

Morning Market Tidbits

Shrinking the Fed balance sheet: More tortoise, less hare

In focus

The Fed is using two policy tools to help bring inflation down: it has raised short-term interest rates and allowed maturing Treasury and agency mortgage-backed securities roll off its balance sheet. It sees both as raising borrowing costs for households and business, thereby moderating economic activity. With inflation nearing the Fed's 2% target, it is debating how and when to normalize its policy stance, which would include reductions in short-term interest rates and an end to balance sheet runoff, commonly referred to as quantitative tightening or QT. Rate cut discussions have dominated the news, but how the Fed will handle its balance sheet is now coming into focus.

In a note yesterday, [US Rates Watch: Logan and QT: QT taper now in March](#), we analyzed the implications of recent FedSpeak on balance sheet policies. On Saturday, Dallas Fed President Logan said "we should slow the pace of runoff as ON RRP balances approach a low level." Additionally, the December FOMC meeting minutes mentioned, "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". We expect the Fed to announce in March that the pace of securities runoff will slow.

The rationale for slowing the pace of runoff is clear. When the Fed allows securities to mature off its balance sheet, it leads to tighter liquidity conditions in short-term funding markets through a reduction in bank reserves. Initially, when reserves are plentiful, balance sheet reduction has little effect on market functioning. As runoff continues and reserve become scarce, financial markets need to reallocate reserves from those institutions that find themselves with excess reserves to those that are short of desired reserves. This can sometimes cause market dislocations, often around month-end, quarter-end, and year-end when demand for liquidity is high. By reducing the pace of runoff, the Fed would improve the ability of markets to reallocate liquidity efficiently, thereby reducing the risk of market dislocations like those that occurred in 2019.

Understanding when to end balance sheet runoff is tricky since knowing when reserve scarcity is reached is a moving target. That said, we think the US is near the point where a slower pace of balance sheet runoff is warranted. At the March FOMC meeting, when we think the Fed initiates its first 25bp rate reduction, we think it will reduce the cap on runoff for Treasury securities by \$15bn per month, suggesting caps of \$45bn in April, \$30bn in May, and \$15bn in June (Exhibit 1). From July onward, runoff of Treasury securities would end. Other options are possible, including a one-off in the Treasury redemption cap to \$30bn per month leaving the end of runoff more open-ended.

For agency mortgage-backed securities, we expect no change in runoff policies. The Fed prefers to hold an all-Treasury portfolio, if possible, to reduce its footprint in private lending markets during normal times. Once balance sheet runoff ends in June, the Fed will likely reinvest MBS repayments back into US Treasuries, as it has done in the past.

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FOMC: Federal Open Market
Committee

CPI: Consumer Price Index

SEP: Summary of Economic
Projections

ON RRP = overnight reverse repo

SOMA = System Open Market
Account

QT: Quantitative Tightening

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Exhibit 1: 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

BofA GLOBAL RESEARCH

Market action

The Asian equity markets that we cover closed mixed overnight. Looking at individual markets, the Korean Kospi and the Hang Seng fell 0.3% and 0.2%, respectively. On the flipside, the Shanghai Composite and the Nikkei were up 0.2% and 1.2% respectively, while the Indian Sensex was flat.

As of 7:00 am ET, aggregate European stocks are down 0.4% and S&P500 futures are down 0.5%. In the bond markets, 10-year Treasury yields have increased 2bp to 4.05% and German Bund yields have increased 6bp to 2.20%. The dollar index is up \$0.25 to \$102.46. WTI crude oil prices are \$1.65 higher at \$72.42/bbl, and gold prices are at \$2035.09/oz.

US GDP Tracking**Exhibit 2: BofA US GDP tracking estimate (% q/q saar)**

Our 4Q GDP tracking estimate is up to 1.2% q/q saar after a stronger than expected December vehicle sales and payrolls print

Date	Data release	GDP	Final Sales	PCE	Res. Inv.	Struct	Equip	IPP	Gov.	Exports	Imports	Net exports (level)	CIPI (level)
12/12/23	CPI	1.0	1.8	1.8	-1.9	2.0	1.0	2.5	2.2	8.7	6.2	-933.6	20.4
12/14/23	PPI, Retail Sales, Business Inventories	1.1	1.9	2.0	-1.8	2.1	1.0	2.5	2.2	8.7	6.2	-933.6	13.4
12/15/23	Industrial Production	1.1	1.8	1.9	-1.8	1.8	1.2	2.5	2.2	8.7	6.2	-933.6	13.4
12/20/23	Housing Starts and Permits, Existing Home Sales	1.2	1.8	1.9	0.0	1.8	1.2	2.5	2.2	8.7	6.2	-933.6	13.4
12/21/23	GDP (T) 3Q	1.1	1.7	1.9	0.0	1.8	1.2	2.5	2.2	8.7	6.2	-933.6	18.0
12/22/23	PCE, Durable Goods Orders, New Home Sales	1.1	1.7	1.7	-0.5	1.8	1.9	2.5	2.2	8.7	6.2	-933.6	31.3
12/28/23	Advance Goods Trade Balance, Retail & Wholesale Inventories	0.9	1.5	1.7	-0.5	1.8	1.9	2.5	2.2	1.7	3.2	-947.1	23.7
12/2/24	Construction Spending	0.9	1.5	1.7	-1.2	3.3	1.9	2.5	2.6	1.7	3.2	-947.1	23.7
12/4/24	Vehicle Sales	1.1	2.1	2.0	-1.2	3.3	2.6	2.5	2.6	1.7	3.2	-947.1	23.7
12/5/24	Payrolls, Factory Orders	1.2	2.1	2.0	-0.2	3.3	2.8	2.5	2.3	1.7	3.2	-947.1	26.0
	GDP tracking	1.2	2.1	2.0	-0.2	3.3	2.8	2.5	2.3	1.7	3.2	-947.1	26.0
	Contribution to GDP growth (pp)				1.3	0.0	0.1	0.1	0.4			-0.2	-0.7
	BofA official GDP forecast	1.5	2.0	2.5	1.0	1.0	2.0	2.5	2.0	3.0	2.0	-929.0	38.0

Source: BofA Global Research. Our GDP tracking estimate reflects the mechanical aggregation of incoming data that directly informs the BEA's GDP calculations. The process is distinct from our official published GDP forecast. Boldface cells indicate where data have implications for tracking estimates.

BofA GLOBAL RESEARCH

Overseas Data**Germany**

Industrial Production fell 0.7% m/m in November, the sixth consecutive month of decline. Our Europe economists note that the energy intense sectors, that had explained the bulk of weakness for the last year, have actually seen production increases in November, while the rest declined. Industry is worth almost a quarter of total German GDP, so this creates some downside risks to their -0.1% qoq 4Q23 growth forecast.

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