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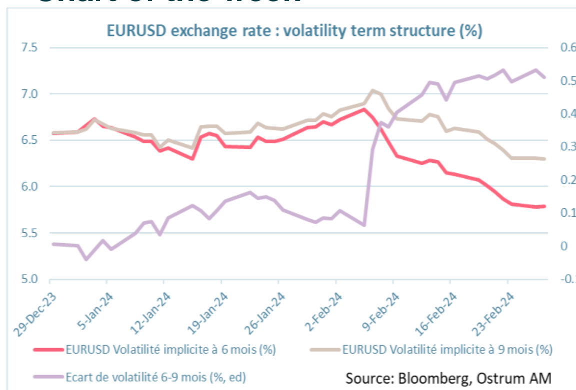
Topic of the week: QT reduction to be Fed's first move

- **At the same time as rate increases, the Fed is piloting the reduction of its balance sheet by reinvesting only part of the proceeds from its portfolio made up of Treasuries and MBS;**
- **Given the difficult budgetary discussions and the risk of congestion in the Treasuries market, the Fed should reduce the portfolio maturities by half;**
- **The liquidity thus freed would reduce the risk of tensions on the repo market and all the financial plumbing linked to the financing of the US federal deficit;**
- **The QT cutback will be the first easing measure before interest rate cuts begin in May at the earliest.**

Market review: As good as it gets?

- **US growth revised to 3.2% in 4Q 2023;**
- **Euro Stoxx 50 as an alternative to the Magnificent 7?**
- **Bund yields hot briefly 2.50%;**
- **The credit rally is slowing.**

Chart of the week



The US presidential election will undoubtedly be a major event at the end of the year, especially since the clear-cut positions of Donald Trump, the likely Republican candidate, may generate high volatility across financial markets.

The foreign exchange market already seems to be factoring in greater volatility after the November 5 election. The slope of the implied volatility of the euro-dollar exchange rate over the 6 to 9 month horizon therefore has moved up significatly.

Figure of the week

0.72

Source : Statistics Korea

This is the fertility rate in South Korea, the lowest in the World.

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● Topic of the week

QT reduction is Fed's next move

The Fed is announcing an easing of monetary policy in 2024. Whilst market participants focus mainly on the number of rate cuts, the first easing measure may relate to the quantitative tightening (QT). A reduction in the pace of contraction of the balance sheet has been under study for several months. We believe that a decision will be made at the March FOMC for implementation in the spring.

The all-important Fed policy for markets

The only game in town

The only game in town: This is how Mohamed El-Erian describes the monetary policy of the US Federal Reserve in his 2016 book. It is undoubtedly the most important economic policy decision for the direction of global financial markets. Changing expectations of upcoming Fed funds rate movements is a source of recurring volatility on the USD bond yield curve, affecting consequently the valuation of all financial assets.

The change in the Fed's communication, which took place in October 2023, generated expectations of monetary relief of up to 7 rate cuts of 25 bp in 2024, i.e. a reduction at each FOMC starting in March. But if interest rate policy attracts all the pundits' comments and market attention, the first measure of policy easing should come from the quantitative policy. Since the start of the monetary tightening, the Fed has stopped reinvesting part of the proceeds from its portfolio made up of Treasuries and MBS (mortgage-backed securities or bonds backed by residential housing loans). This action reduces available liquidity including bank reserves.

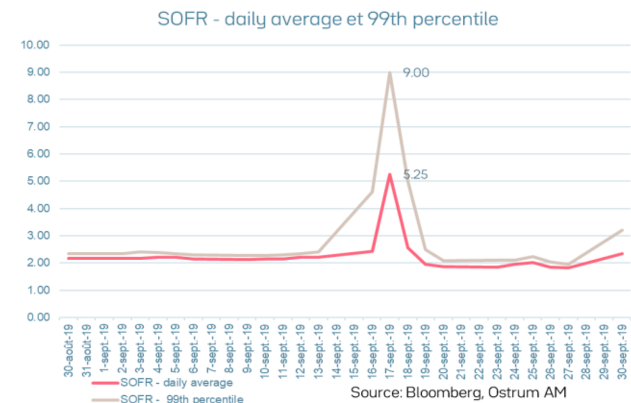
The policy implemented since April 2022 is calibrated so that the Fed passively reduces its holdings of Treasuries by $60 billion each month. When repayments are below this monthly threshold, the Fed does not sell the supplement. With regard to mortgage debt, the objective of reducing the portfolio by $35 billion proved unattainable, with the rise in rates slowing down prepayments. Indeed, mortgage refinancing no longer lures borrowers who benefited from very low interest rates in 2020-2021.

Since spring 2022, the Fed's Treasuries portfolio has decreased by $943 billion as of February 14, 2024. The non-reinvestment of maturities induces a need for additional financing for the US federal government. The net funding requirement from the private sector has increased due to the Fed's divestments. In 2024, the current QT policy would result in an additional financing need of $720 billion. Given a deficit forecast of around $1,600-1,700 billion (the budget has not yet been finalized at this stage), the total to be issued will reach $2,500 billion this year.

The risk of tensions on the repo market

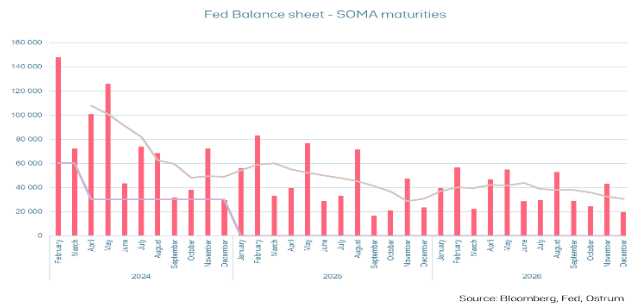
In this context, the risk of congestion in the Treasuries market appears significant. The financial plumbing links the primary bond market (on which the US Treasury issues the bonds) to the repo market (which finances the purchase of bonds) and the arbitrageurs, providing liquidity through basis trades between the physical bonds and derivatives like bond futures contracts (which distributes financial risks across market participants).

The international financial system is thus based on this fragile equilibrium. In September 2019, the repo market suddenly seized up. The reduction in liquidity induced by monetary tightening had caused an excess demand for short-term liquidity, pushing the SOFR rate beyond levels consistent with the monetary policy desired by the Fed. The Central Bank intervened by purchasing securities in excess (mainly T-bills) in order to ease the liquidity constraint.



Source: Bloomberg, Ostrum AM

The federal government debt totals $34,000 billion at present. The US rating was downgraded last year by Fitch whilst Moody's, like the CBO, warns of a negative outlook for public finances. The Treasury's refinancing strategy has so far focused on maturities of less than 5 years, which implies a significant refinancing risk if inflation prevents the Fed from cutting rates. The Fed will likely aim at minimizing the risk of financial stress, in what is considered the bedrock of global financial markets. The simplest way to achieve this is to reduce the pace of quantitative tightening. The amounts not reinvested by the Fed could be halved to $30 billion a month. This would closely match the 2024 maturity profile of Treasuries held in the Fed's SOMA portfolio.



The purple line reflects a scenario of slowing balance sheet contraction starting in April. A threshold lowered to $30 billion would remain below the maturities amounts projected until the end of 2024 and would not require additional reductions in T-bills holdings. This announcement could come at the next FOMC on March 20. The restrictive bias of monetary policy will thus be reduced.

Furthermore, Fed governor Christopher Waller alluded to changes in the composition of the SOMA portfolio. The Fed would preferably only own US Treasury securities and assume little duration or MBS risk. One change in the reinvestment policy could be to focus Treasury bond reinvestments on T-bills or short-term bonds. It would also help the Treasury to deal with the significant refinancing risk over the next few years (along with relief from rate cuts). Active sales of MBS to fund the SOMA portfolio reshuffling remains a remote possibility.

The calibration of quantitative tightening must also consider the amount of liquidity necessary for the proper functioning of the financial system given the regulatory requirements. Bank reserves today total around $3.5 trillion, or around 15% of the balance sheets of commercial banks. The average since 2008 would correspond to $3 trillion. We reached this total of $3 trillion after 9 months of $30 billion QT. Thus, a halving of the QT from April would have the double advantage of reducing the restrictive bias of monetary policy while ultimately normalizing excess liquidity in the financial system.

Conclusion

The Fed is reducing its securities portfolio at a predetermined speed of a maximum of $95 billion per month, including $60 billion for Treasuries. The deleterious political situation, linked to the presidential election in the fall and a significant federal deficit, calls for a reduction to $30 billion per month of the amounts not reinvested to avoid the return of tensions on the repo market and a glut in the US bond market. This is the first concrete decision to ease monetary policy before the rate cuts which should take place from June.

Axel Botte

Market review

As good as it gets?

After a strong start to the year, the rally in risky assets weakened at the end of the month. Inflation remains a concern.

The first two months of the year resulted in very strong performance from risky assets. The Euro Stoxx 50 equity index competes with the Nasdaq. Like the Magnificent 7 across the Atlantic, the European mega-cap stocks offer good visibility on their profit margins at lower valuation multiples than US technology stocks for instance. These growth stocks resisted the rise in long-term rates linked to the upward revision of key rate expectations. Robust growth in the United States, and the inertia of inflation have helped to reduce expectations of monetary easing. Central bankers also continue to call for caution. Their message helped realign expectations with the trajectory projected by the Fed whilst reducing the likelihood of a rapid move by the ECB. The 10-year T-note hovers around 4.30%. In the euro zone, the level of 2.50% on the Bund has revived investor interest.

The second estimate of US GDP for the 4th quarter comes out to 3.2%. Household consumption was revised upwards to 3% as residential investment gathered pace. Corporate equipment spending appears somewhat disappointing, given the rebound in business investment in structures (+7.5%). The trade balance added 0.3 pp to quarterly growth in annualized terms. The January income and spending data indicates a slowdown in household consumption (-0.1% in real terms). Household confidence seems to be affected by the deleterious political backdrop. However, monthly nominal income increased by 1%, which suggests a rebound in spending in February. The PCE deflator stood at 2.4% in February. The ISM manufacturing survey, however, fell to 47.8 last month.

In the euro area, the monthly PMI readings point to modest economic improvement. The manufacturing sector seems to be gradually recovering from a prolonged period of contraction. In the wake of the upside surprise on the US CPI in January, inflation in the euro area appears to moderate only slowly. The increase in the harmonized price index reached 2.7% in February, or even 3.1% excluding volatile elements.

The market trend remains que positive. The decrease in rate cut expectations has not resulted in distrust towards risky assets even as the broad-based rally since the end of October had been largely fueled by hopes for monetary relief. European stocks gain up to 8% for the Euro Stoxx 50, which is an alternative to the Magnificent 7. The Nikkei is making record highs, now eyeing the 40,000 level thanks to a still weak yen (150 against the greenback). In the United States, the earnings season ends with more favorable surprises on profits than on sales. The S&P 500's aggregate profits increased by 7% over one year.

On the fixed income markets, the T-note yield has found equilibrium around 4.30% at the end of the week. Market rate expectations are now in line with FOMC projections. There is nevertheless a slight steepening pressure. The Bund attracted buying interest around 2.50%. The German benchmark yield seems unlikely to return to the level of 3% which coincided with a peak above 5% on the US 10-year bond. At the same time, swap spreads have narrowed to 35 bp. Sovereign spreads are stable at tight levels. The successful issuance of BTP Valore (attracting more than €18.3 billion demand) is keeping a lid on Italian BTP spreads (143 bp). The maturities of BTP Italia, in April and October 2024, will allow the Italian Treasury to tap household savings again. The 10-year OAT spread remains within 50 bp. The market still seems to ignore the downgrade risk (to the rating outlook) as Moody's and Fitch will update their sovereign credit opinions on April 26.

The credit market is consolidating at tight levels. The European credit swap spread has risen to 86 bps. Flows on specialized ETFs point to profit taking at this juncture. However, the iTraxx level (55 bp) seems to indicate that some spread tightening potential remains. The performance of high yield is also fading after a 50-bp reduction in yield premiums since the start of the year.

Finally, the US greenback remains solid with the euro at around $1.08. On the other hand, the yen plunged back. The BoJ is struggling to convince market participants of a rapid exit from the negative rate policy.

Axel Botte

Main market indicators

G4 Government Bonds	04-Mar-24	1wk (bp)	1m (bp)	2024 (bp)
EUR Bunds 2y	2.87%	-5	+30	+47
EUR Bunds 10y	2.39%	-5	+15	+36
EUR Bunds 2s10s	-48.7bp	0	-16	-10
USD Treasuries 2y	4.55%	-17	+18	+30
USD Treasuries 10y	4.2%	-8	+18	+32
USD Treasuries 2s10s	-35.2bp	+9	0	+2
GBP Gilt 10y	4.09%	-7	+18	+56
JPY JGB 10y	0.72%	+3	-7	-20
€ Sovereign Spreads (10y)	04-Mar-24	1wk (bp)	1m (bp)	2024 (bp)
France	48bp	+1	+1	-5
Italy	144bp	-2	+0	-24
Spain	88bp	-1	+1	-8
Inflation Break-evens (10y)	04-Mar-24	1wk (bp)	1m (bp)	2024 (bp)
EUR 10y Inflation Swap	2.22%	+4	+3	+9
USD 10y Inflation Swap	2.51%	+2	+9	+10
GBP 10y Inflation Swap	3.62%	+3	+3	+9
EUR Credit Indices	04-Mar-24	1wk (bp)	1m (bp)	2024 (bp)
EUR Corporate Credit OAS	121bp	+3	-12	-17
EUR Agencies OAS	63bp	+1	-6	-7
EUR Securitized - Covered OAS	69bp	0	-9	-10
EUR Pan-European High Yield OAS	351bp	+6	-91	-48
EUR/USD CDS Indices 5y	04-Mar-24	1wk (bp)	1m (bp)	2024 (bp)
iTraxx IG	54bp	0	-5	-4
iTraxx Crossover	301bp	-4	-27	-13
CDX IG	52bp	-1	-3	-5
CDX High Yield	335bp	-6	-19	-21
Emerging Markets	04-Mar-24	1wk (bp)	1m (bp)	2024 (bp)
JPM EMBI Global Div. Spread	369bp	-5	-32	-15
Currencies	04-Mar-24	1wk (%)	1m (%)	2024 (%)
EUR/USD	$1.085	0.028	1.015	-1.7
GBP/USD	$1.268	-0.008	1.109	-0.4
USD/JPY	JPY 150	0.293	-1.138	-6.2
Commodity Futures	04-Mar-24	-1wk ($)	-1m ($)	2024 (%)
Crude Brent	$83.5	$1.8	$6.4	8.7
Gold	$2 084.8	$56.0	$59.1	1.1
Equity Market Indices	04-Mar-24	-1wk (%)	-1m (%)	2024 (%)
S&P 500	5 137	0.95	3.60	7.7
EuroStoxx 50	4 907	0.87	5.42	8.5
CAC 40	7 933	0.04	4.48	5.2
Nikkei 225	40 109	2.23	10.93	19.9
Shanghai Composite	3 039	2.09	11.32	2.2
VIX - Implied Volatility Index	13.53	-1.53	-2.31	8.7

Source: Bloomberg, Ostrum AM

Additional notes

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