Daiwa's View

Consensus on the Fed's QT (Dec 2023)

- MBS balance expected to continue decreasing, even after halt to reduction in UST balance
- QT expected to slow in spring 2024
- Consensus is optimistic for economic conditions, assuming ample liquidity remaining

FICC Research Dept

Kengo Shiroyama
81-3-5555-8755
kengo.shiroyama@daiwa.co.jp

Kenji Yamamoto
81-3-5555-8784
kenji.yamamoto@daiwa.co.jp

Daiwa Securities Co. Ltd

In this report, we confirm what the consensus is regarding the Fed's balance sheet reductions (QT).

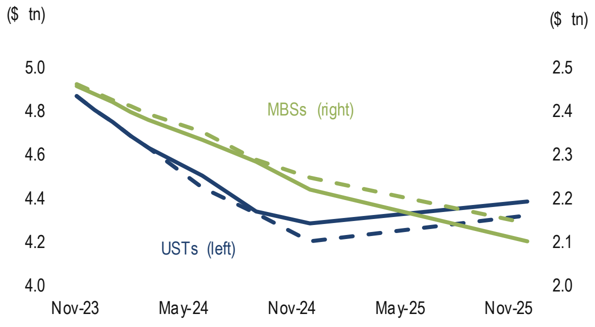
On 4 January, the New York Fed announced the results of the Survey of Primary Dealers (SPD) and the Survey of Market Participants (SMP). Figures are median responses unless otherwise noted.

There have been no major changes to the outlook for QT in either survey compared to before. On the asset side, the balance of US Treasuries (UST) is expected to start to increase from 2025. Meanwhile, the balance of MBSs is expected to continue to decrease, even after the UST balance starts to increase (Chart 1). The respondents' view that the decrease in the MBS balance will not reach the monthly roll-off cap has also not changed since the previous surveys.

Respondents appear to anticipate that this spring will see a slowing of QT, which is a focus of attention. Looking at the pace at which the Fed's total assets decline monthly, the SPD indicated the pace of decline would slow in March 2024, while the SMP indicated this would happen in April 2024 (Chart 2). The response period for both surveys was 29 November to 4 December 2023, indicating that a slowdown in QT in the first half of 2024 was widely expected even before the release of the minutes of the December FOMC meeting and the remarks by Dallas Fed President Lorie Logan. It is possible that the consensus regarding when QT will slow shifted to an even earlier time after both surveys were conducted.

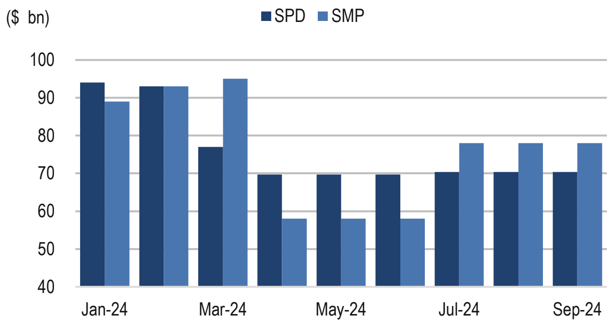
As both surveys still assume that rate cuts will start at the June 2024 meeting, respondents expect QT to start to slow before the start of rate cuts. However, the MBS balance is expected to decrease even after reduction of the UST balance has stopped. Total assets are also expected to continue declining into next year.

Chart 1: Estimated UST and MBS Balances Held by SOMA



Source: New York Fed; compiled by Daiwa.
Note: Solid lines and dotted lines denote SPD and SMP data, respectively.

Chart 2: Pace of Decline in Fed's Total Assets (monthly)



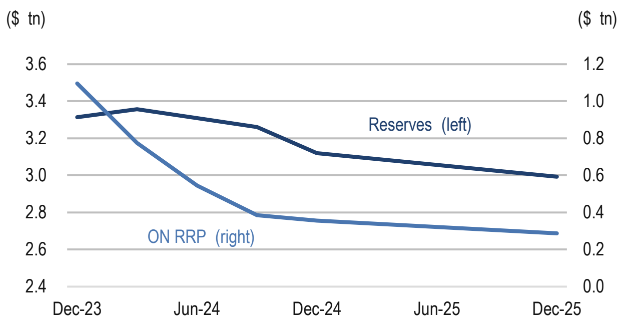
Source: New York Fed; compiled by Daiwa.
Note: Figures from Apr 2024 are calculated assuming quarterly decline occurs evenly.

On the liability side, the outlook continues to be that the overnight reverse repurchase (ON RRP) balance will continue to decline, but that the pace of decline is likely to be moderate. However, results from the latest surveys anticipate the balance decreasing to below $300bn towards the end of 2025, as compared to a decline to $500bn that was anticipated in the previous surveys (Chart 3). This seems to be a reflection of the rapid pace at which the ON RRP balance has declined.

Meanwhile, the decline in the reserve balance towards the end of 2025 is expected to be limited to $3tn, which is an upward revision from the previous surveys. This appears to be a reflection of how the reserve balance has increased recently while QT has been mainly reducing the ON RRP balance. Another likely influence is the increased interest in a coming slowdown in the pace of QT due to the rapid decline in the ON RRP balance.

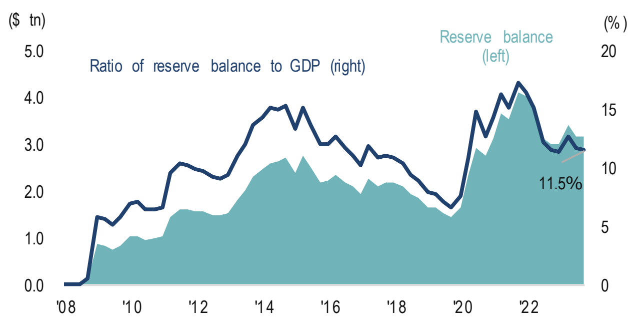
However, with the reserve balance worth $3tn, the ratio of the reserve balance to current US GDP exceeds 10%. Even considering the outlook that nominal GDP will continue to grow, the ratio is higher than 8% or 9%, which is the Fed's point of reference for an end to QT. Assuming the US achieves a soft landing, the ratio has not reached the QT target (Chart 4). This is an optimistic outlook for economic conditions, assuming rate cuts will be implemented moderately, the pace of QT will slow early, and ample liquidity will remain in the market. As Dallas Fed President Logan stated, the object of slowing the pace of QT is to "help get to a more efficient balance sheet in the long run." Slowing the pace does not mean an early end to QT. The market's optimistic view could loosen financial conditions, which could, in the end, lead the Fed to prolong the period of monetary tightening.

Chart 3: Estimated Balances of ON RRP and Reserves



Source: New York Fed; compiled by Daiwa.

Chart 4: Reserve Balance, Ratio of Reserve Balance to GDP



Source: Department of Commerce, New York Fed; compiled by Daiwa.

IMPORTANT

This report is provided as a reference for making investment decisions and is not intended to be a solicitation for investment. Investment decisions should be made at your own discretion and risk. Content herein is based on information available at the time the report was prepared and may be amended or otherwise changed in the future without notice. We make no representations as to the accuracy or completeness. Daiwa Securities Co. Ltd. retains all rights related to the content of this report, which may not be redistributed or otherwise transmitted without prior consent.

Ratings
Issues are rated 1, 2, 3, 4, or 5 as follows:
1: Outperform TOPIX/benchmark index by more than 15% over the next 12 months.
2: Outperform TOPIX/benchmark index by 5-15% over the next 12 months.
3: Out/underperform TOPIX/benchmark index by less than 5% over the next 12 months.
4: Underperform TOPIX/benchmark index by 5-15% over the next 12 months.
5: Underperform TOPIX/benchmark index by more than 15% over the next 12 months.

Benchmark index: TOPIX for Japan, S&P 500 for US, STOXX Europe 600 for Europe, HSI for Hong Kong, STI for Singapore, KOSPI for Korea, TWII for Taiwan, and S&P/ASX 200 for Australia.

Target Prices
Daiwa Securities Co. Ltd. sets target prices based on its analysts' earnings estimates for subject companies. Risks to target prices include, but are not limited to, unexpected significant changes in subject companies' earnings trends and the macroeconomic environment.

Disclosures related to Daiwa Securities
Please refer to https://drp.daiwa.co.jp/rp-daiwa/direct/reportDisclaimer/e_disclaimer.pdf for information on conflicts of interest for Daiwa Securities, securities held by Daiwa Securities, companies for which Daiwa Securities or foreign affiliates of Daiwa Securities Group have acted as a lead underwriter, and other disclosures concerning individual companies. If you need more information on this matter, please contact the Research Production Department of Daiwa Securities.

Explanatory Document of Unregistered Credit Ratings
This report may use credit ratings assigned by rating agencies that are not registered with Japan's Financial Services Agency pursuant to Article 66, Paragraph 27 of the Financial Instruments and Exchange Act. Please review the relevant disclaimer regarding credit ratings issued by such agencies at: https://drp.daiwa.co.jp/rp-daiwa/direct/reportDisclaimer/credit_ratings.pdf. If you need more information on this matter, please contact the Research Production Department of Daiwa Securities.

Notification items pursuant to Article 37 of the Financial Instruments and Exchange Law
(This Notification is only applicable to where report is distributed by Daiwa Securities Co. Ltd.)
If you decide to enter into a business arrangement with our company based on the information described in this report, we ask you to pay close attention to the following items.

- In addition to the purchase price of a financial instrument, our company will collect a trading commission* for each transaction as agreed beforehand with you. Since commissions may be included in the purchase price or may not be charged for certain transactions, we recommend that you confirm the commission for each transaction. In some cases, our company also may charge a maximum of ¥2 million per year as a standing proxy fee for our deposit of your securities, if you are a non-resident.
- For derivative and margin transactions etc., our company may require collateral or margin requirements in accordance with an agreement made beforehand with you. Ordinarily in such cases, the amount of the transaction will be in excess of the required collateral or margin requirements**.
- There is a risk that you will incur losses on your transactions due to changes in the market price of financial instruments based on fluctuations in interest rates, exchange rates, stock prices, real estate prices, commodity prices, and others. In addition, depending on the content of the transaction, the loss could exceed the amount of the collateral or margin requirements.
- There may be a difference between bid price etc. and ask price etc. of OTC derivatives handled by our company.
- Before engaging in any trading, please thoroughly confirm accounting and tax treatments regarding your trading in financial instruments with such experts as certified public accountants.

* The amount of the trading commission cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.
** The ratio of margin requirements etc. to the amount of the transaction cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

When making an actual transaction, please be sure to carefully read the materials presented to you prior to the execution of agreement, and to take responsibility for your own decisions regarding the signing of the agreement with our company.

Corporate Name: Daiwa Securities Co. Ltd.
Registered: Financial Instruments Business Operator, Chief of Kanto Local Finance Bureau (Kin-sho) No.108
Memberships: Japan Securities Dealers Association, The Financial Futures Association of Japan, Japan Investment Advisers Association, Type II Financial Instruments Firms Association, Japan Security Token Offering Association