The conventional wisdom is that foreign buyers will step in to satisfy a majority of the funding gap. The reality is that foreign buyers have reduced purchases of treasuries materially over the past three years and were actually net sellers of treasuries to the tune of over $200 billion in 2016. Even if foreign buyers increased purchases, that demand will have to come at the expense of some other financial asset because dollar liquidity as a whole will have been reduced (as a function of the Fed). The impact will be widening spreads between risk assets and risk-free assets and higher nominal interest rates of risk assets (corporate bonds and the discount rate applied to equities).

As yields are pushed higher and as less market liquidity is available to fund maturing liabilities, corporate refinancings will become more difficult, less credit will be extended to consumers, and delinquencies and defaults will rise. Savings will increase as consumers and businesses need to source dollars in order to fund liabilities maturing in the future. Spending will decrease, investment will decrease and corporate profits will suffer. The Fed will reverse course but only after it becomes evident that financial markets and economic activity are deteriorating.

While it is unclear at what point critical mass will set in as the Fed shrinks its balance sheet, the force pulling risk assets down in aggregate will be like gravity, no matter how gradual at first. Because the market is focused on fiscal reform rather than monetary policy and because the markets misunderstand the impact of balance sheet reduction on liquidity and the real economy, risk is broadly mispriced. The Fed will surely step in and reverse course in order to avoid a 2008-like crisis with the highest probability scenario being that the Fed responds with more QE, in an aggressive way and sooner than most think. Similarly, and with a high degree of confidence, it should be expected that the Fed is successful in stabilizing markets before the market reaches a true liquidity crisis (90%+ probability of Fed success). However, the Fed will have to be reactionary to market declines rather than proactively altering course in response to deteriorating fundamentals; if the Fed stops shrinking its balance sheet and returns to easy monetary policy while markets remain at all-time highs, it risks losing credibility when it is most needed.

As a consequence, it will not be sufficient for fundamentals to deteriorate in order for the Fed to reverse course; it will have to have become evident in financial markets (lower equities and higher credit spreads). In a scenario in which the Fed's action forces market deterioration but not to the extent that a full crisis ensues, the equity markets will likely have corrected 10-20% (and the high-yield credit markets 20-30%) before the Fed becomes concerned (depending on how orderly or disorderly the early moves).

There is a saying that markets can remain irrational for longer than you can stay solvent. Because of this, execution is the key to neutralizing the unpredictability of timing and the market. Rather than short equities which may suffer greater losses in the end, shorting credit on a relative value basis is the most effective way to manage risk (both timing and mark-to-market) while also providing asymmetric return; in early 2008, credit spreads widened significantly while equities remained neutral as credit instruments fundamentally remain more closely and sensitively linked to initial moves in interest rates. Furthermore, there is naturally less downside risk and volatility to shorting a bond index that is trading in aggregate above par than there is to shorting the equity market which could easily see prices gains that incrementally diverge from fundamentals for extended periods of time.