SMBC SMBC Group

US Macroeconomics

October 12, 2023

Joseph Lavorgna, Chief US Economist | 212.893.1528 | joseph.lavorgna@smbcnikko-si.com

The Fed's Best Laid Plans

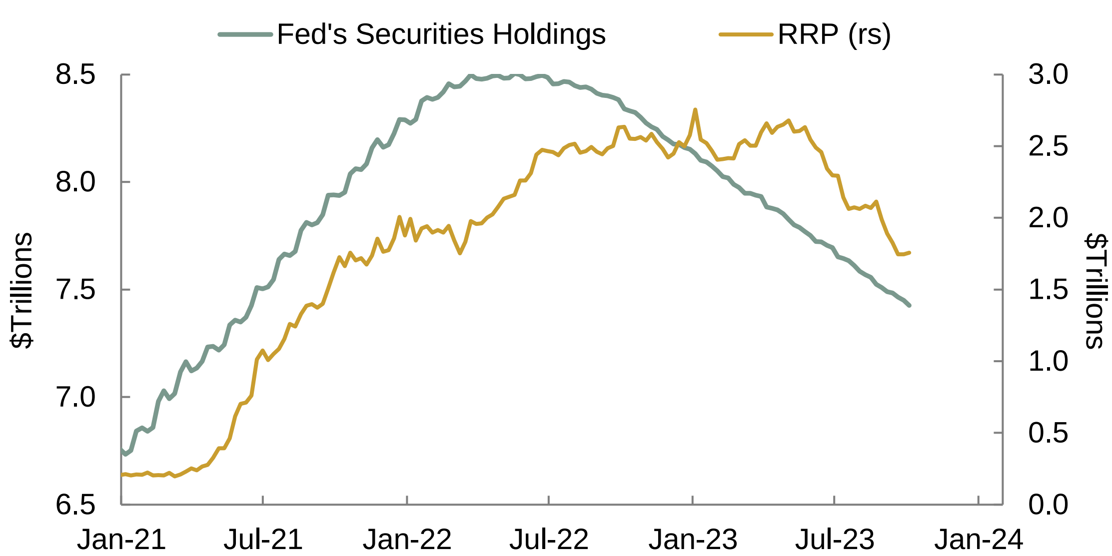
Quantitative tightening (QT) is draining liquidity from the financial system. Approximately $80 billion of securities have been rolling off the Fed's balance sheet each month. Since peaking at $8.5 trillion in May 2022, the Fed's combined treasury and mortgage-backed securities holdings are down to $7.5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

Disclaimers

This document is provided by SMBC Nikko Securities America, Inc. (“SMBC Nikko”), the US-registered broker-dealer affiliate of Sumitomo Mitsui Banking Corporation, for informational purposes only. This document was prepared by SMBC Nikko’s economist(s). The views statements, assumptions and forecasts expressed herein are those of the author(s) and do not reflect the judgment of any other person or of SMBC Nikko. It does not constitute an offer, or solicitation of the sale or purchase, of securities or other investments. The information contained herein is obtained or derived from sources believed to be reliable, but SMBC Nikko and the author(s) make no representations as to its accuracy or completeness. In some cases, such information may be incomplete or summarized. This document has been prepared based on assumptions and parameters determined by the economist(s) in good faith. The assumptions and parameters used are not the only ones that could have been selected, and therefore no guarantee is given as to the accuracy, completeness, or reasonableness of any such quotations, disclosures, or analyses. Past performance is not a reliable indicator of any future results.

This document has been prepared for and is directed at institutional investors and other market professionals, and is not intended for use by retail customers. It does not take into account any specific investment objective, financial situation, or particular need of any recipient. The information contained herein should, for whatever purpose, be used solely at the discretion and responsibility of the recipient. SMBC Nikko and its affiliates do not accept any liability or responsibility for any results in connection with the use of such information. Recipients are responsible for making final investment decisions and should do so at their own discretion after conducting a careful examination of all documentation delivered prior to execution, explanatory documents pertaining to listed securities, prospectuses, and other relevant documents, and their own independent analysis and assessment of the merits of any transaction. The financial instruments discussed may be speculative and may involve risks to principal and interest.

Conflicts of Interest Disclosures

The views statements, assumptions and forecasts expressed herein may differ from those expressed in globally branded research produced by SMBC Nikko or its affiliates. The trading desks of SMBC Nikko and its affiliates trade or may trade as principal in the financial instruments that are the subject of this material, and the author(s) of this document may have consulted with the trading desks while preparing this document. The proprietary interests of SMBC Nikko and its affiliates may conflict with those of the recipient. SMBC Nikko and its affiliates may seek to do business with the companies mentioned in this material and the trading desks may have accumulated, be in the process of accumulating, or accumulate long or short positions in the financial instruments mentioned and may have acquired them at prices no longer available. The trading desks may also have or take positions inconsistent with the views expressed in this document or may have already traded on those views.

This material is not a research report, and neither this material nor its author(s) is subject to SMBC Nikko policies and procedures that apply to the globally branded research reports and research analysts of SMBC Nikko and its affiliates or to legal requirements designed to promote the independence of investment research. It is not subject to any prohibition on dealing ahead of the dissemination of investment research. This means that on the date of this document, SMBC Nikko, its affiliates, and their respective directors, representatives, or employees, may have a long or short position in any of the instruments mentioned in this document and may make a market or trade in instruments economically related to the securities, derivatives or other underlying assets mentioned herein, in each case either as principal or as agent.

No part of the author(s) compensation was, is, or will be, directly or indirectly related to the specific recommendations or views expressed herein. The personal views of authors may differ from one another.

Distribution, possession or delivery of this document in, to or from certain jurisdictions may be restricted or prohibited by law. Recipients of this document are required to inform themselves of and comply with all such restrictions or prohibitions.