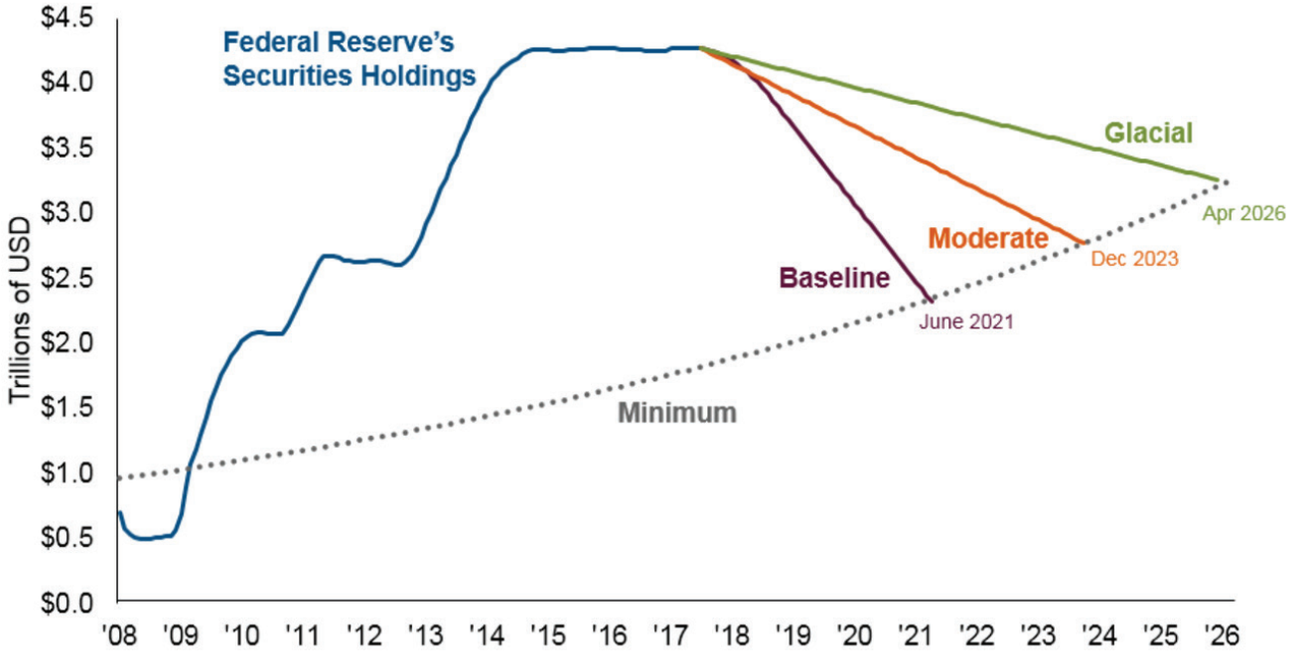
The End of an Era

The Federal Reserve chose not to raise the federal funds rate at the September 19-20 FOMC meeting (as expected), but policymakers did announce the start date for the much-anticipated balance sheet unwind. The Fed will begin slowly shrinking its balance sheet in October, marking the end of an era. As we explained in our video, Whiteboard Economics: The Fed's Balance Sheet Unwind, we do not anticipate much turbulence from this well-telegraphed roll off. The Fed's balance sheet will remain large well into the 2020s based on the three scenarios outlined in the chart below.

The Fed also left its "dot plot" unchanged for 2017 and 2018, pointing to one more hike this year and three hikes next year. The "dot plot" continues to pit the Fed against financial market participants on the question of short-term rates. Before the September meeting, fed funds futures priced in fewer than one additional rate hike through year-end 2018! We think the discrepancy is due in large part to the bond market's obsession with low inflation. Our view is that inflation is a lagging indicator. Using inflation to form your outlook is a bit like trying to drive your car by looking out the rear windshield. Instead, investors should pay attention to strong U.S. and global growth and the strong labor market for clues on what the Fed will do next. At the press conference after the meeting, Chair Yellen reiterated such a view, saying that while the Fed's "understanding of inflation is imperfect," policymakers still expect inflation to return to 2% "over the next couple of years." If inflation stabilizes and moves higher, one additional rate hike will prove too few.

Path of the Federal Reserve's Balance Sheet Under Various Scenarios



Baseline - the Fed's "normalization program" laid out in June ($10 billion/month increasing $10 billion every three months until it reaches $50 billion/month); **Moderate** - $20 bln/month; **Glacial**- $10 bln/month

Source: Federal Reserve, Payden Calculations