Remember QT? It's About to Get a Lot More Interesting: Macro Man
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By Cameron Crise
(Bloomberg) -- One of the major stories of the week has
been the Fed's verbal pushback against the notion that something
has somehow changed in the FOMC's commitment to tame inflation.
A number of speakers have emerged from the woodwork to suggest
that the so-called "dovish pivot" is but a chimera and that the
expected policy trajectory is largely unchanged.
Naturally, everything is subject to the whims of the data.
And with both payrolls and CPI slated for release over the next
week, nothing is written in stone at this juncture. Thus far the
shrinkage of the Fed's balance sheet has been little more than a
sideshow, but that's likely to change. Let's have a fresh look
at some of the key issues pertaining to quantitative tightening.

* "Confirmation bias" has kind of been the theme of the week in
this column, and Fed balance-sheet policy is a great example of
this behavioral phenomenon. If you run the numbers, the real-
time linkage between the size of the Fed's asset holdings and
financial-market returns is pretty skimpy, but that hasn't
stopped market participants from attributing all manner of
behavior to developments in the SOMA portfolio.
* That's not to say that there is no impact, of course. Clearly
things can get to a point where there is no effective surplus of
cash in the money market, at which point funding rates can start
to move in a discontinuous fashion. That was the cause of the
"repo explosion" in September of 2019, and in April we had an
early look at when QT might start to have a similar impact this
time around.
* In a curious coincidence, that column was published on the day
that the size of the Fed's balance sheet peaked; effectively, QT
started then rather than in June when the Fed quit rolling over
all of its maturing securities. What's notable is that since the
"official" start of QT in June, which really only took effect in
the middle of that month when bond-holdings matured, the equity
market has had a pretty good time of it. So much for QT starting
to bite, eh?

* Well, if we run through the numbers, we wouldn't expect it to
be a big deal. As a reminder, during QE it's the asset side of
the Fed's balance sheet that matters, but during QT it's the

liability side. And if we look at changes in Fed liabilities since mid-June, we find something quite interesting. Both bank reserves and the balance of the reverse repo facility have actually risen over the past month-and-a-half; it’s been the Treasury drawing down cash that has offset the decline in Fed bond-holdings.

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	FED ASSETS	CCY IN CIRC	RRP	TGA	RESERVES	OTHER
SINCE JUNE 15	-42.4	-2.1	26.1	-154.4	86.0	2.0
PROJECTED THRU YEAR END	-475.0			85.0		

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* The first row in the table above runs through those numbers (all amounts in billions of dollars, naturally.) The second line illustrates how things are going to change. Based on $47.5 billion of QT this month and a monthly rate of $95 billion thereafter, the Fed’s balance sheet is slated to shrink by some $475 billion through the rest of the year. Here’s the thing, though: the Treasury expects to rebuild its cash balances by some $85 billion through year-end.
* In other words, instead of more than offsetting the impact of QT on bank reserves and the RRP, the TGA will start amplifying it. That in turn raises the question of where the brunt of what will effectively be $560 billion of QT will be felt. The Treasury’s latest quarterly refunding announcement offered up the prospect of only modest increases in bill issuance, which suggests that balances in the RRP facility will remain elevated. That in turn implies that there will be a sharp drop in bank reserve balances.
* All of this is fairly well-understood by money market specialists, though perhaps it’s not appreciated quite as much by QT tourists. Thus far, bank liabilities have remained fairly steady -- there hasn’t been a significant drop in deposits. This is important because as the column linked above notes, it is when bank reserves as a percentage of liabilities drop below 11% or so that we should expect to see non-linear upward pressure on funding rates -- and thus calls for QT to end.

* A drop in liabilities would mean that the banking system would require fewer reserves in aggregate, thus increasing the scope for the Fed to shrink the balance sheet. Thus far, it isn't happening, and the estimate of $2.07 trillion to $2.28 trillion reserves as a terminal point remains intact. Last week, Barclays put out a note citing a virtually identical threshold at which QT would start to hurt.
* In sum, we should all expect the sound and the fury surrounding QT to pick up notably in the coming weeks and months, with bank reserves dropping sharply after a recent period of stability. That in turn will provide a convenient scapegoat for any weakness in risky asset prices, and perhaps might even become part of the background narrative.
* We'll need to see what actually happens with bill issuance and the Treasury's general account before pinpointing an exact time-frame for QT to start having an impact on money-market rates, but it is reasonable to think that it isn't actually that far off. Still, there's a lot of wood to chop between now and next spring, but there's no guarantee that the process will unfold smoothly.
* NOTE: Cameron Crise is a macro strategist who writes for Bloomberg. The observations he makes are his own and not intended as investment advice. For more markets commentary, see the Markets Live blog.

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