead to reduction in the balance sheet. However, with the Fed becoming less patient regarding inflation, the impact of its balance sheet strategy should not be taken lightly. This is also an important issue for interest rates. There have been precedents in which the Fed's exit strategy was temporarily obstructed by serious risk-off situations, as was the case in 2016.

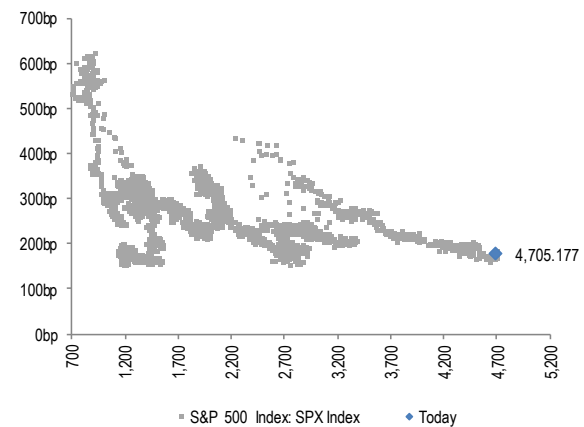
As mentioned above, the Fed's balance sheet strategy may have an impact on stock price valuations. In addition, stock prices and credit spreads are strongly correlated in a nonlinear relationship, although it is difficult to see the relationship in the graph, since it is not a simple linear relationship. (The scatter diagram of stock prices and credit spreads—right-hand chart below—provides a glimpse of part of the relationship between the two assets. For an accurate understanding, the concept of default distance in the Black-Scholes-Merton model must be used.)

**Moody's BAA-rated Corporate Bond Spread, S&P 500 Index**



Source: Bloomberg; compiled by Daiwa Securities.

**Moody's BAA-rated Corporate Bond Spread, S&P 500 Index (scatter diagram)**



Source: Bloomberg; compiled by Daiwa Securities.

In short, as the Fed is now rapidly heading towards the exit in line with diminishing tolerance, its balance sheet strategy may have an impact on stock price valuations. In addition, stock prices may have an impact on credit spreads. Once stock prices and credit have been thrown out of balance, the Fed could be forced to temporarily suspend its exit strategy. This is likely to become an underlying theme in the market in 2022.

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