Shrinking Deficits Cushion Fed's Retreat From Markets -- WSJ

By Sam Goldfarb

(Dow Jones) -- A shrinking federal budget deficit is providing a major boost to investors, enabling the Treasury Department to cut longer-term debt issuance despite the Federal Reserve's recent move to buy fewer bonds.

The prospect of the Fed shrinking its bondholdings, a policy known as quantitative tightening, or QT, has long been a nagging concern for investors. While it's early to conclude that the Fed maneuver won't hit markets, the strong rally in stocks and bonds in recent months suggests that the relationships are more complicated than many analysts had assumed.

"It's important to realize that QT and QE are not symmetric," said Thomas Simons, senior vice president and money-market economist in the fixed-income group at Jefferies LLC.

To support financial markets and the economy during the pandemic, the Fed engaged in a bond-buying policy known as quantitative easing, or QE. The program, which aimed to help maintain demand for goods and services across the economy, had the effect of more than doubling the central bank's asset portfolio of mostly Treasury and mortgage securities to roughly $9 trillion.

Starting in June, the Fed began reducing the size of that portfolio by letting some of its bonds mature without replacing them, a state known as runoff. Next month, it is poised to double the speed of that process by allowing up to $60 billion in Treasurys and $35 billion in mortgage securities to run off each month.

Some market pundits have warned that the Fed's actions could significantly increase the supply of new Treasurys available to investors, pushing their prices lower and raising their yields, which serve as a benchmark for interest rates across the economy.

Instead, though, the opposite is happening.

Thanks to surging tax revenues and a drop in pandemic spending, the federal government has been cutting the sizes of its bond auctions since late 2021. It continued to cut in May when the Fed was on the verge of shrinking its balance sheet, and announced further cuts this month even after the process had started.

Rather than rising, yields on the longer-term Treasurys that matter most for the economy have fallen since mid-June, as investors bet that a slowing economy will force the Fed to soon stop raising its benchmark short-term interest rate. That in turn has helped fuel a rebound in stocks, with the S&P 500 rallying 15% from its June 16 low.

An important distinction between quantitative easing and tightening is that the Fed gets to choose what bonds to buy when it is expanding its balance sheet. When it lets those bonds run off, the U.S. Treasury can raise funds to pay their principal by borrowing in short-term bills rather than longer-term notes and bonds -- significantly reducing the impact of the tightening policy.

It is also predictable that a shrinking budget deficit would mitigate the impact of quantitative tightening because the Fed is trying to cool a hot economy that is bringing in more tax revenue, said Mr. Simons of Jefferies.

Some investors and analysts say that quantitative tightening has dragged on bonds that already don't attract as much demand from investors, such as the recently introduced 20-year Treasury. That bond was yielding 3.46% Friday, or almost 0.5 percentage point more than the 10-year note and 0.2 percentage point more than the 30-year bond. The yield premium on the 20-year issue over the 30-year bond is unusual given that yields tend to rise as a bond's maturity increases, reflecting risks including inflation.

The Fed's move to shrink its holdings of mortgage bonds has also been cited as one reason why the spread between yields on mortgages and Treasurys has widened this year.

While the Treasury has been cutting the size of its note and bond auctions to date, it could always turn around and start increasing them a few months from now.

Still, most analysts don't expect that to happen. At the end of July, short-term bills that mature in one year or less made up 15.1% of the outstanding Treasurys -- at the very bottom end of the 15%-20% range that a Treasury advisory committee has recommended to the government.

That provides one rationale for Treasury to increase issuance of bills rather than notes and bonds. Another reason is the huge amount of excess demand for bills at the moment, evidenced by their low yields relative to interest rate expectations and the trillions of dollars that investors have parked in a Fed facility that serves an alternative for short-term lending.

Some analysts also note that the Treasury has typically met a large new funding need by issuing bills first and only later rolling those into longer-term bonds. Following that pattern, Mr. Simons said, the government might start increasing the size of its note and bond auctions only around the end of 2023, after which it would still take time for the market to feel an impact.

Many investors, meanwhile, are more focused on inflation and the Fed's plans to raise short-term interest rates than they are on the central bank's balance sheet.

Leah Traub, a portfolio manager at Lord Abbett, said her team has been holding fewer two-year and three-year bonds than their benchmark index on the expectation that the Fed won't cut rates next year, as many other investors expect.

Quantitative tightening, by contrast, is less of a concern.

"As long as the pace of tightening isn't changing and the outlook for the budgetdeficit isn't changing, then I think the markets are priced for it already," she said.

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