Yardeni Research

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Morning Briefing

QT, MBS & BOJ

Check out the accompanying chart collection.

Executive Summary: The Fed is set to ease monetary policy by lowering the federal funds rate this week, but it will still be tightening policy by shrinking its balance sheet. However, as Eric explains, quantitative tightening hasn't been very effective—reserves are much higher today than pre-pandemic. Has the Fed really tightened policy that much, and what will happen when it ends QT? … Also: the investment opportunity represented by mortgage-backed securities. … And: Where BOJ policy may be headed and what it means for the yen.

Weekly Webcast. If you missed Monday's live webcast, you can view a replay *here*.

Federal Reserve: Quantitative Tightening, Qualitative Easing. The Fed's quantitative tightening (QT) campaign has been slow and ineffectual. That's a feature, not a bug. It's a symptom of the Fed's preference for easy financial conditions and stable financial markets over monetary policy that's dictated solely by economic data. It also sets the Fed up with an inconvenient and historically uncommon policy stance: easing monetary policy by lowering interest rates while tightening it by shrinking the balance sheet.

Let's review QT's progress, and discuss how the Federal Open Market Committee (FOMC) may use its policy tools going forward:

(1) *Reserving reserves*. In June 2022, the FOMC began reducing its then-$9 trillion balance sheet (*Fig. 1*). It did so by refraining from reinvesting all of the proceeds from maturing Treasuries and mortgage-backed securities (MBS). The goal of QT is to reduce reserves, the opposite of quantitative easing (QE). By that metric, the Fed has failed. Bank reserve balances most recently totaled $3.32 trillion, more than double the sum just prior to the pandemic (*Fig. 2*).

(2) *Why so many reserves?* There are a few reasons that QT has been the grossly underachieving stepbrother of QE. For one, fewer MBS matured because homeowners

ceased to refinance or prepay their mortgages as rates surged (*Fig. 3*). The Treasury Department also opted to issue the bulk of its debt in Treasury bills, which were easily financed by money-market funds' cash in the reverse repurchase facility (RRP) (*Fig. 4* and *Fig. 5*). The cash remaining in the RRP fell to $239 billion on Monday, the lowest since 2021. This lever is quickly evaporating, and reserves are likely to fall soon.

The FOMC slowed the pace of QT this June because it does not want to upend the short-term interest-rate markets, as it did in 2019.

(3) *Navigating in fog*. The FOMC doesn't know what level of reserves is too low or would cause short-term interest rates to spike. Fed officials were shocked by how quickly reserves became scarce during their last go at QT in 2019, when Eric was on the New York Fed's money market desk. When he probed New York Fed President John Williams and the System Open Market Account (SOMA) portfolio managers while working at the *WSJ*, their response was "you know reserves are scarce when you see it." Essentially driving blind, the Fed put up bigger guardrails to prevent itself from going over a cliff.

In August, the Fed *explicitly allowed* banks to count their high-quality assets (i.e., Treasuries and agency MBS) that can be pledged to the Fed's Discount Window in internal liquidity stress tests. This reduces banks' overall demand for reserves to meet stress-testing requirements. Moreover, the new standing repo facility (SRF) can absorb any short-term pressure, like during corporate tax dates or quarter ends.

The upshot is that QT can go on for longer with these safety measures. Still, the FOMC might end QT in order to have harmonized interest-rate and balance-sheet policy. Ending QT—whenever it's done—will put downward pressure on Treasury yields.

(4) *QT on the surface, QE under the surface*. One of the many idiosyncrasies of this tightening cycle has been the counteractive easing measures. The Bank Term Funding Program (BTFP) backstopped the banking system's duration crisis (*Fig. 6*).

The Fed's so called "deferred asset" has been a more subtle form of easing. It's basically negative remittances to the Treasury Department. Typically, the Fed sends the Treasury the difference between interest income from its securities holdings and the costs of those holdings, such as interest paid on reserves and operating costs. These remittances totaled more than $800 billion from 2012 to 2021. But with short-term interest rates it pays on reserves so much higher than the interest income earned from the assets it purchased over the years, the Fed has operated at a cumulative $197 billion loss—its deferred asset—over the past two years (*Fig. 7*).

Once the Fed returns to profitability, it will "pay down" the deferred asset and then begin remitting to the Treasury again. But in the meantime, the Fed is stimulating economic activity by households, businesses, and consumers, essentially by borrowing from the future.

(5) *Exorbitant privilege*. The Fed's deferred asset is far from the primary reason that the US economy has been so strong despite two years of tighter monetary policy. That said, Fed officials shouldn't be so shocked that US households have $1.8 trillion of interest income to spend and therefore are less sensitive than usual to higher interest rates (*Fig. 8*). Other central banks aren't as fortunate.

The Bank of England, for instance, is selling British gilts outright to tighten its monetary policy and provide more room for potential easing in the future. That's drawn ire from taxpayers, who must fund the losses on sales of low-rate gilts via His Majesty's Treasury! As a result, bazooka-style QE used during the pandemic is criticized more often by the public "across the pond" than in the US.

US households' interest income should fall as the Fed cuts the FFR. But if asset prices rise, and companies are able to issue debt that yields more than Treasuries as their risk of default decreases, will there be any negative impact? In other words, the Fed isn't pulling away the punch bowl by lowering rates. It's just providing a different—more powerful—punch.

Interest Rates: Hunting for Yield. MBS have provided a particularly attractive income opportunity since the Fed began its last tightening round. Mortgage rates have traded 250-300 bps above Treasury yields, well above the historical average of 171 bps (*Fig. 9*). As the record $6.5 trillion sitting in money-market funds searches for higher yields once the Fed cuts the overnight rate, extra money flows into agency-backed MBS could compress that spread (*Fig. 10*). The narrowing may not be as great as investors are used to, however.

Consider the following:

(1) *Doubly government backed.* Agency MBS are implicitly backed by the government via their stamp of approval by the government-sponsored enterprises, a.k.a. GSEs. However, they received another support line from the central bank. The Fed grew its MBS book to a peak of $2.7 trillion in April 2022, or around 30% of the total market. Because of very slow

prepayments, that's down to just $2.3 trillion today, or a quarter of the $9.3 trillion market.

(2) *Spreads widen*. Without the buying power of the Fed suppressing yields, the MBS spread has widened to more than 291 bps currently—the highest level since 1986. Is the mortgage market really more stressed than it was during the Great Financial Crisis? Not exactly. MBS spreads are also wider because they're highly correlated with interest-rate volatility (*Fig. 11*). The Treasury market has been more volatile over the past two years thanks to Fed tightening and elevated inflation. As the Fed begins cutting rates and inflation moderates further, those pressures fall.

Another source of pressure on MBS yields was the mini regional banking crisis in 2023. The Federal Deposit Insurance Corporation (FDIC) built a receivership fund out of the assets of failed Silicon Valley Bank and Signature Bank. The FDIC had to sell $114 billion of MBS, using the proceeds to repay the banks' creditors. The MBS spread widened 30 basis points to a new cycle high during this episode.

(3) *New norm?* MBS have negative convexity. That is, the price of the bond suffers more from rates rising than it benefits from rates falling, because homeowners have the option to prepay their mortgages in the latter scenario. But the negative convexity is pretty weak right now because prevailing rates are still higher than the rates most homeowners locked in during pandemic. In other words, there's minimal prepayment risk. Convexity will grow more negative as rates are lowered, but we don't expect rates to fall substantially in our Roaring 2020s scenario.

Long term, it's likely that the Fed will reinvest its maturing MBS holdings into Treasuries. In that case, the MBS spread is likely to reset to a new, higher norm than before the Fed started to tighten monetary policy in early 2022.

Japan: The Only Hawks in Town. The Bank of Japan (BOJ) has shifted from the easiest central bank in the developed world to the only one raising interest rates. The narrowing differential between Japanese rates and US rates has strengthened the yen from more than ¥160 to the dollar to ¥140 as of this weekend (*Fig. 12*).

Our base-case scenario assumes that Japan's inflation scare (if you can call it that) is manageable and that the Fed will not lower rates by as much as financial markets expect. Consider:

(1) *Committed to the bit*. Did the BOJ find new hawkish wings after maintaining negative

interest rates for much of the past decade? Perhaps. Governor Kazuo Ueda has brushed off political pressure, assuring that the BOJ would raise interest rates as long as the economic backdrop continues to call for it. BOJ policymaker Naoki Tamura said last week that the BOJ should raise rates to at least 1.0% next year, *Reuters* reported on September 12.

(2) *Inflation problem?* The BOJ does not want too much volatility in Japanese markets. Fortunately, it meets later this week after the FOMC does, so Japanese policymakers can digest the Fed's initial impact on the markets first before making their decision.

But how much of a problem does the BOJ have to manage? Japan's PPI slowed in August for the first time in eight months, from 3.0% y/y to 2.5% (*Fig. 13*). Producer prices declined 0.2% m/m, largely because energy inputs fell 4% y/y and the stronger yen weighed on import prices. That could lead the BOJ to leave the policy rate unchanged at 0.25% later this week.

Goods inflation has been the primary contributor to Japanese inflation. CPI goods prices were up 4.0% y/y in July, whereas services prices were only up 1.4% y/y (*Fig. 14*). The core CPI is already below the BOJ's 2.0% target. We expect the stronger yen to weigh on consumer inflation.

(3) *Yen outlook.* With long-term Japanese rates at a 10-year high, the impetus for substantial interest-rate hikes seems weak (*Fig. 15*). The yen trading around ¥135-140 against the dollar may be enough to ease Japanese inflation back to the BOJ's target 2.0%. Depending on the outcome of Japan's Liberal Democratic Party election in two weeks (the winner of which will likely become Prime Minister next year), the markets may shift their expectations to more dovish monetary policy. So plenty of question marks remain with respect to the path of BOJ policy.

It is not our base case, but there are a range of scenarios that could narrow the spread between US and Japanese rates. Betting on a stronger yen isn't a bad hedge for investors broadly positioned for our Roaring 2020s scenario.

Calendars

US: Tues: Retail Sales Headline, Core, Ex Gas & Autos -0.2%/0.2%/0.3%; Industrial Production 0.1%; Capacity Utilization 77.9%; Business Inventories 0.4%; NAHB Housing Market Index 41; Atlanta Fed GDPNow 2.5%; API Weekly Crude Oil Inventories. **Wed:** Fed

Interest Rate Decision 5.25%; FOMC Economic Projections; Housing Starts & Building Permits 1.31mu/1.41mu; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production. (FXStreet estimates)

Global: **Tues:** Germany ZEW Economic Sentiment 16.4; Canada CPI 0.1%m/m/2.2%y/y; Elderson; McCaul; Buch; Rogers. **Wed:** Eurozone Headline & Core CPI 0.2%m/m/2.2%y/y & 0.3%m/m/2.8%y/y; UK Headline & Core CPI 2.2%/3.3%y/y; UK PPI Input & Output -0.3%/0.0%; Nagel; McCaul. (FXStreet estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): All three of these indexes had forward earnings rise simultaneously w/w for a second straight week and for the first time since the July 26 week. LargeCap's forward earnings rose 0.2% w/w to a new record high. It has achieved new record highs for 37 straight weeks and in 48 of the 53 weeks since September 15, 2023; last week is now the lengthiest string of weekly record-high forward earnings for LargeCap in nearly 19 years (since the November 11 week of 2005, when it hit record highs for 42 straight weeks). MidCap's rose for a fourth week following three straight declines, gaining 0.3% w/w to 1.5% below its record high in early June 2022, and has risen in 20 of the past 25 weeks. SmallCap's moved up for a second week following four straight declines from a 40-week high in early August, rising 0.3% w/w to 9.9% below its mid-June 2022 record. Through the week ending September 13, LargeCap's forward earnings has soared 19.0% from its 54-week low during the week of February 1, 2023; MidCap's is 7.2% above its 55-week low during the week of March 10, 2023; and SmallCap's is 4.3% above its 72-week low during the March 17, 2023 week. These three indexes' forward earnings downtrends since mid-2022 have been relatively modest compared to their deep double-digit percentage declines during the Great Virus Crisis and the Great Financial Crisis. Their forward earnings momentum has improved from three-year lows just over a year ago, but LargeCap's is improving faster than the SMidCap's. Here are the latest consensus earnings growth rates for 2024 and 2025: LargeCap (9.5%, 15.3%), MidCap (0.2, 16.8), and SmallCap (-7.9, 19.5).

S&P 500/400/600 Valuation (*link*): Valuations were broadly and sharply higher during the September 13 week for these three indexes, but remain below their recent multi-year highs. LargeCap's forward P/E rose 0.7pts w/w to 20.9 from a four-week low of 20.2 and is 0.8pt above its 14-week low of 20.1 during the August 9 week. It's now 0.5pt below its 30-month high of 21.4 during the July 12 week, but is up 3.9pts from a seven-month low of 17.0 during the October 27 week. It’s now up 5.8pts from its 30-month low of 15.1 at the end of September 2022, which compares to an 11-year low of 11.1 during March 2020. MidCap’s forward P/E rose 0.4pt w/w to 15.4 from a nine-week low of 15.0, but remains 0.4pt below its 22-week high of 15.8 the week before that. It’s now 0.6pt below its 27-month high of 16.0 at the end of March and up 3.1pts from a 12-month low of 12.3 at the end of October. These compare to a record high of 22.9 in June 2020 and an 11-year low of 10.7 in March 2020. SmallCap’s forward P/E rose 0.4pt w/w to 14.9 from a four-week low of 14.5 and is now 0.5pt below its 32-month high of 15.4 during the July 26 week. It’s up 4.3pts from its 14-year low of 10.6 in September 2022 and compares to a record low of 10.2 in November 2009 during the Great Financial Crisis. That also compares to its record high of 26.7 in early June 2020 when forward earnings was depressed. The forward P/Es for the SMidCaps have been mostly below LargeCap’s since August 2018. MidCap’s 27% discount to LargeCap’s P/E is up from a 25-year-low 29% discount during the July 5 week. It had been at a 19% discount during the March 2, 2023 week, which was near its best reading since October 14, 2021. SmallCap’s 30% discount is up from a 24-year low 34% discount during the July 5 week. That compares to a 20% discount during the March 2, 2023 week; that one was near its lowest discount since August 2021. The SMidCap’s P/Es had been mostly above LargeCap’s from 2003 to 2018.

US Economic Indicators

Regional M-PMI (*link*): The New York Fed was the first to report on manufacturing activity for September, and revealed that business activity in New York State expanded for the first time in nearly a year. Here are the highlights: The *headline general business conditions* (to 11.5 from -4.7) measure rebounded 16.2 points, as it swung from negative to positive territory, reaching its highest level since April 2022. Both the *new orders* (9.4 from -7.9) and *shipments* (17.9 from 0.3) gauges rose sharply this month, climbing by 17.3 points and 17.6 points, respectively, with the former pointing to a modest increase in orders and the latter signaling strong growth in shipments. Meanwhile, *inventories* (0.0 from -10.6) levelled off after liquidating the prior two months. Turning to the labor market, *employment* (-5.7 from -6.7) continued to fall, though at a modest pace, while the *average workweek* (2.9 from -17.8) recovered from a steep drop in hours worked during August to a slight increase in hours worked this month. *As for pricing*, the prices paid (23.2 from 23.4) measure held steady, while prices received (7.4 from 8.5) remained low. Looking ahead, firms expect conditions to improve over the next six months, with the index of future business activity measure climbing eight points to 30.6. Capital spending plans, however, fell 11 points to -2.1—dipping below zero for the first time since 2020.

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