THE RATE AND CREDIT VIEW

The End (of QT) is Nigh

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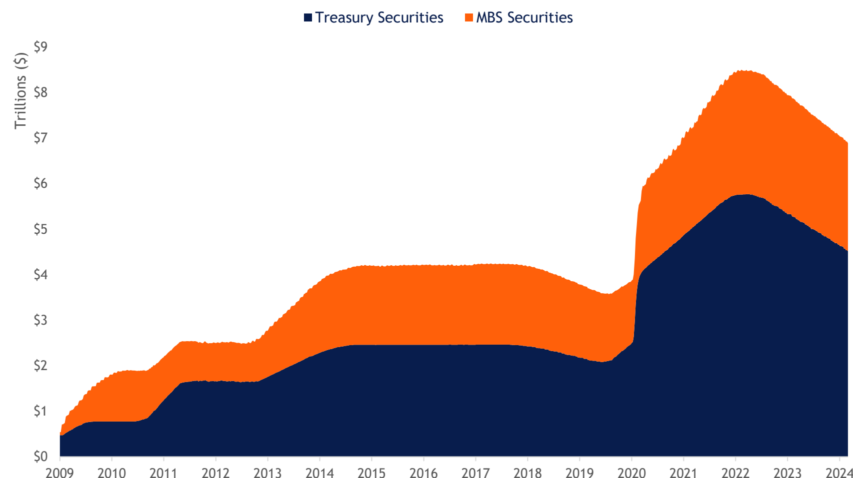
EXECUTIVE SUMMARY

- While the recent May Federal Reserve (Fed) meeting went largely as planned in terms of rate cuts, it did offer up a bit of a dovish surprise. The Fed announced that it intends to slow the pace of balance sheet runoff (aka quantitative tightening or just QT) starting June 1.
- Additionally, according to the recent "Annual Report on Market Operations" report, the Fed believes it can reduce its balance sheet to $6 to $6.5 trillion (from $6.9 trillion currently) before *expanding* its balance sheet in line with reserve growth.
- Further, the report states that the Fed would like the composition of its balance sheet to be primarily Treasury securities.
- Bottom line is that after the current portfolio reduction phase, which will likely be completed sometime next year, the Fed will continue to be a large buyer of Treasury securities, which will ultimately help support Treasury supply concerns.

"Going Slower to Go Further"

In an effort to drain excess amounts of liquidity in the financial system, the Fed has been slowly shrinking the size of its balance sheet. After peaking at $8.5 trillion, the Fed has been allowing up to $60 billion of Treasury bonds and $35 billion of mortgage-backed securities (MBS) to organically roll off its balance sheet. In line with the Fed's directives, balance sheet holdings of Treasuries and MBS decreased by $924 billion during 2023 and is more than $1.5 trillion lower than peak levels. The runoff of securities, which make up 94 percent of Fed's assets, drove the overall decrease in the balance sheet to the current $6.9 trillion level. The Fed's balance sheet is currently made up of roughly $4.5 trillion in Treasury securities and $2.4 trillion in MBS.

The Fed Has Shrunk its Balance Sheet by $1.5 Trillion



Source: LPL Research, Bloomberg, 05/07/24
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At the May Fed meeting though, the Fed said it will lower the monthly cap on the amount of Treasuries it will allow to mature without being reinvested, to $25 billion from $60 billion, while keeping the cap for MBS unchanged at $35 billion. The reduction in the Treasury cap is an attempt to slow the pace of reserve destruction – a step meant in part to ease the potential strain on short term funding markets. Fed Chairman Jerome Powell explicitly stated that the point of slowing balance sheet runoff is to potentially take the balance sheet to a lower level than otherwise could be possible at the current pace. Specifically, he stated the goal was to go slower to go further – a potential lesson learned from the last/only other time QT took place.

The Fed is attempting to stop balance sheet normalization when bank reserves go from "abundant" to "ample"— that is, when changes in the supply of reserves have a real but modest effect on short-term rates.

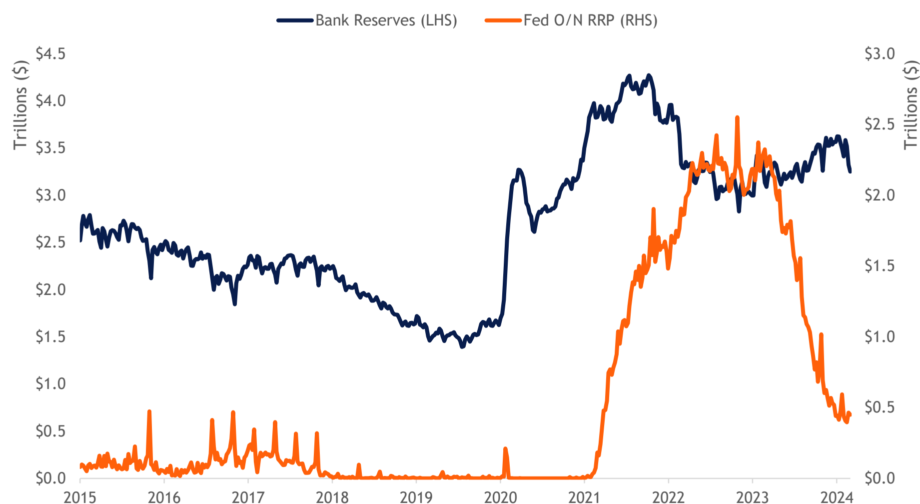
Lessons Learned

This section is fairly wonky but provides a roadmap, per se, of how and why the Fed is running down the size of its balance sheet and the liquidity that the Fed is trying to remove from the financial system.

There are two avenues in which liquidity is impacted by the Fed's balance sheet runoff: bank reserves and assets held at the Fed's overnight reverse repo facility (O/N RRP). Bank reserves represent the minimum amount of deposits a bank must have on hand. And when bank reserves fall below a certain threshold, bank lending is impaired. The Fed's O/N RRP facility allows certain money market funds to borrow from or lend to the Fed, using government securities as collateral, and agreeing to buy or sell back those securities at rates set by the Fed, on an overnight basis. This channel has very little impact on market liquidity.

The Fed is attempting to end balance sheet normalization when bank reserves go from "abundant" to "ample" — that is, when changes in the supply of reserves have a real but modest effect on short-term rates. Currently, most of the liquidity drain has come from the O/N RRP channel with very little impact on bank reserves, which has allowed the Fed to continue to withdrawal liquidity. However, as the O/N RRP approaches zero or close to zero, it's likely bank reserves will start to contract. And if history is a guide, reserves could contract quickly.

Fed is Watching Excess Liquidity Carefully



Source: LPL Research, Bloomberg, 05/07/24
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There is an uneven distribution of reserves that, in aggregate, could suggest liquidity is still abundant, but smaller and midsized banks could be closer to reserve scarcity.

The risk for the Fed is that bank reserves fall below levels deemed adequate, similar to what took place in 2019. Last time the Fed attempted to reduce the size of its balance sheet, it played a role in the abrupt disruption in the short-term funding markets. A number of events caused a 2019 spike in repo rates, according to an Office of Financial Research (OFR) Working Paper. On Sept. 17, 2019, intraday repo rates rose to more than 3% above the upper end of the federal funds target range. This was 30 times larger than the same spread during the preceding week.

The authors explain that the spike resulted in large part from a confluence of fundamental factors—large Treasury issuances, corporate tax deadlines, and an overall lower level of reserves. By mid-September 2019, aggregate reserves had declined to a multiyear low of less than $1.4 trillion while net Treasury positions held by primary dealers had reached an all-time high. As a result, the reserve constraints on banks and bank-affiliated dealers played a contributing role in the repo spike. The Fed quickly changed course and provided liquidity to shore up the repo market; however, the repo spike marked the end of the Fed's first attempt to reduce the size of its balance sheet. Fed officials are determined to be more careful this time around.

There are other risks as well. There is an uneven distribution of reserves that, in aggregate, could suggest liquidity is still abundant, but smaller and midsized banks could be closer to reserve scarcity. Banks have more options for funding than other market participants (the standing repo facility, the discount window, other Fed facilities). But that doesn't necessarily mean the banks will use them even when needed.

An All Treasury Portfolio Is Coming

Another big takeaway from recent pronouncements from the Fed is the desire to get its balance sheet to an all Treasury security portfolio. As mentioned, the Fed currently owns over $4.5 trillion in Treasury securities but also $2.4 trillion in MBS. Fed officials, however, would like the balance sheet to be primarily Treasury securities.

Recent comments and data releases suggest that the Fed wants the share of MBS holdings to decline from around 34 percent of the portfolio today to around 10 percent over the next decade. Moreover, during the upcoming portfolio maintenance and growth phases, all principal payments from MBS securities are to be reinvested into Treasury securities and principal payments from Treasury securities are reinvested into new Treasury securities at auction. When the portfolio resumes growth, reserves management purchases are conducted only in Treasury securities—consistent with the Committee's intention to return to a portfolio composed primarily of Treasury securities.

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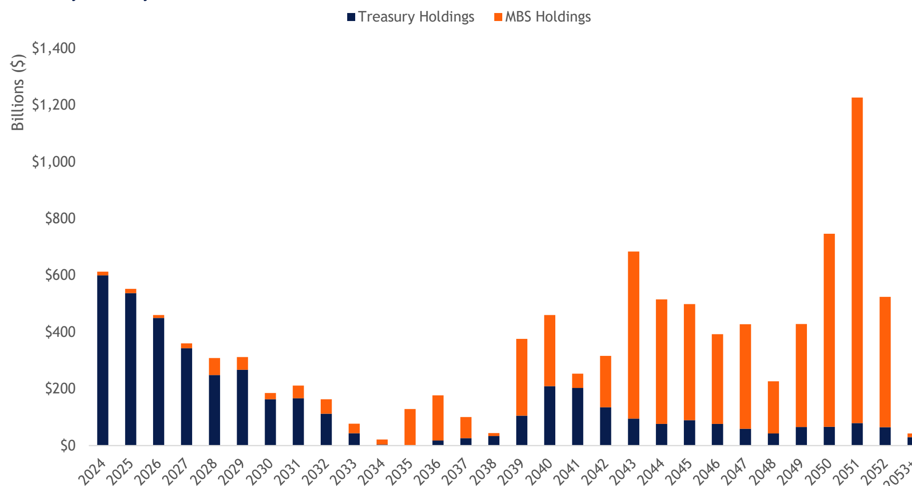
The Fed May Have to Sell Its MBS Holdings

Securities Held by Maturity Date



Source: LPL Research, Bloomberg, 05/07/24

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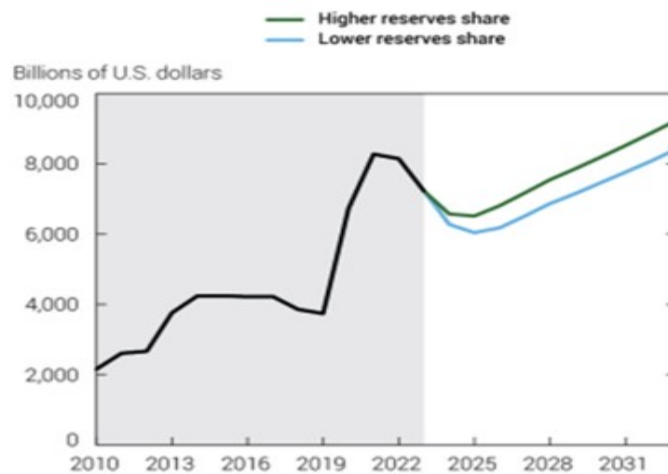
However, due to the meaningful increase in mortgage rates and the slow pace of prepayments, the composition of MBS holdings is primarily in longer maturity securities. As such, assuming the Fed wants to meaningfully reduce its MBS holdings, either a) mortgage rates will have to come down dramatically in order to entice existing home owners to abandon their low rate mortgages (mortgage rates tend to price off of the 10-year Treasury yield) or b) the Fed will have to outright sell MBS. While there has been no indication the Fed intends to sell its MBS holdings, the "higher for longer" narrative makes sales more likely. The good news for MBS investors? At current mortgage rates, new issuance has been benign so Fed sales would come at a time when there is a dearth of MBS paper in the market. Funds, banks and, potentially, foreign investors would likely be able to take down the sales without much of a market impact but risks remain and is likely why we continue to see spreads above historical averages.

What Comes Next?

Under either a higher reserve or lower reserve environment, the Fed's balance sheet is expected to plateau around the $6 to $6.5 trillion level before expanding to much higher levels than recent peak

While balance sheet normalization will likely take a year or two to finally play out, the Fed recently released its playbook on how the Fed's balance sheet will evolve over time. The Federal Reserve Bank of New York released its "Annual Report on Market Operations" report, which outlines past and potentially future operations regarding the balance sheet holdings. According to the report, the Fed believes it can reduce its balance sheet to $6 to $6.5 trillion (from $6.9 trillion currently) before further expanding its balance sheet in line with reserve growth. Under either a higher reserve or lower reserve environment, the Fed's balance sheet is expected to plateau around the $6 to $6.5 trillion level before expanding to much higher levels than recent peak levels, which should be supportive for markets. Of course, as the great philosopher Mike Tyson has noted "everyone has a plan until they get punched in the mouth," so an unexpected spike in the repo rate could scrap current plans altogether, causing the Fed to end balance sheet runoff abruptly.

Projected Fed Balance Sheet Holdings



Any economic forecasts set forth may not develop as predicted and are subject to change.

What Does This Mean for Investors?

Bottom line is that after the current portfolio reduction phase, which will likely be completed sometime next year, the Fed will continue to be a large buyer of Treasury securities, which will ultimately help support Treasury supply

While it's hard to make a case that the Fed's balance sheet normalization has had any impact on markets, there remains a risk that the Fed will take reserves down to levels that disrupt short-term funding markets à la 2019. In the interim though, given the excess amount of liquidity, markets (and bank lending) have continued to operate in an excess liquidity environment, which has been the Fed's goal. So… so far, so good. As the Fed has hoped for, balance sheet runoff has been tantamount to watching paint dry.

The increase in Treasury yields over the last few years has been a direct result of the Fed's primary monetary policy tool – increases in the fed funds rate – and not likely due to balance sheet normalization. Though, there has been many concerns regarding the amount of Treasury supply coming to market at the same time the Fed and other large Treasury buyers are reducing their footprint in the Treasury market. So, with the recent decision to slow the pace of Treasury runoff and then potentially grow its balance sheet by only owning Treasury securities, the Fed will likely be a big buyer of Treasuries again. Bottom line is that after the current portfolio reduction phase, which will likely be completed sometime next year, the Fed will continue to be a large buyer of Treasury securities, which will ultimately help support Treasury supply concerns.

That said, and as mentioned in the September *Rate and Credit View* (here), America has a debt problem. With budget deficits expected for the foreseeable future, the amount of Treasury supply is expected to increase over the next decade, which means demand will need to increase as well. While the Fed can likely be a buyer of considerable scale, the Treasury Department will need to find alternate sources of demand, which means yields will have to stay around current levels to attract more price-sensitive demand.

The current increase in supply will occur amid a backdrop of slowing inflation and expectations of Fed rate cuts later this year. Investors might require some concessions to digest the larger issues, but the improved outlook for rates this year should attract some additional demand from the sidelines.

As such, with the economic data (so far) continuing to reflect a more resilient economy than originally expected, we think Treasury yields are likely going to stay in a trading range at least in the near term. And despite the ongoing supply discussion, we think the 10-year Treasury yield could end the year in the 3.75% and 4.25% range as the Fed gets more comfortable with the (expected) slowing of inflation data.

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The Standard & Poor's 500 Index (S&P500) is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

Please read the full *Outlook 2024: A Turning Point* publication for additional description and disclosure.

A mortgage-backed security (MBS) is a type of asset-backed security that is secured by a mortgage, or more commonly a collection ("pool") of sometimes hundreds of mortgages. The mortgages are sold to a financial institution (a government agency or investment bank) that "securitizes", or packages, the loans together into a security that can be sold to investors. The structure of the MBS may be known as "pass-through", where the interest and principal payments from the borrower or homebuyer pass through it to the MBS holder, or it may be more complex, made up of a pool of other MBSs.

Floating rate bank loans are loans issues by below investment grade companies for short term funding purposes with higher yield than short term debt and involve risk.

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High yield/junk bonds (grade BB or below) are not investment grade securities, and are subject to higher interest rate, credit, and liquidity risks than those graded BBB and above. They generally should be part of a diversified portfolio for sophisticated investors.

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Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) is essentially net income with interest, taxes, depreciation, and amortization added back to it, and can be used to analyze and compare profitability between companies and industries because it eliminates the effects of financing and accounting decisions.

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