Global Research Unlocked

Slowing the shrink; the impact and impetus behind a QT moderation

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Key takeaways

- BofA Global Research analysts join the podcast to discuss emerging risks, opportunities, and growth themes in global markets
- The Fed is likely to slow Quantitative Tightening (QT) this year, which, by itself, could mean slightly lower Treasury yields
- We discuss how QT works and whether we'd expect to see another round of Quantitative Easing

Rate policy isn’t the only big Fed change likely for ‘24

Since emerging from the COVID pandemic, the Fed has contracted the size of its balance sheet, also known as Quantitative Tightening (QT). They’ve done this by allowing their Treasury holdings to mature without reinvesting the proceeds. This has placed upward pressure on yields, all else equal. But the Fed is expected to slow this process later this year. Mark Cabana says this is good news for the Treasury market as it means the private sector will have less total supply to absorb. And while some investors are fond of making the connection between the Fed balance sheet and the S&P 500, it’s interesting that the S&P is making new highs while the balance sheet has shrunk, albeit from elevated levels. Mike Gapen discusses why that may be happening. *Global Research Unlocked can now be found on public podcast platforms, including Spotify, Apple Podcasts, Google Podcasts, and Amazon Music. These podcasts are first released to clients and then to the platforms.*

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Full Podcast Transcript

T.J. Thornton, Head of Product Marketing: Hello and welcome to Global Research Unlocked, where we discuss what's rising from growth industries, rising risks and opportunities in global markets. I'm T.J. Thornton, Head of Product Marketing at BofA Global Research, and we're recording this episode on Monday, February 5, 2024.

We think are likely why the Fed will be slowing down QT because they don't want to force banks to let go of some of that valuable excess liquidity that they're choosing to hold onto. And they certainly don't want to do that and risk, potentially, putting banks in a situation where they don't have enough liquidity to meet any outflows that they experience or they don't have enough liquidity to avoid large scale securities sales. And that's the key reason why we think they'll be slowing down QT later this year.

- Mark Cabana

Much of the focus on the Fed has been on when, or by how much they might cut interest rates, but it's not just rate policy that's changing. The Fed is currently reducing the size of its balance sheet by selling bonds or letting them mature, but the Fed's expected to slow this process down later this year. We'll discuss what that might mean for interest rates and just how important excess liquidity is for asset prices and the US economy. Joining us today are Mark Cabana, Head of US Rates Strategy, and Mike Gapen, Head of US Economics. Thanks for joining us today.

Mark Cabana, Head of US Rates Strategy: Thanks for having us.

Michael Gapen, Head of US Economics: Thanks for having us T.J.

T.J. Thornton: Sure, first question's for Mark. Back to this concept of QT or Quantitative Tightening, could you just give us a basic definition of what it is and also what kind of impact you think it's had on rates?

Mark Cabana: The Fed has been going through a process of reducing the size of its balance sheet. The market has known this as Quantitative Tightening or QT. When the Fed allows its balance sheet to contract, it's really allowing its securities holdings, primarily its holdings of Treasury securities and agency mortgages, to redeem without reinvestment. The Fed has set a certain amount of redemptions each month that it will tolerate in its Treasury and mortgage portfolio. They've set that target at $60 billion per month for Treasuries, $35 billion per month for mortgages, and they allow these securities to roll off without reinvestment. Now, importantly for the market is that, as the Fed allows this process of its securities portfolio to unwind or to reduce over time that does in turn mean that the private sector has to hold more of these securities. In essence, for every dollar that matures off of the Fed's portfolio in their Treasury holdings, that's one more dollar that the private sector needs to hold as well, and that increases the stock of duration risk that the private sector needs to absorb, and in theory, more duration risk to the market should put more upward pressure on yields. Now, before the Fed started QT, and they really started QT or this process of unwinding their balance sheet post-COVID in June of 2022, before they started in this process, we estimated that there could be a 40 basis point impact on the 10-Year Treasury Yield from the expected reduction of their securities portfolio. Now, that's a very imprecise estimate. It uses rough rules of thumb that prior event studies around Fed balance sheet activity have created. And since then we have obviously seen 10-Year Treasury Yields rise by much more than 40 basis points, but we do think that the unwind or the reduction of the Fed's securities portfolio has put upward pressure on Treasury yields and it has caused Treasuries to cheapen, let's say versus SOFR (Secured Overnight Financing Rate) swaps. And if you look at 2 year SOFR swaps or 10 year SOFR swaps, since the Fed started the QT process, you've seen at least 2 year Treasuries cheapened by about 15 basis points and 10 year Treasuries cheapened by about 15 basis points.

T.J. Thornton: Mark, the next evolution in QT is a tapering or a slower shrinking of the balance sheet. It's not like they're going back to QE (Quantitative Easing), where they're buying a bunch of bonds and mortgages during COVID and during the financial crisis. But what does this next phase mean for rates and other parts of the market, do you think?

Mark Cabana: Sure, the Fed is discussing publicly the idea of slowing down the pace of their securities portfolio runoff or engaging in a slower QT process. Now remember the Fed is reducing its balance sheet by $60 billion per month in Treasuries, $35 billion per month in mortgages or up to that amount. And they're going to presumably reduce the maximum monthly reduction in Treasuries as they slow the balance sheet. We don't know the timing. Mike and I think that it will probably happen in the first half of this year. We actually, as a base case now have the timing for a slowdown in the Fed's balance sheet reduction occurring at the May FOMC (Federal Open Market Committee) meeting. We pushed that out from March based upon some guidance that we heard from the Fed at the January FOMC meeting. But we think that's when they will announce a slowdown in QT and they will be doing that because they don't want to withdraw too much excess liquidity from the banking system where they want to be a bit more careful about that withdrawal, as they continue to proceed with QT. What does this mean for rates? It has meant that there would be less supply that the market is expecting it will need to take down as the Fed slows the shrinkage of its balance sheet. Certainly, good news for the Treasury market, in that if the Fed slows QT, it will mean less total supply that the private sector needs to take down and somewhat less duration risk that the private sector needs to hold as the Fed slows QT.

T.J. Thornton: Okay, great. I wanted to move a bit into some of the real world impacts of QT. Capital markets, as we were reminded recently, didn't rebound as much as many expected last year. There are a lot of factors behind that, but do you think QT plays a role at least through the provisioning of liquidity?

Michael Gapen: Hey, T.J., I do think QT played a role, maybe not so much on the liquidity side of the story, but on the duration side, as Mark mentioned when the Fed is shrinking its balance sheet, it's putting longer dated Treasury mortgage backed securities out into the hands of private holders, and generally that puts upward pressure on interest rates. Now, the Fed started to taper in June of 2022, but it was signaling in advance that this was likely coming. The S&P 500, for example, peaked out at just short of, I think 4800 in late 2021, and it didn't rise above that level again until December of 2023, so it played a part in addition to higher front end rates, communication from the Fed that it would do whatever it takes to slow inflation down, even if that meant inducing a recession, which obviously didn't come, thank goodness. But I do think QT played a role in keeping asset markets subdued over the course of 2022 and slowed the rebound in 2023.

Mark Cabana: Yeah, maybe building on Mike's response, when we, at least on the Rates Strategy team think about the impact of QT in the capital markets more broadly, we generally think about it in terms of what is the additional increase in Treasury yields that will be required for the private sector to hold the amount of debt that needs to be issued by the government. And again, if the Fed is allowing its securities to roll off, then there's more duration risk that the private sector needs to hold. Now, that's how we think the clearest connection to capital markets works, but there is a very meaningful cohort in the market that I sometimes describe as "M2 Equity Investors." These are folks who are investing in risk assets and they typically are thinking about the attractiveness of risk assets in relation to what the central bank or the Fed's balance sheet is doing. And if the Fed is believed to be adding liquidity into the system, growing the money supply as a result of the balance sheet growth, then these investors want to be positioned for risk on, and the same is true, if the Fed is shrinking its balance sheet. If the Fed is indeed shrinking its sheet, this section of capital markets will probably be a bit more cautious on risk, and that may indeed have been one of the factors at play that was behind the struggles that a risk assets had for a period of time as the Fed was signaling QT and also starting its rate hiking process.

T.J. Thornton: Got it. And I wanted to follow up on that idea because right, many of us have seen the chart that shows money supply versus say the S&P. Money supply or at least the Fed's balance sheet has been rolling over. It's off the highs. Is that the same as money supply for one? And then how do you explain the fact that despite that rolling over of markets, at least the S&P, the NASDAQ, some of the big US indices are sitting at highs, does that sort of challenge that view?

Michael Gapen: I would say that the balance sheet equal to the money supply, no, it's when securities are purchased or sold, it's certainly a component of the money supply: reserves, currency, what we would call base money, but there are other components longer term time deposit CDs and other types of near money that comprise M1 and M2. Not necessarily should we think of say a direct one-to-one relationship. In general, yes, I think the size of the Fed's balance sheet should be correlated or have positive correlation with asset prices and economic growth. Again, when the Fed's buying assets, it's taking longer duration securities out of the market, putting downward pressure on term premium, the reverse happens when it runs its balance sheet off. But as you mentioned, T.J., the balance sheet's been running off for quite a while now, but the economy and asset markets have done pretty well, so I think it kind of points to two things. One, this is really our second cycle using the balance sheet and there's a lot we don't know about its transmission mechanism, how strong it is. As Mark mentioned, we may not be getting a very large movement in long-term Treasury yields for very large purchases or sales in Treasury securities from the Fed's balance sheet, maybe just the relationship isn't quite that strong. The other thing I think it tells you is that the US emerged from the pandemic in a very good state, and the economy overall was resilient to interest rate increases, whether that came from the Federal Reserve, Federal funds rate increases or a shrinking balance sheet.

T.J. Thornton: Okay. This one's for both of you. One of the ways that QT is transmitted to the economies through bank reserves at the Fed, but bank reserves haven't fallen as quickly as maybe you'd expect, as the Fed balance sheet has come off or rolled over. Does this negate the impact that QT would've had, just the fact that bank reserves have stayed high and is just a matter of time before reserves start to fall more quickly in line with the Fed balance sheet?

Mark Cabana: Now, as the Fed has conducted QT, they have reduced their balance sheet by almost $1.3 trillion. The securities portfolio has comprised $1.37 trillion of that reduction. And what we have observed is that on the liability side of the Fed's balance sheet, really all of QT over 100% of QT has been absorbed by a decline in this overnight reverse repo facility. It's the excess cash that money funds are investing with the Fed on a daily basis. And we've seen that reserve balances have actually grown, so the cash that commercial banks want to hold with the Fed has gone up. And we don't think that this is accidental. Money market mutual funds are investing less with the Fed because there's been an increase in debt outstanding. There's been an increase in Treasury bill supply, money market rates are higher and so money funds are choosing not to invest as much cash with the Fed. They're choosing to invest in higher yielding, private sector alternatives, money market alternatives. And we think that reserve balances and commercial banks have gone up because they're demanding more liquidity and they're demanding more liquidity we think because they want to ensure that they've got adequate liquidity, if they see deposit outflows. There was some banking system stress that we all know in 2023 very well. We believe that banks are choosing to hold more liquidity because they're sitting on still large unrealized securities losses. They never want to sell a security, if they can avoid it, and the best way to avoid that is to hold more cash with the Fed. And they're also holding more cash with the Fed because some of the supervisory or regulatory guidance that they have received around how they manage their liquidity has changed. We've really seen that QT has been evolving on the liability side of the Fed balance sheet by lower RRP (Reverse Repurchase Agreement) balances. Reserves have gone up, and we do think that reserves are going up for very prudent liquidity risk management reasons. Now it's only a matter of time, if the Fed continues QT, before these reserve balances start to fall. Total utilization of the Fed's overnight RRP, at least as of today, is around $550 billion. If the Fed continues QT for another six months or so, the overnight RRP will almost certainly be at zero. And then once reserve balances start to fall; it will drain some of that really valuable liquidity that banks have been holding onto away from them. And the question is, how willing will banks be to let that excess liquidity go and what risks might go along with that if the Fed were to continue QT? And these questions, we think are likely why the Fed will be slowing down QT because they don't want to force banks to let go of some of that valuable excess liquidity that they're choosing to hold onto. And they certainly don't want to do that and risk, potentially, putting banks in a situation where they don't have enough liquidity to meet any outflows that they experience or they don't have enough liquidity to avoid large scale securities sales. And that's the key reason why we think they'll be slowing down QT later this year.

T.J. Thornton: Okay, thank you Mark. Another question, I've mentioned QE a few times perhaps 'cause I remember it very fondly. But we're currently not expecting recession in the US, at least that's not our econ teams forecast, but if we did see one over the next several years, do you think that the Fed would turn to QE again?

Michael Gapen: I think that the answer to that of course depends on how deep the recession would be, but certainly, I think I would lean in the direction of saying would the Fed turn to QE again? Yes, I think it very well could. I do think the neutral rate of interest has risen in the US economy coming out of COVID, but perhaps not by all that much to avoid zero lower bound episodes going forward. It's completely conceivable in my mind that say for example, the Fed begins to normalize rates later this year and it puts them on a track to a terminal policy rate, say at about 3%, so you're right, we're not currently expecting a recession in the US. If the Fed is able to get most of the way through its normalization cycle, the funds rate is sitting somewhere about 3% nominal terms, it should be roughly a 100 basis points in real terms, if inflation's running 2%, that's not a lot of room to cut rates. If we look back historically, rate cutting cycles and response to recessions often involve 300 basis points or more of policy rate cuts. In my mind, it's completely conceivable that the Fed could find itself at the zero lower bound again in future downturns, and then debate, do we need to turn back to the balance sheet again? Do we need to buy Treasuries and mortgage backed securities again? Do I think the Fed would turn to QE? Yes, they probably wouldn't want to. Of course they would prefer just to conduct policy with interest rate policy, but they've got a mandate to achieve if they found themselves at the zero lower bound, I think they would turn to QE again.

T.J. Thornton: Okay. And another question just on the current state of affairs in the US economy, obviously we are not looking for recession. However, the path of QT of rate cuts will be determined in large part by what happens with inflation, what happens with US growth. What do you think is happening with US growth at the moment? We recently had a strong employment report; December retail sales were very strong as well. Are we seeing any signs that higher rates are having an impact? There's an assumption that they will, but are we seeing that yet or is it inevitably, getting pushed out?

Michael Gapen: I think there's two places that we can point to for signs that higher interest rates are having or have had an impact on the economy. I think these would be housing and bank loan growth. Certainly activity in the housing sector has slowed down in response to higher mortgage rates. There's been structural demand for housing coming out of COVID. We're underbuilt relative to our demographics. And for a variety of reasons, the sector has not seen a major contraction like it often has when the Fed's raised rates this fast. But nonetheless, inventories are low. There's been a lock in effect from higher mortgage rates, so there hasn't been a lot of activity yet, but I think it's a sector that I think has clearly responded to higher rates by slowing down. And the second area I mentioned would be bank lending, where growth on a year on year basis, commercial and industrial loans are down in nominal terms and lending to households for the residential real estate market, as well as consumer loan growth, those have both slowed down to roughly 3-4% in nominal terms over the past year or roughly flat in real terms. It's an open question though, what's happening in the economy. Certainly in the second half of last year, growth and economic activity reaccelerated; the US had a very good second half of 2023. I would say it's too early to conclude that say hiring in the labor market is reaccelerating after the January employment report last week. So certainly a blowout number and I think the labor market is in very solid footing, but distortions in activity around the end of the year from COVID where, for example, we make our holiday purchases earlier than we used to. And since we're still catching up on employment and many face-to-face leisure and hospitality service sectors, we don't have as many of the normal post-holiday layoffs as we used to, so I think the seasonal factors tend to boost January employment. I'm not here to say that report was weak by any means. I just question whether it was as strong as the headline number suggests. We don't expect a recession in 2024, and we think the outlook looks reasonably good. If the Fed's able to begin its normalization cycle later this year, housing could look better, bank loan growth could improve, the industrial side of the economy could gradually recover, and I think recession risk could be lowered even more.

T.J. Thornton: Mark and Mike thanks for joining us today.

Michael Gapen: Thank you.

Mark Cabana: Thanks for having us T.J.

T.J. Thornton: It's hard to quantify it exactly, but QT has likely pushed Treasury rates higher, especially at the long end, so tapering of QT should be helpful in bringing rates down at least modestly when it does happen. Between big deficits and QT, there's been a lot of Treasury supply for the market to absorb and the aspect that's tied to QT at least will ease. We expect tapering to start in May, but it has been a moving target and could change again. And for those investors that invest according to whether money supply or M2 is rising or falling, less of a decline in the Fed's balance sheet should mean less liquidity drain, a positive. Also, Mark makes an interesting point, which is that bank reserves will eventually fall if QT continues. This is one reason the Fed is sensitive to letting this process continue for too long. Thanks for joining.

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