

January 9, 2024

Fed QT Discussion Begins

FOMC Meeting Minutes, Logan Speech Put QT In The Spotlight

- Month- and year-end repo strains put QT pace under discussion
- RRP drain means liquidity could become scarcer sooner
- We see a roll back in pace of QT between March and June
- iFlow shows long duration trade in USTs morphing into "buy everything" trade

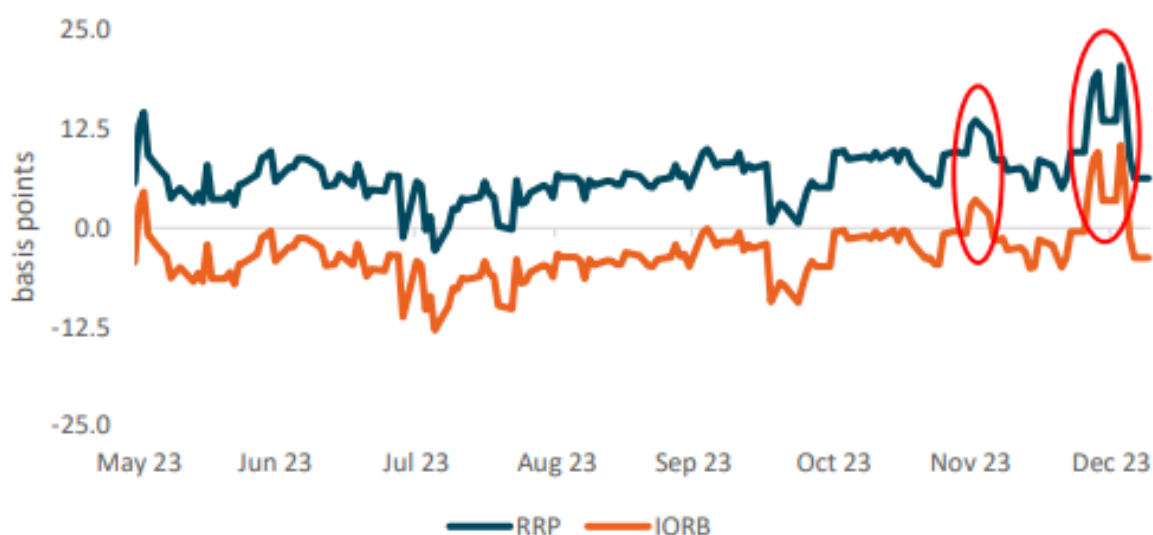
Pace Of QT To Come Under Scrutiny

Before we went temporarily dark ahead of the holidays, our [final piece of 2023](#) presented a reconsideration of the Federal Reserve's quantitative tightening (QT) program. We argued that although we previously had been of the view that QT would continue apace well in 2024, we were mindful of the risk that reserve scarcity could develop sooner than we had initially anticipated (see [this piece](#) from early November, for example), requiring some slowing – or even an outright cessation – of balance reduction.

The subtle change in view between early November and mid-December was motivated at the time by stresses in the repo market, coinciding with November month-end, when repo rates rose well above their recent historical levels. Another funding squeeze developed at year-end, with repo rates and take-up surging, although they have stabilized somewhat since the turn of the year. Nevertheless, even though the jumps in repo rates were short-lived and occurred near month- and year-end, the price action suggests that there may be bottlenecks in interbank liquidity and banks' desire to maintain reserves somewhat above their lowest comfortable level.

Repo Rates Spike In November & December

GC repo spreads over administered rates



Source: BNY Mellon Markets, Bloomberg

The Fed hasn't been blind to these developments, of course, and appears ready to think about discussing the balance sheet roll off more fulsomely. The first sign of this arose in the minutes to the December FOMC meeting published on Jan. 3. In an unexpected passage, the minutes pointed out that "several" participants suggested that "it would be appropriate for the Committee to begin to discuss the technical factors that would guide a decision to slow the pace of runoff well before such a decision was reached in order to provide appropriate advance notice to the public."

This past weekend, the same topic came up in a speech by Dallas Fed President Logan. She mused that, "The emergence of typical month-end pressures suggests we're no longer in a regime where liquidity is super abundant and always in excess supply for everyone." Furthermore, she stated that given the current rapid shrinkage of the Fed's overnight reverse repo facility (RRP), "it's appropriate to consider the parameters that will guide a decision to slow the runoff of our assets. In my view, we should slow the pace of runoff as ON RRP balances approach a low level." The time has come, it appears, for the Fed to begin thinking about tapering QT runoff.

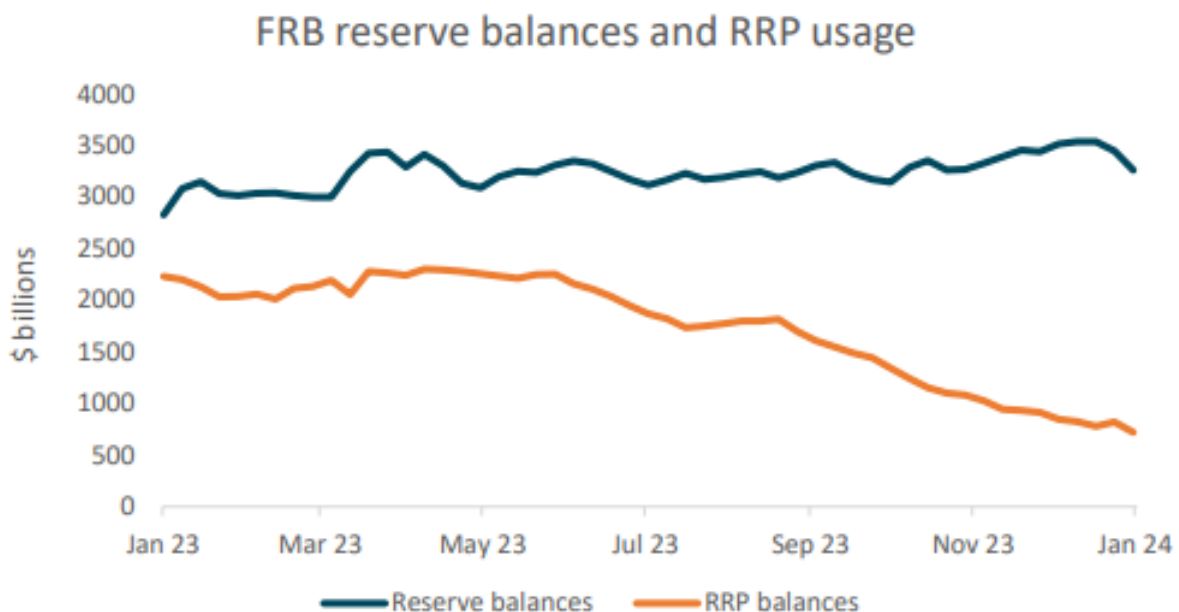
Logan's point about the RRP facility is especially salient. In the past, Fed officials – in particular, Chair Powell – had expressed comfort both in the absolute level of reserves in the banking system as well as the role that elevated (at the time) RRP balances played in keeping liquidity sufficiently high. However, the RRP facility is down by approximately \$1.5trn from last summer's highs, now to about \$700bn. Our own view is that RRP balances will duck under \$500bn by March and below \$200bn by May. The buffers are being eroded.

In addition, Logan advanced the idea that while overall bank reserves are still comfortable above \$3trn, the distribution of reserves amongst banks might not be uniform, and that “individual banks can approach scarcity before the system as a whole,” thus requiring the system to redistribute liquidity to potentially stressed banks.

There is no obvious answer to the question of when these scarcities will become apparent or at what levels reserves cease being abundant and approach merely ample. Furthermore, visibility on which – if any – banks could approach scarcity sooner than the system as a whole is lacking. Hence, timing the beginning of a reduction in QT is a moving target. We note that while still above \$3trn, bank reserves during December fell from a recent high of \$3.5trn to just over \$3.25trn. If our expectations around RRP drainage are close to reality, we would pinpoint sometime between March and May.

In our recent *Macro Morning Briefing* (see [here](#)), we revised our Fed rate cut view, bringing it forward from this summer to March, or at the outside May. Coincidentally, that is around the same time we reckon that the pace of QT could be reduced. These are separate policy actions, and the QT debate is less about monetary policy for macroeconomic reasons and more about balance sheet policy related to money market plumbing. Additionally, given the experiences in money markets at the ends of November and December, more acute stresses could crop up sooner, leading to renewed urgency of this discussion.

RRP Drain Continues Apace, Even As Reserves Stay Elevated



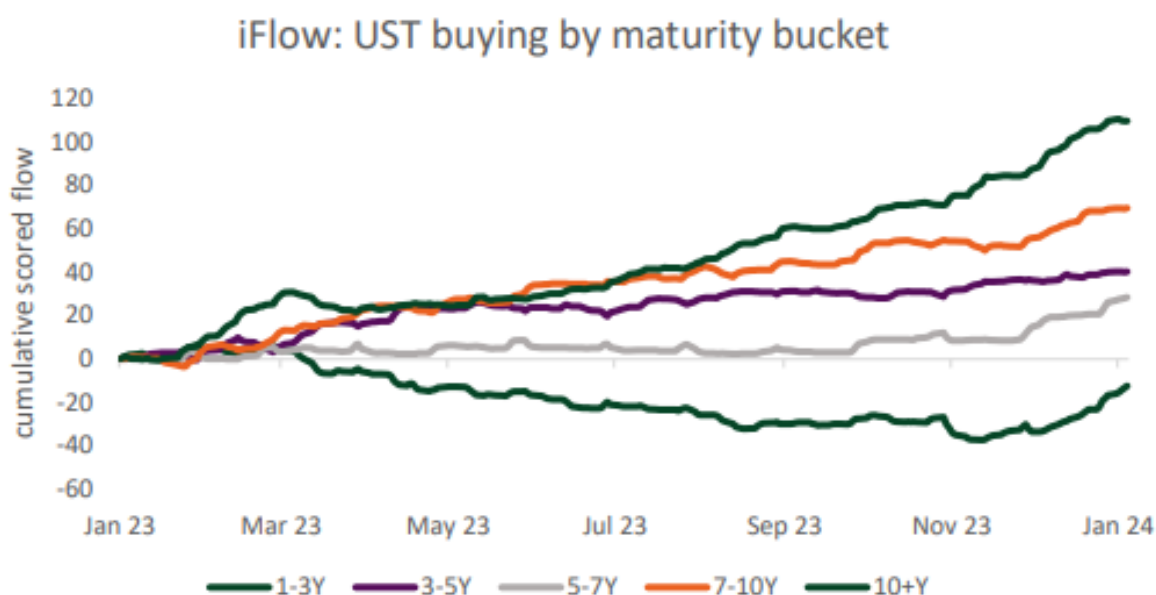
Source: BNY Mellon Markets, Bloomberg, Federal Reserve Board of Governors

iFlow Points To "Buy Everything" Behavior Across The Curve

Turning to iFlow, we note a shift in US Treasury demand from real money investors. In our last publication of 2023 in December, we noted a clear shift into long duration – increasing flow into the longer end of the Treasury curve. Nearly a month later, we observe this trend continuing, although it’s not just the longer-duration maturity buckets seeing accelerating inflows – the shorter-maturity segments are also seeing an uptick in buying.

The chart below is a replication of the one we posted back on Dec. 19, but now with nearly four weeks of additional data. Note the 1-3y and 3-5y buckets (dark blue and violet lines, respectively). They exhibit notable upward movements since the middle of December. Rather than just a long duration trade, there is a “buy everything” theme present. We suspect this has to do with bullish (i.e., dovish) views on rates, and hence a movement afoot to position oneself across the curve.

Buying Across The Curve



Source: BNY Mellon Markets, iFlow

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