January 14, 2025

Morning Briefing

Fed's Switcheroos At FOMC & QT

Check out the accompanying chart collection.

Executive Summary: Is this year's rotation of voting members on the FOMC likely to shift the monetary policy needle? Which way? Today, Eric identifies the new hawks and doves and speculates about how they might vote at January's meeting. … Also: Although the Fed has been easing monetary policy, its quantitative tightening continues. Yet bank reserves remain elevated notwithstanding the Fed's balance-sheet runoff. QT may not be terminated until bank reserves fall enough to increase short-term interest rates or until higher long-term bond yields put undue pressure on the economy.

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

Strategy I: Fed's Ongoing Musical Chairs. There will be four new voters at the Fed's January 28-29 meeting. All 19 members—including 7 Fed governors and 12 regional bank presidents—participate in each Federal Open Market Committee (FOMC) meeting. However, only the governors and New York Fed president have permanent votes to decide monetary policy actions; the remaining 11 presidents rotate annually for four voting spots. Considering the growing disagreement within the FOMC, it's even more important to understand the voting dynamics.

We first noted the emerging dissent among FOMC participants in our August 22 *Morning Briefing*. Since, there have been two voted dissents. Governor Michelle Bowman dissented in favor of a smaller 25bps cut when the FOMC reduced the federal funds rate (FFR) by 50bps on September 18. Cleveland Fed President Beth Hammack, who joined in August, dissented in favor of no cut on December 18. However, Hammack is no longer a voter.

Also not voting this year are Atlanta Fed President Raphael Bostic, San Francisco Fed President Mary Daly, and Richmond Fed President Thomas Barkin. The new voters are Chicago Fed President Austan Goolsbee, St. Louis Fed President Alberto Musalem (who joined the FOMC in April), Boston Fed President Susan Collins, and Kansas City Fed

President Jeffrey Schmid. Goolsbee was an alternate voter on the FOMC's July decision, when the Cleveland Fed presidency was vacant.

Consider how the voting-rolls shakeup may influence monetary policy as the FOMC grapples with stickier inflation and the uncertainty of Trump 2.0:

(1) *Ornithology*. There are a couple like-for-like swaps in the voting shift. Goolsbee is one of the most dovish FOMC members, yet he can be thought of as replacing another dove in Daly. While Hammack, the only voter with the gusto to dissent at the last meeting, has departed, Musalem is another hawk. He recently told the *WSJ* that the Fed must be cautious about lowering rates further, as the labor market is in good shape and inflation is "still out of bounds." We agree! It's no surprise that Hammack's and Musalem's views more closely align with ours given their years of private-sector experience.

While Hammack dissented in December, the dot plot from the FOMC's December *Summary of Economic Projections* suggested that four total FOMC participants favored no rate cut (*Fig. 1*). Musalem was likely one of those four. A *recent speech* by Collins suggests she is in favor of a pause. Schmid *said* he believes policy is roughly neutral at the moment, neither restrictive nor stimulative. He's also a hawk in terms of balance-sheet policy, favoring a continued quantitative tightening (QT) policy to shrink the Fed's asset holdings while also fully exiting the mortgage-backed securities (MBS) business and shifting toward shorter-duration Treasuries. More on that later.

Fed officials are likely just becoming more emboldened to depart from Fed Chair Jerome Powell's view after the economy proved much stronger and long-term Treasury yields shot up while they were cutting the FFR. Barkin, who was a voter and decided not to dissent, *said* earlier this month that "the current labor market equilibrium is more likely to break toward hiring than toward firing." That's a huge difference from the FOMC minutes, which showed broad-based concern that the downside labor-market risks are greater than the inflation risks. He is also a believer in the productivity story and recently opined "so long as people keep their jobs and asset values remain solid, they should continue to spend."

We think more FOMC members will start to echo Barkin's tune. How can the Fed be worried about labor-market downside even though the supercore PCED rate is 150bps above the 2.0% target, unemployment is 4.1%, payroll growth was north of 250,000 last month, and the 10-year yield is above 4.76% (*Fig. 2* and *Fig. 3*)?

(2) *Disbarred*. Fed Vice Chair for Supervision Michael Barr is stepping down from his post

18 months early to avoid a legal battle with Trump 2.0. Barr is a regulatory hawk who has drawn the ire and critique of not just Wall Street and free marketeers but also fellow Fed officials. Had President Trump sought to remove Barr early, Barr may have won on legal grounds, but only after a long and distracting legal fight. With Barr gone, there's upside for banks. They may be discussed during big bank earnings calls later this week.

Barr has pushed an even stricter regulatory regime known as the "Basel III endgame," which would have forced banks to hold even more capital to satisfy already onerous requirements from the first two Basel accords. Governor Bowman, and even Powell at times, have been vocal critics. It was already likely that Basel III would be watered down from Barr's initial proposal. We wrote in our August 27 *Morning Briefing*, "the Basel III endgame regulatory framework will be relatively loose. Combined with the end of Chevron deference, financials may be entering a sustained period of more favorable regulatory change after a decade-plus of tighter oversight following the Great Financial Crisis (GFC)."

Notably, Trump does not have his pick of the litter to replace Barr. Because his term as governor is not up, Barr will remain on the FOMC, and a current Fed governor must be selected as vice chair. That leaves Christopher Waller and Bowman, the two Republican Fed governors.

Waller had a long spell as a hawk before joining Powell's easing crusade. His dovish leanings may be reminiscent of Powell's political pivot, in that he is attempting to play to Trump's preference for lower interest rates.

Bowman is a monetary policy hawk but a regulatory dove. Having been a community banker, she is critical of the Fed's stress tests and bank exams. She may be more aligned with incoming economic policymakers in Trump 2.0 who tend to be critical of the stimulative excess that comes from over-easy monetary policy, favoring deregulation to give the private sector room to innovate and grow.

Trump 2.0 may also shake up some of the government's regulatory bodies, such as the Office of the Comptroller of the Currency (OCC), the Consumer Financial Protection Bureau (CFPB), and the Federal Deposit Insurance Corp (FDIC). All of these changes would be positive for big bank stocks, in our opinion.

Strategy II: Quantitative Tightening Playbook. Primary dealers, the large banks that help finance US Treasury auctions, have been pushing back their expected end date for quantitative tightening (QT). At the November FOMC meeting, participants expected QT

would be done in May. In December, they pushed it back to June. We think QT can run until Q3 or Q4, but continuing it for that long will be increasingly difficult for the Fed. It is highly likely the FOMC will end QT at the first sign of trouble. Here's more:

(1) *Running on reserves*. Bank reserves have barely budged despite two-plus years of balance-sheet runoff. There are $3.25 trillion of reserves in the US banking system, down from a peak of $4.19 trillion in September 2021 but roughly double pre-pandemic levels (*Fig. 4*). There are several reasons that reserves remain elevated: The Fed slowed its pace of balance-sheet reduction in June, relatively few MBS have matured due to low prepayments, and the multi-trillion dollars of money-market-fund assets in the reverse repurchase facility (RRP) financed much of the Treasury's issuance.

With just $179 billion in the RRP, bank reserves could break below $3 trillion in the first half of this year (*Fig. 5*).

(2) *Bond impact*. The Fed allows $30 billion of Treasuries to mature each month without reinvesting the proceeds. However, it still reinvests the rest of the maturing securities, partly into newly auctioned longer-dated Treasuries. That increases the amount of duration on its balance sheet, leaving private-sector balance sheets a little lighter and able to buy riskier or longer-duration assets rather than finance 10-year Treasury notes (*Fig. 6*).

Arguably, this has helped keep financial conditions relatively easy. Still, runoff is runoff, and a full-fledged end to QT would support bond prices as the Fed reinvests all of its proceeds.

Additionally, we suspect a policy change sometime this year: All maturing MBS (there are currently $2.2 trillion on the Fed's balance sheet) may be reinvested into Treasuries (*Fig. 7*). This would add another source of buying support for Treasuries and lower bond yields. As homebuyers adjust to higher mortgage rates and prepay/refinance old mortgages for personal reasons, higher prepayments can rapidly increase the amount of MBS maturing each month (*Fig. 8*).

An end to QT would also mean that big banks won't have to absorb as much of the new Treasury bonds on their own balance sheets (*Fig. 9*).

(3) *What could trigger the end of QT?* The reduction in bank reserves could cause short-term interest rates to rise, similar to the repo rate spike in 2019. The FOMC will most likely terminate QT once it sees a marginal, yet sustained, increase in repo rates. However, the 10-year Treasury bond yield breaching 5% could be another trigger. If higher long-term

yields put undue pressure on the economy, the Fed could use its balance-sheet policy to ease financial conditions by ending QT.

Calendars

US: Tues: NFIB Business Optimism Index 100.8; Headline & Core PPI 0.3%m/m/3.0%y/y & 0.2%m/m/3.2%y/y; Williams; Lane. **Wed:** Headline & Core CPI 0.3%m/m/2.8%y/y & 0.2%m/m/3.3%y.y; Empire State Manufacturing Index 4.5; MBA Mortgage Applications. (FXStreet estimates)

Global: Tues: Italy Industrial Production 0.3%; Breeden. **Wed:** Eurozone Industrial Production 0.4%m/m/-1.9%y/y; Germany GDP -0.2%; Germany Wholesale Prices 0.1%; France CPI 0.2%m/m/1.8%y/y; Spain CPI 0.4%m/m/2.8%y/y; UK Headline CPI 0.4%m/m/2.7%y/y; UK Core CPI 3.4%y/y; UK Input & Output PPI 0,2%/0.1%; UK Retail Price Index 0.6%m/m/3.7%y.y; De Guindos. (FXStreet estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): During the January 10 week, forward earnings rose for two of these three indexes. After doing so for nearly all of 2024, LargeCap's forward earnings rose to yet another record high. MidCap's improved to a 27-month high and is just 0.6% below its record high in early June 2022. SmallCap's ticked down from a 12-week high to 11.2% below its June 2022 record. LargeCap's forward earnings has soared 21.9% from its 54-week low during the week of February 1, 2023; MidCap's is 8.2% above its 55-week low during the week of March 10, 2023; and SmallCap's is just 2.8% above its 72-week low during the March 17, 2023 week. These three indexes' forward earnings downtrend from mid-2022 to early 2023 was relatively modest compared to their deep double-digit percentage declines during the Great Virus Crisis and the Great Financial Crisis. Here are the latest consensus earnings growth rates for 2024, 2025, and 2025: LargeCap (9.9%, 12.6%, 13.3%), MidCap (-0.7, 13.4, 15.9), and SmallCap (-12.6, 17.4, 18.7).

S&P 500/400/600 Valuation (*link*): Valuations dropped to 17-week lows for all three of these indexes during the January 10 week. LargeCap's forward P/E fell 0.5pt w/w to 21.2 and is now 1.1pts below its 43-month high of 22.3 during the December 6 week. It's up 4.2pts from a seven-month low of 17.0 during the October 27, 2023 week and 6.1pts 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 fell 0.4pt w/w to 15.2 and is now 1.9pts below its 40-month high of 17.1 during the November 29 week. It's up 2.9pts from a 12-month low of 12.3 at the end of October last year and compares 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 fell 0.4pt w/w to 15.2 and is 1.9pts below its 41-month high of 17.1, also during the November 29 week. It's up 4.6pts 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 26% discount to LargeCap's P/E compares to 22% during the November 29 week, which was the lowest since the March 9, 2023 week and up from a 25-year-high 29% discount during the July 5, 2024 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 28% discount compares to 23% during the November 29 week, which was the lowest since the March 9, 2023 week and up from a 24-year-low 34% discount during the July 5, 2024 week. That compares to a 20% discount during the March 2, 2023 week; that one was near its lowest discount since August 2021. SmallCap's 3% discount to MidCap's is widening again but remains among the smallest since July 2021. Prior to that, from 2003 to 2018, SmallCap's P/E had been mostly above MidCap's, and both were above LargeCap's.

Global Economic Indicators

Germany Industrial Production (*link*): German industrial production beat expectations in November, but the underlying picture remains weak. Germany's *industrial production*, which includes construction, jumped 1.5%, above the consensus estimate of a 0.5% uptick, though remains on a steep downtrend, sliding 8.6% from February 2023's peak. During November, energy output expanded 5.6%, while construction rose 1.2%, with transportation equipment production also adding to the gain. Excluding energy and construction, output advanced 1.0%, though was 3.2% below a year ago. *By sector*, there was widespread strength in November, with output of capital (1.4%), consumer (0.9), and intermediate (0.5) goods all in the plus column.

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