US Rates Watch

Fed MBS reinvestments into USTs explained

End of Fed QT = start of UST buying

Following several Fed comments on the balance sheet (Exhibit 1), client questions have focused on market implications of tapering and the end of QT. We changed our QT expectation following the Logan speech and Dec FOMC minutes (see: US Rates Watch) but acknowledge uncertainty on the timing and implementation of QT adjustments; we will refine our view with further Fed guidance. We currently anticipate the Fed will allow MBS to continue paying down once QT ends and for reinvestments to be conducted through secondary UST purchases. This is consistent with Fed policy action in 2019 and the Fed's longer run objective to hold a predominantly UST portfolio. We project MBS paydowns of around $15bn/ month in 2H '24 to be allocated across the UST curve.

MBS paydowns → UST purchases rationale

Consistent with what was announced by the Fed in 2019, we expect that once QT ends, MBS paydowns up to the redemption cap ($35bn) will be reinvested into USTs (Exhibit 2). Under Section 14.2(b) of the Federal Reserve Act, the Fed can only buy and sell direct obligations of the US government or agency of the US government in the open market. In other words, Fed rollovers through the primary market (at auction) cannot be used to grow the securities portfolio. Treasury market rollovers can be done in the primary market only with maturing *Treasury* securities, an option for all Treasury holders.

When the Fed is reinvesting maturing or prepaid MBS into UST, they need to do so in the *secondary* market, much like QE. When the Fed is reinvesting MBS, they use a forecasted amount of prepayments received mid-month but do not receive the cash until the end of the month. Since these reinvestments would grow the Fed's balance sheet, all Fed reinvestments of MBS into UST must occur in the secondary market.

Scale of UST purchases depends on MBS paydowns

Our base case assumptions for MBS paydowns show a $15bn average pace of monthly paydowns from July – December 2024. This is well below the current monthly MBS paydown cap of $35bn, which suggests roughly $15bn of reinvestments per month into the secondary UST market. As shown in Exhibit 3, the pace of paydowns picks up only modestly to $20bn on average if rates are about 125bps lower vs our base case. Our MBS projections suggest that it would require a 10y rate between 2.5-2.75% to trigger the $35bn monthly cap. Any MBS that paydown in excess of the cap we expect would be reinvested back into the MBS market, also consistent with 2019 precedent.

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MBS =Mortgage backed security

UST = US Treasury

QT = Quantitative tightening

QE = Quantitative easing

WAM =Weighted average maturity

SOMA = System Open Market Account

Anticipate purchases to be done across UST curve

Using 2019 as a guide, we expect the Fed will likely reinvest back into the secondary UST market to "roughly match the maturity composition of Treasury securities outstanding." Using current market weights, this suggests the composition of purchases shown in Exhibit 4. There are however many uncertainties around this, and the Fed could choose to concentrate purchases at the front-end of the curve or in bills to have less of a duration impact. The small gap between SOMA UST WAM and market supports our view of buying across curve instead of bills only (Exhibit 7).

Fed and UST buybacks can support liquidity

Using our expected QT timeline, Fed purchases of USTs on MBS paydowns would start in July, shortly after we expect UST to initiate buyback operations. As discussed in November refunding: rate sensitive, UST has guided that they will provide an update on buyback timing at the refunding meeting later this month and we have a May start reflected in our supply forecasts. While UST buybacks do not remove net supply from the market like Fed purchases, they are aimed at helping support market functioning & liquidity by targeting relatively cheap securities.

Exhibit 5 shows the buyback bucket and allocations that UST last provided guidance around in August '23. We align these buckets with potential Fed reinvestments in Exhibit 6, which suggests that buying support will likely be roughly evenly distributed across the nominal curve with a modestly higher allocation at the back end as a share of gross issuance. Off the run USTs will likely see the greatest support as relatively cheap securities will be the target of buyback liquidity operations and tend to be purchased by the Fed during secondary market operations.

Bottom line: While there are still many unknowns around phasing out of QT, an important implication for the UST market will be the reinvestment of MBS paydowns into secondary Treasury market purchases. Once QT ends, we expect a monthly pace of around $15bn MBS paydowns to be reinvested in USTs, consistent with the composition of outstanding debt. These purchases alongside UST buyback operations will likely support liquidity particularly in off the run securities across the curve.

Exhibit 1: Fed comments on Fed balance sheet
Views on QT taper timing and end are disparate

Fed speaker	Date	QT comment
Gov. Waller	1/16/2024	Roughly 10-11% reserves as share of GDP is endpoint for balance sheet; thinks that QT can taper as ON RRP approaches zero, more uncertainty around reserve levels; slow the pace of QT sometime this year (not for MBS); standing repo facility usage sign for understanding reserve scarcity
Mester (Cleveland)	1/11/2024	Slowdown of QT not imminent, Fed will discuss this year.
Williams (New York)	1/10/2024	Don't seem close to the point of slowing asset runoff. Hard to predict where ample reserves are.
Bostic (Atlanta)	1/8/2024	Open question on whether asset runoff pace should change.
Logan (Dallas)	1/6/2024	In my view, we should slow the pace of runoff as ON RRP balances approach a low level.
Minutes	Released (1/3/2024)	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.
Powell	12/13/2023	At a certain point there won't be any more to come out of ONRRP and then reserves will start to come down; intend to slow and then stop the decline in size of the balance sheet when reserve balances are somewhat above the level judged to be consistent with ample reserves; we're not at those levels

Source: BofA Global Research, 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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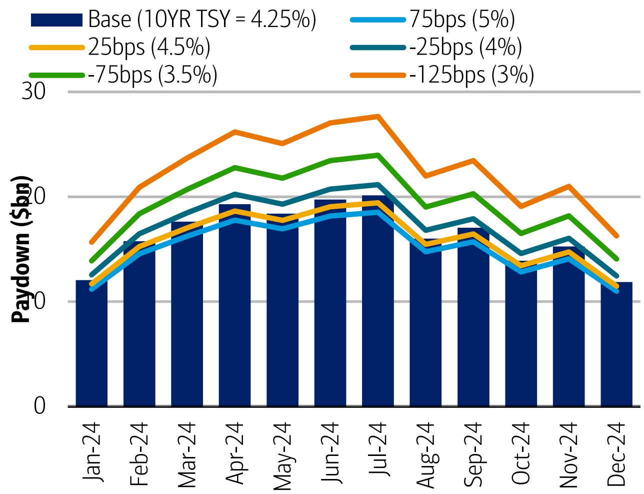
Exhibit 3: Fed Portfolio - Agency MBS Paydown Projection Scenario Analysis
Base case shows monthly average paydown pace of $15bn over 2H '24



Source: BofA Global Research

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Exhibit 4: Anticipated allocation of UST secondary market operations using February '22 buckets
Sector weights are based on debt composition as of December '23, approximate monthly amounts assume MBS paydown pace of $15bn/ month

	Maturity (yr)	Sector weight	Approx/ month
	0-2¼	29%	4.3
	2¼-4½	20%	3.0
	4½-7	13%	2.0
	7-10	8%	1.2
Nominal coupons	10-22½	12%	1.7
	22½-30	10%	1.5
	1 - 7½	6%	0.9
TIPS	7½ - 30	3%	0.4

Source: BofA Global Research, US Treasury

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Exhibit 5: UST anticipated buyback purchase allocations
Max amounts per month and quarter based on UST guidance at the August '23 refunding meeting

	Maturity (yr)	Max amount/ quarter	Approx/ month
Cash management & Liquidity	0-2	34	11.3
	2-3	4	1.3
	3-5	4	1.3
	5-7	4	1.3
	7-10	4	1.3
	10-20	4	1.3
Liquidity: nominal coupons	20-30	4	1.3
	0-7.5	1	0.3
Liquidity: TIPS	7.5-30	1	0.3

Source: BofA Global Research, US Treasury

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Exhibit 6: Fed + UST buying will likely be roughly evenly distributed across the curve as a share of issuance
Buying flow roughly evenly distributed across the curve with modest concentration at the back end; Note: UST buybacks assume max stated amount and exclude cash management buying

Maturity (yr)	0-7	7-10	10-30
Fed	9.3	1.2	3.2
UST	5.3	1.3	2.7
Gross issuance (refunding month)	241	42	83
Flow of buying	6.1%	5.9%	7.1%

Source: BofA Global Research, US Treasury

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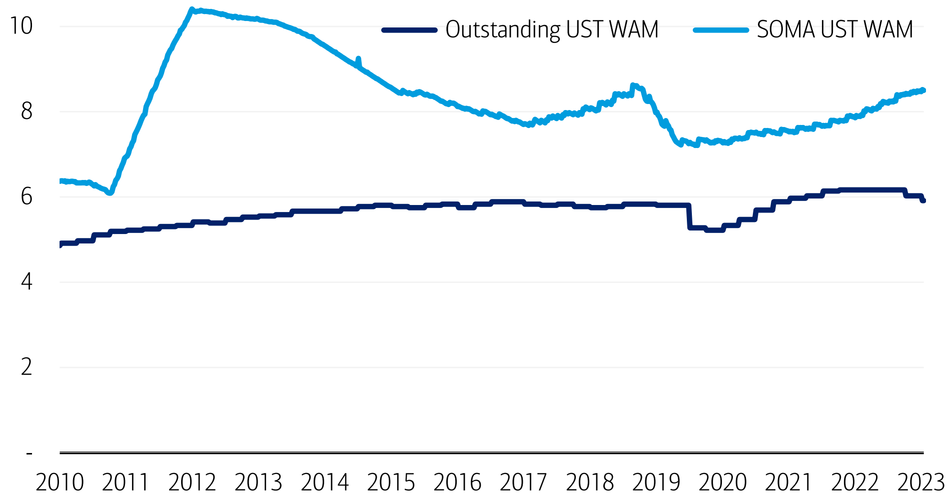
Exhibit 7: WAM of SOMA portfolio and outstanding UST debt
The small gap between SOMA UST WAM (8-8.5Y) and UST WAM (6Y) suggests Fed can invest at UST WAM and trust SOMA will pull towards market over time



Source: BofA Global Research, Federal Reserve, US Treasury

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