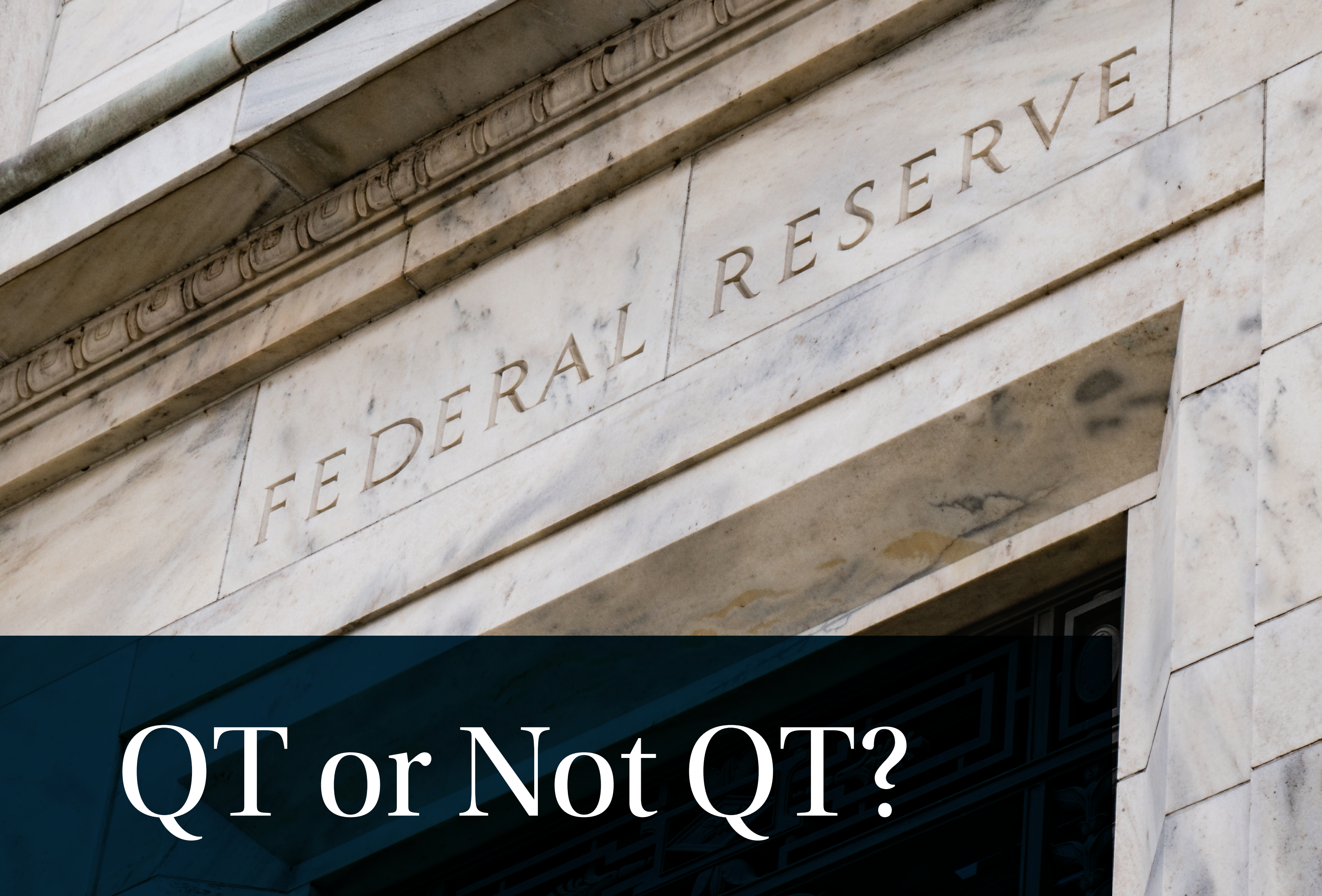


QT or Not QT?

MACRO STRATEGY | November 26, 2024

Key Takeaways

- The Federal Reserve's balance sheet is too large relative to pre-COVID levels and still needs to see a significant reduction in size to limit the scale of excess liquidity.
- Despite the reduction in policy rates, the Federal Reserve has continued Quantitative Tightening, bringing forward the date when the Federal Reserve will need to adjust the composition of their securities portfolio.
- Once the correct portfolio size is reached in 2025, the next stage will be to transition toward a Treasury-only portfolio and to shorten the average duration over time.
- The composition of the portfolio directly impacts the amount of inflationary pressure created by the balance sheet. It is not just the size, but also the composition that matters to the outlook.

MetLife Investment Management

Rightsizing the Fed's Balance Sheet

Against the aggressive expansion of the balance sheet in response to the COVID pandemic, the Federal Reserve expanded its balance sheet from $4.1 trillion, or 18.8% of GDP, to a peak of $9.0 trillion, or 35.6% of GDP, in Q1 2022. This is nearly double the pre-COVID level, which was already elevated relative to the balance sheet seen in the wake of the Great Financial Crisis.

The Federal Reserve has been shrinking its balance sheet, or conducting "Quantitative Tightening" (QT), since Q2 2022 and, over that time, has reduced the balance sheet by $1.9 trillion, reducing the balance sheet as a percentage of GDP to 24.8%, still well above the 2019 level.

How much further does the balance sheet need to shrink?

How much further the balance sheet needs to shrink is a question that requires an explanation of what the Federal Reserve's balance sheet is used for in the first place. Simply put, the balance sheet is the asset backing the dollar. The math can be seen in the table below with the assets of the Federal Reserve comprising their holdings of securities in what is known as the "System Open Market Account" (SOMA), loans to banks via repurchase agreements or other loan types, loans to other central banks, gold, claims on the International Monetary Fund and currency holdings. The liabilities are currency, borrowings from banks, the Treasury General Account which can be thought of as the Treasury's checking account, and other factors. How each of these have evolved and the announced goals for the structure of the balance sheet offer insight into the final size of the balance sheet.

Federal Reserve Balance Sheet Detail*

$ billions	Dec-19	Mar-22	Oct-24	Change	Optimal	Difference
	Pre-COVID	Peak	Current			
Supplying Total	4,127	8,986	**7,064**	2,937	6,108	-956
SOMA Portfolio	3,751	8,555	**6,626**	2,875	5,760	-866
Treasuries	2,329	5,760	**4,358**	2,029	5,758	1,400
Agencies	2	79	**2**	0	2	0
MBS	1,420	2,715	**2,266**	846	0	-2,266
Amortization (net)	112	323	**231**	119	231	0
Repurchase agreements	235	0	**0**	-235	0	0
Term Credit + Loans	0	24	**72**	72	0	-72
Float + other + swaps	29	36	**43**	14	43	0
Gold + SDR	16	16	**21**	5	21	0
Currency	50	51	**53**	3	53	0
Absorbing Total	2,566	5,212	**3,848**	1,282	3,800	-48
Currency	1,802	2,268	**2,357**	554	2,450	93
Reverse RP	254	2,041	**627**	374	400	-227
TGA	352	557	**847**	495	850	3
Other + Capital	158	346	**17**	-141	100	83
Excess Reserves	1,561	3,773	**3,216**	1,654	2,308	-908

* "Difference is "Optimal" less "Oct-24". Change is "Oct-24" less "Dec-19" (i.e. pre-COVID).
Source: Federal Reserve and MIM

Since the balance sheet supports the liabilities of the Federal Reserve, it is useful to start there and see how those liabilities have evolved over time to determine how many assets must be held against them.

- **Currency:** The amount of currency outstanding has grown from $1.8 trillion to $2.4 trillion. The additional $554 billion outstanding suggests that, all else equal, the balance sheet would need to be at least $554 billion larger as, once cash is printed and distributed, it is difficult to reduce this segment. Currency outstanding should also grow naturally over time, so we assume an additional $100 billion in currency when the balance sheet reaches its optimal level.
- **Reverse repurchase agreements:** Pre-COVID, this category represented just $254 billion of liabilities, which was almost entirely the result of a cash-parking service for foreign governments. The program evolved to act as an absorption tool for excess banking system reserves and ballooned up to as high as $2.6 trillion. As of October 2024, it stands at $627 billion, of which $398 billion is for cash management on behalf of foreign governments. If this segment is returned to its traditional role, the overall level of usage should just be only $100-$200 billion higher than seen in 2019, we assume a level roughly $150 billion higher.
- **Treasury General Account (TGA):** The cash management tool for the US government and, as such, is not something subject to change via policy by the Federal Reserve. Its current level is almost $850 billion, which although a bit high is within the two-quarter range suggested by the Treasury Department at the most recent quarterly refunding. The figure is more than double the $350 billion level seen pre-COVID.
- **Other and Federal Reserve capital:** Not set by Federal Reserve policy and should be assumed to be roughly $100 billion.

On net, these liabilities and an expected normalization of tools used to manage the balance sheet would suggest that the assets held by the Federal Reserve could decline by a further $1.0 trillion. That would put excess reserves in the banking system (the difference between the asset and liability sides of the Federal Reserve's balance sheet) at 7.5% of nominal GDP, the level seen immediately pre-COVID. (For historical reference, the excess reserves in the banking system prior to the GFC vacillated around 0.1% of nominal GDP). The vast majority of this reduction would need to be the result of maturities in the SOMA portfolio, specifically (in the long run), a significant reduction of mortgage-backed securities (MBS) holdings on the balance sheet.

How Does the Balance Sheet Need to Change as it Approaches an Optimal Level?

The answer is significant and will impact different asset classes, the shape of the Treasury yield curve and the amount of stimulus that is newly created each month by the ongoing rollover of a too-large balance sheet.

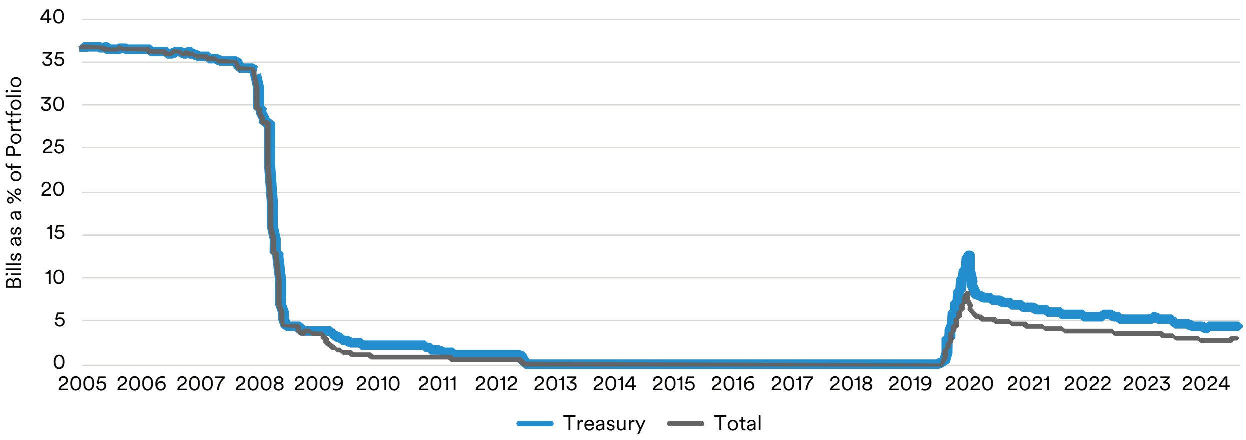
As noted, the table above suggests that the securities portfolio of the balance sheet needs to shrink by roughly $900 billion to reduce the overall level of excess reserves by $1.0 trillion. However, within that shrinkage figure is a $2.3 trillion reduction in mortgage-backed securities (MBS) holdings and a $1.4 trillion increase in Treasury Securities as the Federal Reserve moves towards its espoused goal of a "primarily Treasury securities" portfolio. As this shift occurs, we would also anticipate a shift toward normalizing the composition of the Treasury holdings by rebuilding the Treasury Bill portfolio to the ratio that existed in 2019 or even pre-Great Financial Crisis (GFC).

Treasury Bills had previously accounted for a substantial portion of the "System Open Market Account" (SOMA) portfolio. At year-end 2007, prior to the GFC, Treasury Bills accounted for $242 billion, or 32.1% of the total Treasury debt held by the Federal Reserve and, since the portfolio was Treasury-only, the same percentage of the SOMA portfolio. Prior to COVID, in December 2019 bill holdings were $170 billion, or 7.3% of Treasury holdings, or 4.5% of the expanded portfolio. Currently (as of October 2024), that figure had risen to $195 billion but that represents just 4.5% of the Treasury portfolio and just 2.9% of the SOMA portfolio.

A portfolio comprised entirely of 10-year Treasury notes is not only more stimulative to the economy on an ongoing basis than a Treasury Bill-only portfolio would be (hence "Operation Twist"*), it is also more rooted and less easy to adjust to evolving economic conditions given that, by definition, the holdings roll off more slowly and, as they do, maturing debt proceeds continue to be pushed into higher risk-duration securities. In contrast, a Treasury Bill-only portfolio does not provide the same absorption of risk duration while also providing the Federal Reserve with the option of tightening policy via balance sheet reduction without a corresponding coupon sale program.

* Operation Twist refers to the policy undertaken by the Federal Reserve in 2011 to lengthen the duration of their Treasury Securities portfolio. The Federal Reserve undertook sales of Treasuries with maturities of less than three years to purchase securities with maturities of between six and thirty years.

Treasury Bills as a % of Federal Reserve's SOMA Portfolio



Source: Federal Reserve and MIM

Returning to pre-COVID norms of 7.3% would, in the absence of MBS, mean more than doubling Treasury Bill holdings to $420 billion or that the Treasury-only portfolio expansion of $1.4 trillion required by the elimination of MBS holdings would boost Fed holdings of coupons by $1.2 trillion and bills by roughly $200 billion. Moving back to pre-GFC bill holding levels, which we view as ideal, would require the entire MBS-driven Treasury expansion of $1.4 trillion in additional to a further Operation "Untwist" of $250 billion.

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