US Rates Watch

Logan and QT: QT taper now in March

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Logan speech points to early QT slowing

Fed communication from the December FOMC minutes and Dallas Fed President Logan's speech Saturday point to an early slowing of Fed QT (Exhibit 1). The BofA US Economics Team now calls for tapering to be announced in March while retaining its view for an end to QT in the summer. Front end swap spreads should widen modestly.

Logan's ON RRP "low level": likely $200-250b

The most important line on QT from Logan's speech: "we should slow the pace of runoff as ON RRP balances approach a low level". What defines "a low level"? Logan did not specify but we might guess it is ON RRP at $200-250b. Our logic on the $200-250b level: (1) it represents ~10% of peak ON RRP use (2) since mid Sept '23 the st dev of daily ON RRP changes is $60b which means a 3-4 st dev move could take ON RRP to zero. Both these considerations imply a relatively "low level" of ON RRP balances.

"Low level" of ON RRP could be reached by spring '24

The Fed ON RRP could reach a "low level" between March & June '24. Our logic: (1) Fed ON RRP balance is currently ~$700b & recent trend of ON RRP reduction since mid-Sept '23 has been $200b/m, if current trend holds the "low level" of $200-250b could be reached in March (2) our ON RRP projections show a slower pace of ON RRP decline at $100b/m which would see the "low level" of $200-250b reached in June '24 (our Fed B/S projection details are in Fed ON RRP drop: hikes done + bank buffer). The US Rates Strategy team sees risks skewed to a more rapid pace of ON RRP decline.

Fed QT slowing implementation: lower redemption cap

The BofA base case is now that the Fed will cut the monthly UST redemption cap by $15bn/m starting in Mar with QT ending in July (Exhibit 2). Other Fed QT taper options are possible such as one-off UST cap reduction to $30bn/m leaving the end of runoff more open-ended. For USTs, Fed monthly maturities above the cap would be rolled over at auction; this implies higher SOMA holdings of newly issued securities & marginally less specialness risk. For MBS, the cap is unlikely to be reduced because of the Fed's preference for an all-Treasury portfolio (in '19, the Fed only reduced the UST redemption caps (Exhibit 3)). Once QT ends, Fed should reinvest most MBS repayments into USTs.

Market impact: wider spreads & 2H '24 / '25 SOFR/FF

The UST impact of an early QT slowing = wider spreads & SOFR/FF b/c less UST private sector supply & potentially more UST demand (via Fed MBS reinvestment into USTs). Spread widening expected to be most pronounced in shorter tenors; SOFR/FF widening concentrated in 2H '24 & '25 tenors. This should help our prior SOFR/FF widening bias btw 1y1y & 2y1y tenors (see Funding & '25 debt limit). It may also benefit a SOFR/FF 6m vs 1Y steepening w/ near-term higher SOFR risk but medium-term funding stability.

QT = quantitative tightening

ON RRP = overnight reverse repo

SOMA = System Open Market Account

Exhibit 1: Recent FOMC balance sheet communications
Fed officials are considering slowing the pace of balance sheet reduction

FOMC Communication	Relevant Text
Dec '23 FOMC Minutes	Several participants… suggested that it would be appropriate for the Committee to begin to discuss the technical factors that would guide a decision to slow the pace of runoff well before such a decision was reached in order to provide appropriate advance notice to the public
Logan Speech	In my view, we should slow the pace of runoff as ON RRP balances approach a low level

Source: Federal Reserve

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Exhibit 2: BofA base case QT path following recent Fed communications ($bn)
Fed is expected to reduce UST cap $15b/m starting in Mar & end QT in Jul '24

QT Pace	Jan '24	Mar '24	May '24	Jun '24	Jul '24	Sep '24
UST Cap	60	45	30	15	0	0
MBS Cap	35	35	35	35	35	35
MBS Reinvest to USTs	0	0	0	0	35	35

Source: BofA Global Research

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Exhibit 3: Fed QT path in '19 ($bn)
Fed reduced cap only on USTs & reinvested MBS proceeds into USTs once QT ended

QT Pace	Jan '19	Mar '19	May '19	Jun '19	Aug '19
UST QT	30	30	15	15	0
MBS QT	20	20	20	20	20
MBS Reinvest to USTs	0	0	0	0	20
Total QT	50	50	35	35	0

Source: Federal Reserve

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Rate cuts begin in March, QT to end after June

Our BofA US Economics team's outlook for monetary policy includes rate cuts beginning at the March FOMC meeting, with the Fed executing four-25bp rate cuts over the course of the year at the March, June, September, and December meetings, for a total of 100bp in rate cuts in 2024 (see Sticking the landing). We maintain the same quarterly schedule for rate cuts in 2025, bringing the total number of rate cuts to 200bp over the next two years. We expect a terminal funds rate of about 3.0% to be reached in early 2026.

BofA's outlook for monetary policy also includes an end to QT at mid-year. The Fed has made it clear that balance sheet runoff can extend beyond the first rate cut in an environment where the committee is normalizing its policy stance. This would be the case in the Fed's – and our – baseline where the US economy achieves a soft landing, and the federal funds rate follows inflation down while preserving some degree of real policy tightening. In contrast, should a recession materialize, the Fed would be easing to underpin economic activity and would likely end QT at the same time as rate cuts begin. Rate cuts would likely be larger in size and with greater frequency than anticipated in the Fed's current baseline in this environment.

That said, we have noted that there is a high degree of uncertainty around when liquidity scarcity will be reached, with functioning in front-end markets providing important signals as to when reserves and overall liquidity conditions are turning from abundant to scarce. Historically, the Fed has preferred to taper monthly purchase amounts or runoff rates as it approaches the end of its asset purchases or securities runoff, though we have more episodes of the former than the latter to draw from. President Logan's remarks do not provide much additional clarity as to how any tapering schedule may be implemented beyond noting that a slower pace of runoff will allow the financial system to redistribute liquidity more efficiently as ON RRP balances approach a "low level."

Tapering of Treasury runoff to be announced in March

We take this opportunity to fine tune our expectations for the end of QT, consistent with (1) our outlook for rate cuts that begin in March, (2) balance sheet runoff that continues past the first rate cut, (3) an end to QT at mid-year, and (4) the Fed's preference for an all-Treasury portfolio in the longer run.

At the March FOMC meeting, when we think the Fed initiates its first 25bp rate reduction, we expect the Fed to announce the tapering of runoff for its holdings of Treasury securities. At present, the caps on runoff are $60bn for Treasury securities and $35bn for agency MBS holdings, though actual runoff on the latter has often fallen well below the cap since the back-up in mortgage rates has slowed prepayment speeds. For example, runoff of agency MBS holdings averaged $15-16bn per month in 4Q 23 and $19-20bn in 3Q 23.

We think the Fed will reduce the cap on runoff for Treasury securities by $15bn per month beginning in April, suggesting caps of $45bn in April, $30bn in May, and $15bn in June (Exhibit 2). From July onward, runoff of Treasury securities would end. This would imply roughly $315bn in additional securities runoff between now and the end of June, bringing ON RRP balances to "low levels".

Alternatively, the Fed could announce in March a one-off reduction in its cap on monthly Treasury runoff to $30bn, while leaving its cap on MBS securities unchanged. This would result in the same amount of runoff between now and the end of June, but the difference would be that the Fed would not pre-announce subsequent cap alterations and fix and end to QT. Instead, the Fed would be reducing the pace of runoff to give itself a better vantage point to understand how funding conditions in front-end markets are evolving. This taper schedule would leave the actual end to QT open-ended, meaning runoff could extend beyond our June forecast for an end of balance sheet runoff.

We expect no change in the redemption cap for agency MBS securities given low prepay speeds and the Fed's preference for an all-Treasury portfolio. We continue to expect the Fed will let agency MBS runoff continue after QT ends, with proceeds from principal payments on MBS securities reinvested into Treasury securities to keep the size of the balance sheet constant.

Overall, our broad outlook for monetary policy remains in place: a beginning of rate cuts in March and an end to balance sheet runoff at mid-year. That said, we read recent Fed communication from the December FOMC minutes and President Logan's remarks to indicate the Fed will likely favor some tapering in the pace of runoff as it approaches the end to QT and we have fine-tuned our outlook for monetary policy as a result

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