Part Two

QT or Not QT?

MACRO STRATEGY | March 18, 2025

Changing the Composition of the SOMA Portfolio

- As the Federal Reserve's balance sheet normalizes, an important step will be to structure the SOMA portfolio to more closely match the composition of outstanding Treasury debt.
- All else equal, this suggests a Fed-driven steepener if we assume an optimal SOMA portfolio size of approximately $5 trillion
- We do not believe the debt ceiling debate will delay the normalization process

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In the previous part of "QT or not QT" we discussed how the Federal Reserve balance sheet needs to change as it approached an optimal level. The final step, discussed by participants in the most recent Federal Open Market Committee (FOMC) meeting, is to structure securities purchases in a way that would move the composition of the SOMA portfolio closer to the composition of outstanding Treasury debt. What would that mean for the current portfolio?

The Composition of US Treasury Holdings in the SOMA

The table below, which shows the current composition of outstanding Treasury debt compared to the composition of the SOMA portfolio, indicates that the Federal Reserve is overweight in longer-duration bonds and underweight in shorter-duration bills and notes.

If we use the optimal portfolio size of ~$5 trillion (and the absence of any Agency holdings) as we did in our prior piece, the Fed will have to buy $1.4 trillion of shorter duration notes while rolling off $350 billion of longer-duration bonds.

All else equal, the composition change implies a steepening of the curve driven by the Fed's need for shorter-term instruments to align with the expected structure of the overall Treasury market.

		Bills	Notes	Bonds	TIPS	FRNs	Total
Total Outstanding[1]	USD	$1,134	$13,924	$4,886	$1,962	$558	$22,465
	Share	5.0%	62.0%	21.8%	8.7%	2.5%	100.0%
SOMA Portfolio[2]	USD	$66	$1,930	$1,511	$312	$8	$3,827
	Share	1.7%	50.4%	39.5%	8.1%	0.2%	100.0%
Ideal Portfolio	USD	$270	$3,321	$1,165	$468	$133	$5,358
	Share	5.0%	62.0%	21.8%	8.7%	2.5%	100.0%
Difference	**USD**	**$204**	**$1,391**	**-$345**	**$156**	**$125**	**$1,531**

1 February 2025 Monthly Statement of Public Debt. Unmatured securities outstanding with maturity dates after 6/30/2025
2 Domestic non-agency security holdings as of March 5, 2025, with maturity dates after 6/30/2025
Dollar values in billions
Source: Federal Reserve, U.S. Treasury, MIM. As of 3/14/2025.

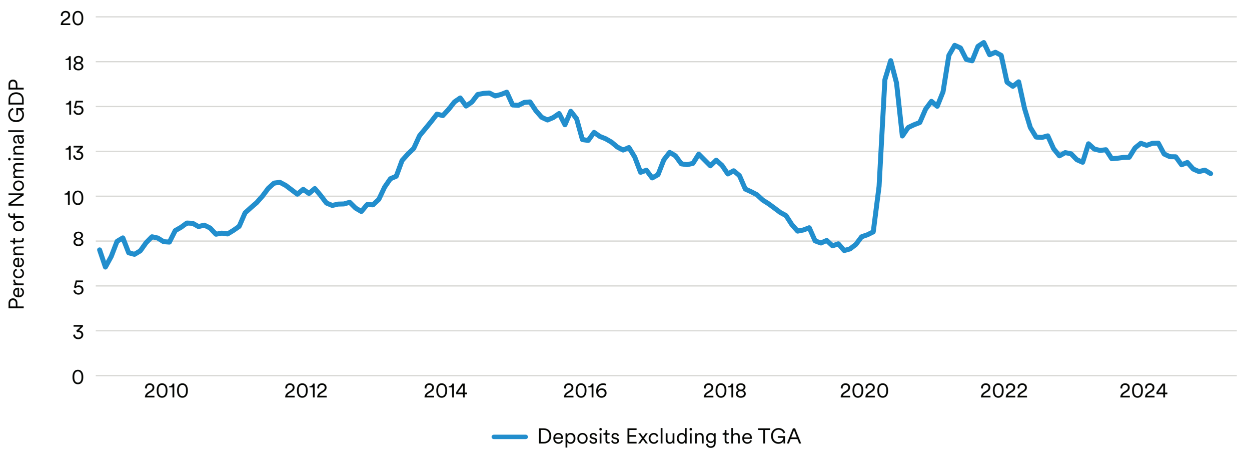
The Timing of Normalization

The Open Market Desk's January Survey of Market Expectations showed that the median expectation for the end of quantitative tightening (QT) was in June or July of this year. Some FOMC participants noted that timing could be delayed if debt ceiling issues cause large swings in reserves over the coming months, and it may be prudent to consider pausing QT until any debt crisis is resolved to avoid reserves falling below acceptable levels. Hitting the debt ceiling would require the Treasury to spend out of the general account (TGA) and curb bill issuance, essentially injecting reserves into the banking system. Once the crisis is resolved, restarting bill issuance would reverse the effect and cause a potentially rapid decline in liquidity.

While certainly a concern, we believe the Fed will not have to curb QT for a few reasons:

1. The Fed did not have to slow the pace of QT during the 2023 debt crisis.
2. Single-party control of the executive branch as well as both bodies of Congress make a debt ceiling crisis less likely this year.
3. Reserves (as a share of GDP) remain reasonable. While they are not as high as the mid-2010s or post-pandemic, they are higher than they were in 2019 when the Fed did have to pause QT.

Banking Reserves Are Still at Reasonable Levels



Source: Federal Reserve, U.S. Bureau of Economic Analysis (BEA), MIM. As of 3/14/2025.

Economic shocks coming from trade, immigration, or fiscal policy are just as, if not more likely to cause disruption in the Fed's QT plans. Our base case is for near-term uncertainty to give way to medium-term growth, allowing the balance sheet normalization process to continue.

Author

SHAN AHMED
Associate, Global Economic & Market Strategy

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