US Rates Strategy

Joseph Abate, US Rates Strategy joseph.abate@smbcnikko-si.com 1 212 893-1592

October 27, 2025

After QT: The case for bills

With QT soon ending, the Fed will turn its focus toward the optimal size and composition of its securities portfolio. We expect the Fed will increase its bill holdings but how quickly and how bill heavy it wishes to make the portfolio may be determined at this week's FOMC meeting.

- A strong case can be made for increasing the Fed's bill holdings which are currently less than 5% of its Treasury portfolio. **More bills would increase the Fed's operational flexibility and reduce the portfolio's influence on market rates outside of QE**.

- But a bill-heavier portfolio will also mean that the market must absorb more term debt. Assuming no changes in Treasury issuance, this might increase term premia by as much as 80bp over time.[1]

- We expect the Fed will initially invest all its MBS roll-offs as well as its reserve maintenance and other liability-offsetting purchases in bills. This will require annual secondary bill market purchases of $300-350bn/y through 2029 when we think it could reach "bill neutrality".

- **The Fed's purchases of bills could help the Treasury delay increasing coupon auction sizes without causing bill yields to rise significantly.** But the effect on yields is temporary because we expect the Fed to return to market neutral purchases once its portfolio WAM has normalized.

Past policy

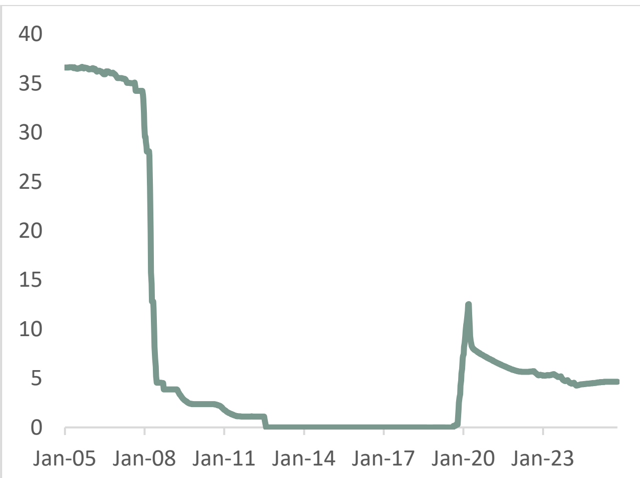
Before the financial crisis, the Fed's System Open Market Account (SOMA) portfolio held more bills than it currently does (Figure 1). In the early stages of the crisis, the Fed sold off most of its bill holdings to finance some of its liquidity programs. After launching QE, the Fed experimented with maturity extension purchases (MEP) to bring long-term interest rates lower once the fed funds rate was at the zero lower bound. Beginning in September 2011, it "twisted" the maturity of the SOMA – selling $660bn in short maturity paper (<3y) and replacing it with purchases of debt with 6 to 30 years remaining maturity. MEP successfully lowered term interest rates and flattened the yield curve.

[1] See, "Transitioning to the Long-run Composition of the SOMA Portfolio: A Preliminary Analysis", FOMC preparation material, April 19, 2019.

Why more bills?

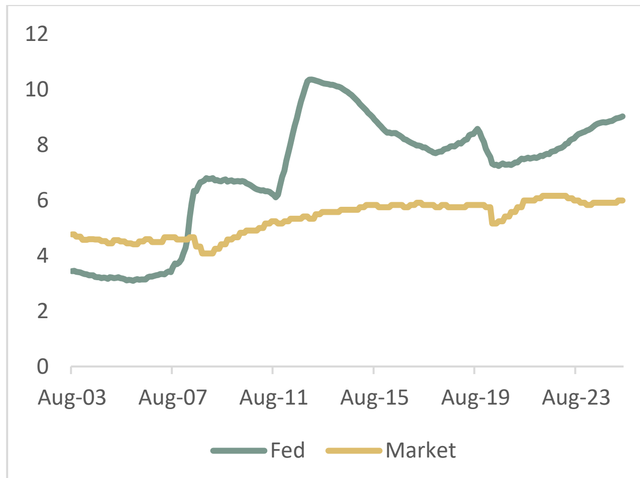
In theory, the Fed's portfolio should have a maturity composition that roughly matches the overall market. A market neutral portfolio in which the WAM of the SOMA matches the overall Treasury market would have little effect on market rates. However, after several rounds of QE meant to bring down long term interest rates, the SOMA WAM is about 3y longer than the overall Treasury market (Figure 2). **But how quickly should the Fed return to a market neutral portfolio?**

Figure 1: Bill share (% TSYs in SOMA)



Source: Federal Reserve, SMBC Nikko

Figure 2: SOMA and Treasury market WAM (y)



Source: Federal Reserve, US Treasury, SMBC Nikko

Operationally, there may be benefits to a bill-heavier SOMA portfolio – one where the bill share is above the prevailing market level. A bill-heavier SOMA portfolio increases the Fed's policy flexibility. In addition to balance sheet expansion (QE)**, with more bills the Fed has more flexibility to twist**. Similarly, a bill-heavier portfolio also **reduces the potential for negative Fed earnings as the maturity of its assets more closely matches that of its liabilities**. Bank reserves, balances in the RRP, and the Treasury's deposit have same day maturities. Currency technically has no maturity as it is not redeemable into anything other than currency.

Negative earnings may be less significant to an institution that can create money. Nonetheless, they attract political scrutiny about QE and the payment of IORB and RRP interest. The Fed remits its portfolio earnings to the Treasury after deducting its operating expenses. When these earnings are negative (as has been the case since 2023) the Fed suspends them until it can earn them back from future portfolio earnings. All things equal, the Treasury needs to issue more debt to account for the absence of its Fed revenue. Our sense is that this earnings suspension period may continue for a few more years. But, over the long run, as term interest rates are normally higher than overnight rates, the Fed's portfolio is "profitable".

But a bill heavier SOMA has costs. Assuming no change in the Treasury's issuance profile, **a shorter-maturity SOMA would leave more longer-duration securities for the market to digest**. In turn, this would mean higher term premia. In 2019, when the Fed explored its optimal portfolio composition, it estimated that a bill-heavy portfolio (where bills are about 1/3 of the SOMA) would increase the 10y term premium by about 25bp immediately upon announcement of the policy and about 80bp cumulative as the portfolio adjusts to the bill target share.[2] To counteract this effect, the Fed would need to lower the fed funds rate by roughly the same amount. This reduces the scope – or policy room – for future rate cuts as the Fed would normally be closer to the zero lower bound.

It also reduces the available supply of safe, government-issued, short-term money-like instruments for investors. Instead, these investors must buy private sector substitutes such as repo and CP which are less liquid in a crisis.[3] While this exacerbated the financial crisis, we are not sure how relevant it is now with the introduction of the RRP in 2013.[4]

Getting there

Assuming the Fed still favors a market neutral portfolio, how long might it take for its bill holdings to increase to 22%? The Fed's 2019 study examined two paths toward a market neutral portfolio. Under the slower path, the Fed would direct its open (secondary) market purchases to a market neutral mix of Treasury maturities. The fast path assumed that all the Fed's open market purchases are in bills until the SOMA reaches WAM neutrality. We consider this path as this seems to be the approach favored by (some) FOMC officials.[5]

Once QT ends, we expect the Fed will stabilize the SOMA portfolio by reinvesting its maturing MBS securities into bills. For simplicity, we assume that the Fed does not sell any of its MBS holdings and that the current monthly pace of roll-offs remains unchanged.[6] But merely stabilizing the SOMA will mean that bank reserves continue to edge lower as the demand for currency increases and the Treasury's cash balance rises.

While we do not think reserves are currently scarce – balances are 12.5% of bank assets – they will become *scarcer* if the Fed does not offset the growth of its other liabilities (Figure 3). Our sense is that the Fed would like to "glide" into its target reserve level guided by the spread between overnight rates and IORB. As a result, it may wait for reserves to edge closer to 12% of bank assets before beginning offsetting currency and Treasury account purchases. **That said, the recent pressure in repo rates could encourage the Fed to begin these purchases *immediately* upon ending QT**. We expect all these open market purchases will be in the secondary bill market regardless of when they begin.

Offsetting cash and the TGA, however, will only keep the absolute level of reserves steady. But banks' demand for reserves increases with their asset growth. As a result, the Fed's balance sheet will need to expand. **For simplicity, we assume that banks wish to maintain a constant 12% ratio between their cash balances at the Fed and their total assets and that their reserve maintenance purchases begin in January 2027 although these may start earlier depending on market rates**. Our

---

[2] FOMC presentation material April 2019.
[3] There is a lengthy literature on the supply of safe assets. With respect to the Fed's bill holdings see, "Considerations for the Longer-run Maturity Composition of the Federal Reserve's Treasury Portfolio", R. Sengupta and A. Lee Smith, Federal Reserve Bank of Kansas City, August 28, 2024.
[4] Of course, not all investors have access to the Fed's program. Those that do not must buy bills at rates below the RRP, raising the potential for negative market rates when policy rates are at the zero lower bound.
[5] Notably, Fed Governor Waller and Dallas Federal Reserve President Logan. See, "Efficient and Effective Central Bank Balance Sheets", L. Logan, Federal Reserve Bank of Dallas, February 25, 2025.
[6] Obviously, this is sensitive to the level of interest rates and home sales. Assuming the Fed doesn't re-test the zero lower bound causing an acceleration of pre-payments, the Fed's SOMA might not be "MBS-free" until early 2036.

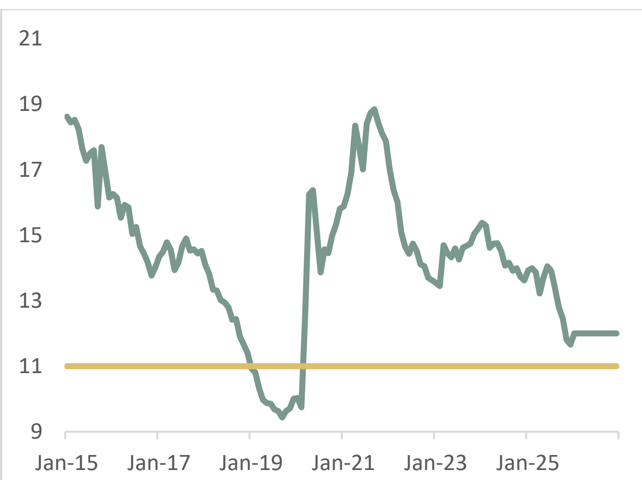
12% assumption is a guess as banks' demand for reserves has increased over time. It is possible for the Fed to reduce their demand by making it easier for banks to monetize their Treasury holdings in a crisis. But banks need to be willing and prepared to use either the SRF or the discount window. Not all banks have applied for access to the SRF while the discount window is available to all. Banks have been encouraged to improve their discount window readiness since the SIVB failure by increasing the amount of pre-placed pledgeable collateral at the Fed. Since 2023, this has increased from $1trn to $3trn. Recent frequent (though small)[7] use of the SRF at narrower spreads between the program's minimum bid rate and market rates suggests that much of the program's stigma has disappeared.

If we assume that bank assets grow at 2.0 and 2.5%/yr in 2026 and 2027 as the economy slows, the level of bank reserves will hold around $3trn in 2026 and reach $3.1trn in 2027. After 2028, we assume bank assets grow 5%/y which is close to their long-run historical average. Reserves reach $3.3trn and $3.4trn in 2028 and 2029, respectively.

We expect that these reserve maintenance purchases will be invested in bills until the Fed's WAM matches the market. This is a little aggressive as the Fed can normalize its portfolio WAM by also increasing its secondary market purchases of short-maturity coupons (although the normalization would proceed at a slower pace). That said**, *if* the Fed directs all its reserve maintenance and offsetting currency/Treasury purchases into bills, it would reach "bill neutrality" in 2029 (22.5%)**. This requires between $300-350bn in secondary market bill purchases annually over the period.

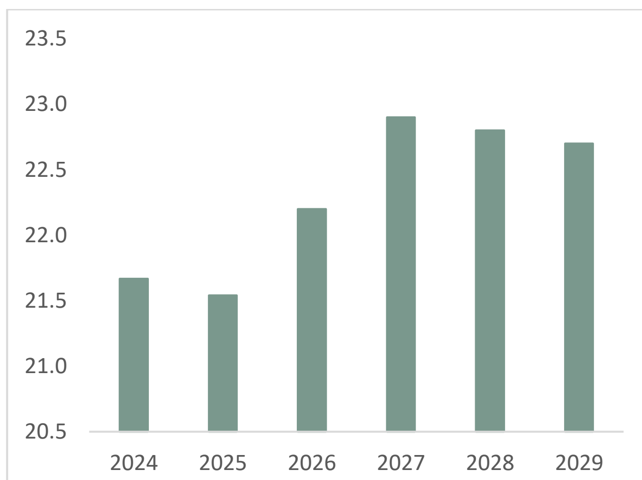
Of course, this is a static analysis as we assume no change in the Treasury's issuance patterns. As the deficit grows, the Treasury's issuance needs will also increase. We expect it will delay increasing coupon auction sizes next year while making up the difference through as much at $650bn in new bill supply. This would bring the bill share of outstanding debt to 22.2% (Figure 4). We expect small coupon increases and heavier bill supply could push the ratio to 22.9% in 2027.

Figure 3: Reserves (% assets)



Source: Federal Reserve, SMBC Nikko

Figure 4: Estimated bill supply (% debt)



Source: US Treasury, SMBC Nikko

[7] Under $10bn.

But the Treasury might delay increasing coupon auction sizes for longer. Alternatively, it might attempt a twist of its own – trimming (or maintaining) term coupon auction sizes and replacing the difference with bills. **In either case, the Fed's secondary market purchases could offset a significant portion of the Treasury's annual bill issuance and could help suppress bill yields**. As bills and repo are close substitutes for money funds, these purchases could also dampen secured funding rates. But this effect may only last a couple of years; once the Fed's portfolio WAM has normalized, we expect its secondary purchases will broaden out across all maturities.

.