22 July 2022

RESEARCH NOTE

Will the Fed's QT Trigger a Financial Crisis as Growth Slows?

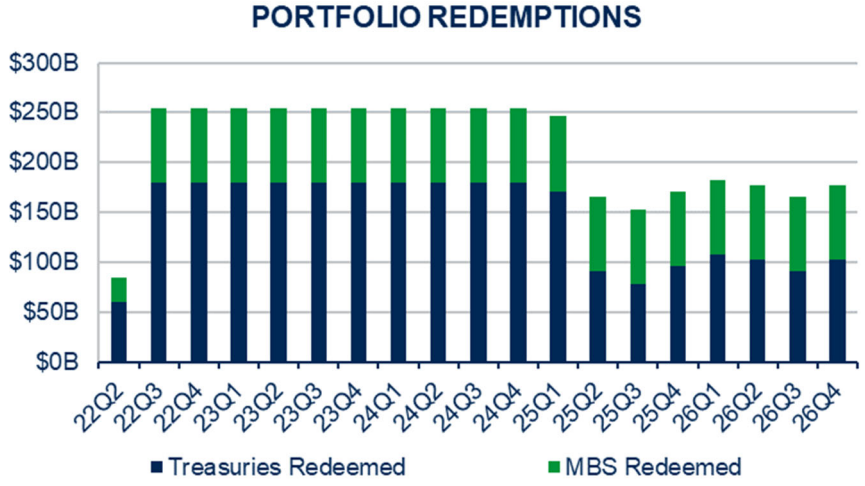
Christian Floro, New York

The Fed will likely proceed with extreme caution on Quantitative Tightening (QT). There are risks around finding new marginal buyers for government debt, especially buyers who care far more for valuation and return. But, the overall market impact should prove limited as issuance shrinks. If signs of instability start developing the Fed will likely put it on the back burner. Rising recessionary fears as demand contracts will likely be a larger driver of nominal interest rates.

How will it work?

Policy rate hikes are the Fed's primary tool to control inflation, but also running in the background is the Fed's Quantitative Tightening (QT). The Fed has only simultaneously had to raise interest rates while unwinding the balance sheet once, in 2017, but then had to abort abruptly when the repo market broke. So not only is uncertainty high around their dual impact, the limited historical precedent also suggests the Fed will likely proceed with extreme caution.

The shrinking process began June 1 and involves a series of growing monthly "caps," or quantity of securities that would be allowed to mature without reinvestment—topping out at $60 billion in U.S. Treasuries (UST) and $35 billion in Mortgage Backed Securities (MBS), for a total of $250 billion every quarter. When there is a shortfall for maturing Treasuries, the Fed will allow bills to mature to meet their target redemptions as needed.



Source: Piper Sandler. As of April 30, 2022.

What will be the market impact?

There are no planned active sales from the Fed's balance sheet for now, so the impact of QT will likely be felt the most during Treasury auction days, when a larger share of Treasury issuance going forward will have to be absorbed by the public. This will likely materialize as higher-term premiums and real yields.

Quantitative Easing aimed to reduce term premia and flatten the curve, so the reverse can be expected during QT. Given that it has been well telegraphed, it's likely that markets have sufficiently priced in the impact, at least in the near term. Its execution (i.e., via balance sheet run-off rather than asset sales) also suggests that the magnitude of this reverse impact should be much smaller than when it was implemented at the height of the pandemic with massive Fed purchases. The limited historical precedent suggests need for caution, however, especially as the pace of QT is programmed to accelerate this fall. As financial conditions continue to tighten and as more Treasury auctions progress, there will likely also be risks around how smoothly a new marginal buyer is found, potentially adding upside risks to yields.

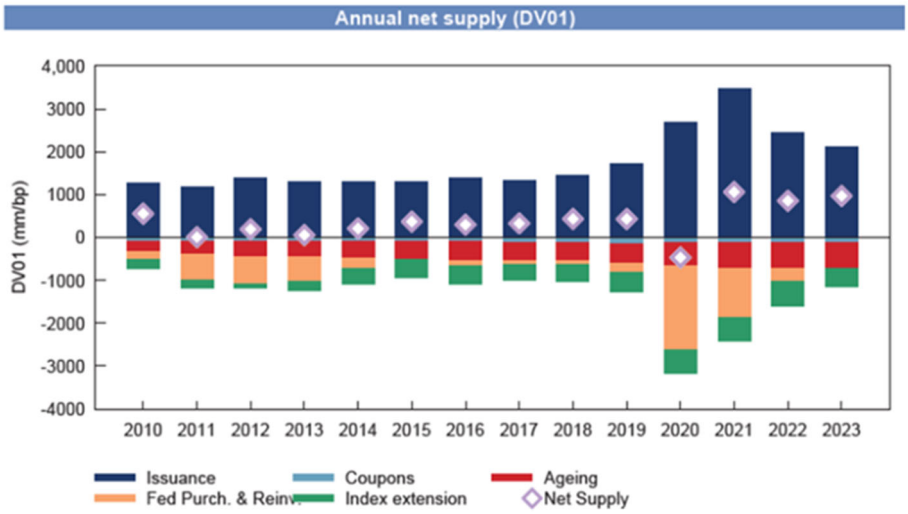
Critical on determining the pricing impact will be assessing the appetite of any marginal buyer. That first requires an understanding of return requirements. The Fed has been a non-economic buyer, intervening to stabilize rates, rather than earn a profit. Alternative buyers filling the gap may now require more yield to compensate for perceived risks, and this may rise as the Fed steps away and amid the inflationary backdrop. If total returns for U.S. Treasury bonds hovering at -13% YTD—the worst in several decades—are any indication, interest rates may have to go up notably to make ownership attractive from a total return perspective.

As for MBS, the impact may be muted for now. The Fed's MBS portfolio's weighted average coupon is roughly 3.16%, and with 30-year mortgage rates reaching as high as 6%, reductions in MBS debt due to prepayment are likely to come in well below the Fed's stated redemption schedule. Coupled with moderating housing activity leading to lower organic MBS supply, the overall backdrop should remain supportive for MBS spreads. There is a potential, however, that the Fed may further increase the pace MBS rolls off through sales if they deem it appropriate, as they've previously communicated, which would see active selling and potential widening in MBS spreads and further weigh on housing activity.

Finally, the outlook will likely revolve around the Fed's commitment to this tool, and it's expected they'll stop if the tool proves too disruptive. This suggests that if liquidity significantly deteriorates to the extent it triggers market stress, potentially challenging proper market function or creating instability of financial markets, it would likely be interpreted as going against the "ample reserves regime."

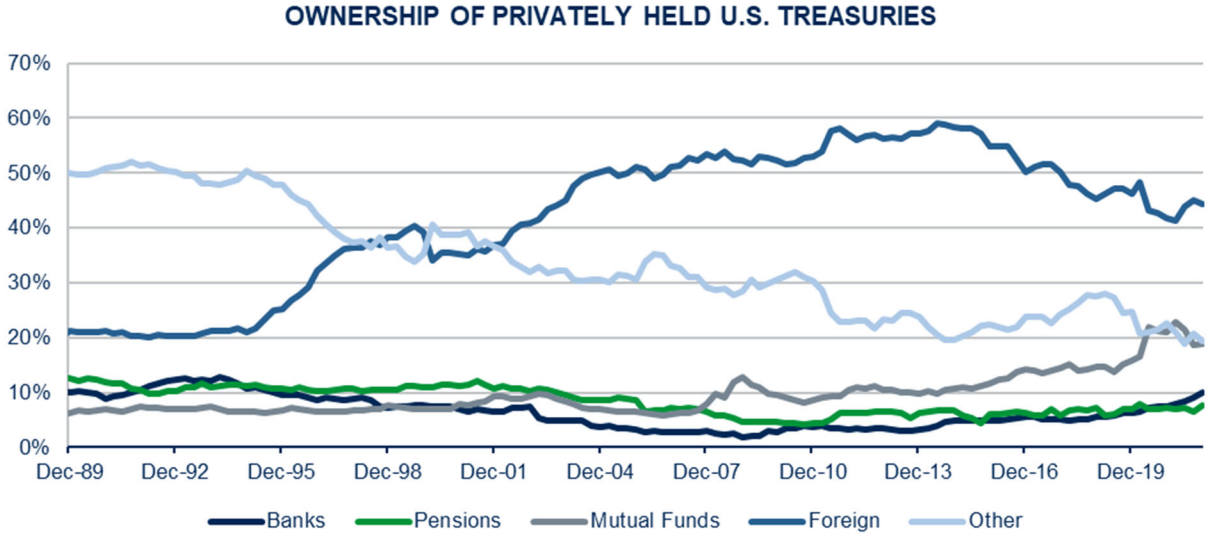
Who will replace the Fed as the marginal buyer?

The expected historic contraction in the budget deficit, and higher-than-expected tax revenues this year, mean the decline in U.S. Treasury supply may fully offset lost Fed demand. Indeed, measuring the sensitivity of likely issuance to interest rate moves is reassuring. Goldman Sachs estimates no increase in monthly supply through 2023 on a net duration supply (DV01) basis, which adjusts all issuance to 10-Year equivalent debt. This means investors may not require additional compensation to take down U.S. Treasury supply, all else equal.



Source: Goldman Sachs. As of July 1, 2022.

Even with falling issuance, auctions will remain larger than they have been in recent history, making it more important to find a marginal buyer.

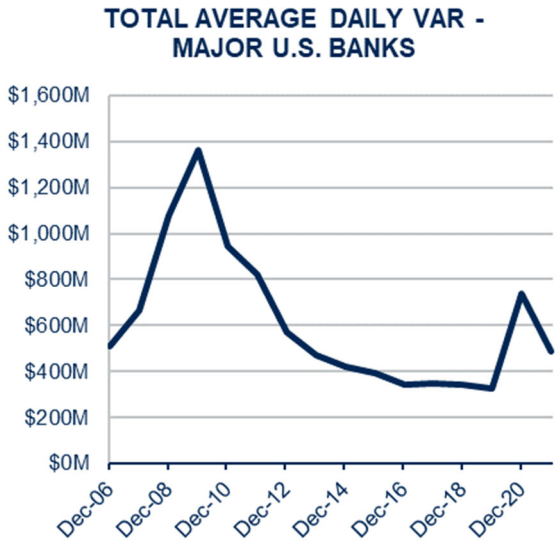


Source: Haver. As of July 1, 2022.

In a system of abundant reserves—which we're in—there should theoretically be sufficient room for **domestic banks** to swap reserves into treasuries, especially as UST are viewed from a risk-weighted perspective as the equivalent to reserves. Among many factors impacting a bank's decision too is that U.S. Treasury yields are above interest on excess reserves. But the decision to buy may prove more complicated, as rising loan demand leaves less room to hold Treasuries and interest rate volatility has already weighed on bank demand. Indeed, commercial bank U.S. Treasury purchases through Q1 have already been subdued. Banks may also shy away from Treasuries, as it may increase their internal risk metrics. There are also the implicit and explicit costs associated with the post-Global Financial Crisis regulatory regime, in addition to

frictions around owning UST. Roughly speaking, and assuming banks buy 10% of net U.S. Treasury supply next year (as they have this year), this means that daily VaR may more than double to $1.2 billion, approaching levels before the 2008 financial crisis. Separately, with the yield curve very flat to inverted, together with expectations that short-end yields will rise further in the near term, carry may not be attractive enough to incentivize increased allocations towards UST, particularly on the long-end. Given this, excess capital may instead be used to buy back shares or given back as dividends.

Foreign banks have been prominent holders of UST, but they may be less eager, too. Higher hedging costs—driven by strong U.S. dollar appreciation—and rising rates globally makes U.S. assets relatively less attractive. It's also worth considering the general trend of de-dollarization and falling global FX reserves, which implies less structural foreign demand for U.S. safe haven assets.



Source: Bloomberg. As of July 7, 2022.

Together with **mutual** and **pension funds**, this could mean much of the demand burden may fall on **households**, which are currently sitting on excess bank deposits. This may be consistent with the last period of QT, where households absorbed a large portion of UST supply. However, if households opt to wind down savings to buffer consumption in the face of declining purchasing power, then it leaves them less liquidity to absorb Treasury supply.

What could go wrong?

Borrowing costs: QT should lead to a rise in risk and liquidity premia, and thus higher borrowing costs. But, this adjustment could be much larger if the pace of balance sheet runoff is accelerated or if system-wide liquidity is significantly lower than currently assumed. Thus, the upward adjustment process in interest rates could more than offset any declines in growth expectations.

Market function: Recent efforts to adjust the balance sheet have disrupted markets. In 2013, the mere mention of tapering asset purchases led to a significant market "tantrum." In 2019, arguably too many reserves were drained from the financial system, which triggered a repo crisis. Regulatory changes post

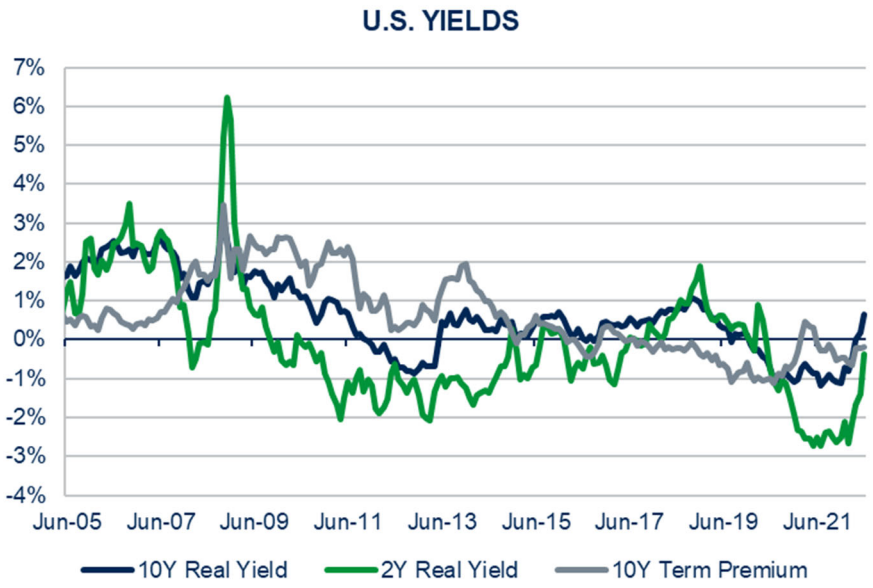
global financial crisis also makes it more difficult for dealers to intermediate efficiently in repo markets. So the question potentially isn't how much the absolute level of liquidity recedes, but whether there are sufficient hurdles to getting it to the right place without disruption.

New issuance: How the Treasury decides to skew issuance could also play a role. It will be easier for the market to absorb less risky, shorter-duration debt. Total issuance matters, too. If short-term collateral remains scarce, then liquidity could continue to flow into the Fed's Reverse Repo Facility (RRP), given more-attractive yields.

Bank deposits: This also may place pressures on bank deposits, which are already showing signs of decline. With deposit rates still at zero, and as market rates rise, there could be a rotation towards money market funds. This suggests the RRP won't be a source of liquidity for the market as widely assumed. Somewhat reassuringly, the Fed's new Standing Repo Facility (SRF) can provide a backstop in the event of a system-wide shortage of liquidity while something goes wrong. Not only does the SRF provide intraday U.S. Treasury liquidity, but it theoretically allows for a smaller minimum size of the Fed balance sheet, giving more room for QT to run before reaching the critical lower bound on reserves.

Summary

There is a limited historical precedent around QT, and the Fed's recent track record around adjusting its balance sheet doesn't give much confidence, either. But for now, while there may be friction associated with finding a new marginal buyer, total issuance is set to shrink. In addition, at the first sign of trouble, the Fed may be quick to course correct. Looking ahead, rising recessionary fears will likely be a larger factor in determining interest rates, but expect real yields and term premiums to continue trending higher, even if nominal yields trend lower.



Source: Bloomberg. As of July 7, 2022.

IMPORTANT INFORMATION

IMPORTANT INFORMATION

Any forecasts in this document are based upon Barings opinion of the market at the date of preparation and are subject to change without notice, dependent upon many factors. Any prediction, projection or forecast is not necessarily indicative of the future or likely performance. Investment involves risk. The value of any investments and any income generated may go down as well as up and is not guaranteed by Barings or any other person. PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS. Any investment results, portfolio compositions and or examples set forth in this document are provided for illustrative purposes only and are not indicative of any future investment results, future portfolio composition or investments. The composition, size of, and risks associated with an investment may differ substantially from any examples set forth in this document. No representation is made that an investment will be profitable or will not incur losses. Where appropriate, changes in the currency exchange rates may affect the value of investments. Prospective investors should read the offering documents, if applicable, for the details and specific risk factors of any Fund/Strategy discussed in this document.

Barings is the brand name for the worldwide asset management and associated businesses of Barings LLC and its global affiliates. Barings Securities LLC, Barings (U.K.) Limited, Barings Global Advisers Limited, Barings Australia Pty Ltd, Barings Japan Limited, Baring Asset Management Limited, Baring International Investment Limited, Baring Fund Managers Limited, Baring International Fund Managers (Ireland) Limited, Baring Asset Management (Asia) Limited, Baring SICE (Taiwan) Limited, Baring Asset Management Switzerland Sarl, and Baring Asset Management Korea Limited each are affiliated financial service companies owned by Barings LLC (each, individually, an "Affiliate"). Some Affiliates may act as an introducer or distributor of the products and services of some others and may be paid a fee for doing so.

NO OFFER: The document is for informational purposes only and is not an offer or solicitation for the purchase or sale of any financial instrument or service in any jurisdiction. The material herein was prepared without any consideration of the investment objectives, financial situation or particular needs of anyone who may receive it. This document is not, and must not be treated as, investment advice, an investment recommendation, investment research, or a recommendation about the suitability or appropriateness of any security, commodity, investment, or particular investment strategy, and must not be construed as a projection or prediction.

Unless otherwise mentioned, the views contained in this document are those of Barings. These views are made in good faith in relation to the facts known at the time of preparation and are subject to change without notice. Individual portfolio management teams may hold different views than the views expressed herein and may make different investment decisions for different clients. Parts of this document may be based on information received from sources we believe to be reliable. Although every effort is taken to ensure that the information contained in this document is accurate, Barings makes no representation or warranty, express or implied, regarding the accuracy, completeness or adequacy of the information.

Any service, security, investment or product outlined in this document may not be suitable for a prospective investor or available in their jurisdiction.

22-2290325