The Fed’s Best Laid Plans

Quantitative tightening (QT) is draining liquidity from the financial system. Approximately $80 billion of securities have been rolling off the Fed’s balance sheet each month. Since peaking at $8.5 trillion in May 2022, the Fed’s combined treasury and mortgage-backed securities holdings are down to $7.5 trillion. Further declines are coming at least in the near-term.

The Fed has stated it wants its total securities holdings as a share of GDP to return to its pre-Covid level of around 20% of GDP, down from around 30% at present. This suggests that another $2 trillion roll-off is in the offing over the next couple of years. Normally, this would be negative for risk assets, but the reverse repo facility (RRP) is providing a near one-for-one offset.

Over the last five months there has been a $900 billion decline in the reverse repo facility (RRP) from $2.7 trillion to the $1.8 trillion at present. Since RRP balances were around $300 billion prior to the pandemic, there is potentially another $1.5 trillion in liquidity that effectively can be added to the financial system over the next 18 months. This would mute the negative effects of QT and keep asset prices higher than they otherwise would be. However, there is another factor to consider: Burgeoning marketable Treasury supply in response to record-large budget deficits.

This year’s budget deficit totaled $1.7 trillion, up from $1.4 trillion last year, and longer-term CBO projections show a further worsening in the government’s finances. Budget deficits relative to GDP will remain around an unprecedented 6%, if not larger, for the foreseeable future. And if there is a recession, deficits will be even larger because there will be a collapse in tax revenues while at the same time there will be tremendous political pressure to increase federal spending to thwart recessionary forces. But the political pressure will not end there.

There also will be tremendous political pressure on the Fed to fund these deficits via renewed QE. Consequently, the Fed may have a difficult time justifying continued QT while at the same time cutting interest rates in response to falling inflation and a weaker economy. Stay tuned.

Sources: Federal Reserve, Haver, SMBC Nikko
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