The Damped Spring Report

"Shifts in growth, inflation, risk premium and positioning all lead to opportunities in markets"

2/24/2025

Almost a year ago, we presented a plan for the Fed to restructure its balance sheet. We called it QT2.0. Until very recently, the Fed had taken no action whatsoever to restructure the SOMA portfolio. Last week in the January FOMC minutes, the Fed began to outline a destination. The Fed wants to adjust the weighted average maturity ("WAM") of the Treasury holdings of the SOMA portfolio to match outstanding Treasury debt WAM. Tweaking the reinvestment plan, which the Fed is likely to implement in May, is an excellent first step, but won't come close to accomplishing the desired shift. We consider last week's news to be an inflection point regarding the balance sheet. If it represents a turn toward meaningful shifts in the SOMA holdings, that will impact markets and potentially monetary policy.

Treasury continues to depend on rolling $6.5TN of Treasury bills. As expected, the QRA kept coupon auctions fixed and provided forward guidance that no increases were planned. If the Trump administration is successful in significantly reducing the deficit, it can maintain the coupon auctions sizes at current levels and organically reduce the bills percentage. However, deficit reduction is not certain and organic extension of Treasury issuance enabled by deficit cuts (which reduce private sector savings) should have the same impact as a coupon increase in a rising deficit environment.

The Fed minutes sounded faint drumbeats of QT2.0. The drumbeat was drowned out by several members of the FOMC considering a pause in QT and Secretary Bessent, counting on deficit reduction, reaffirming that terming out the debt was a "long way away." As the outlook for fiscal policy crystallizes, and the implication of that policy on issuance is realized, and as the Fed ends QT and begins to deal with its bloated balance sheet, we expect markets to hear the drumbeats of duration overhang and for term premiums to widen moderately. These are slow moving, multi-year flows, which we consider a steady headwind on already elevated asset prices.

The Fed is irresponsibly long duration:

- The Fed owns $2.2TN of MBS, which they do not want.
- The Fed is $1.13TN 10Y WAM over its desired WAM.

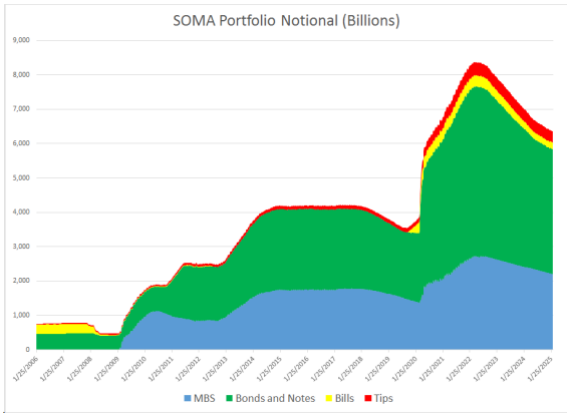
- An aggressive shift in the Fed's reinvestment policy will only reduce this $1.13TN by $120-180BN per year.

Treasury has depended on bills as if a recession was occurring:

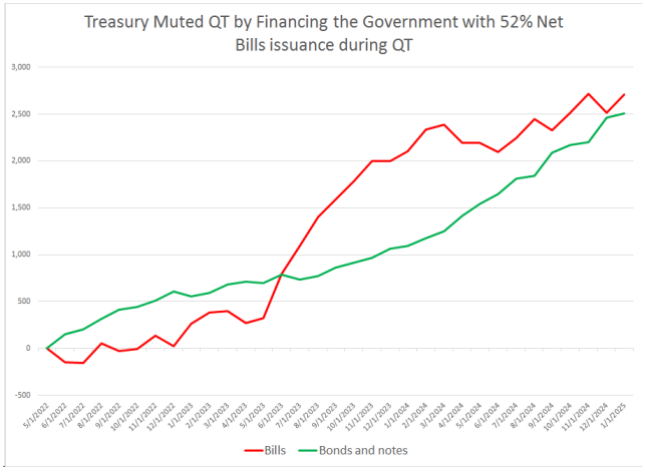
- Our aggressive case budget deficit reduction projection sees auction sizes remaining the same while keeping bills outstanding constant, which would deliver an 18.5% bills ratio over the next three years.
- Our central case projection requires an increase in auction sizes such that total net coupons over the next three years would create $1.4TN of coupons to achieve similar 18.5% Bills Ratio.

SOMA Balance Sheet

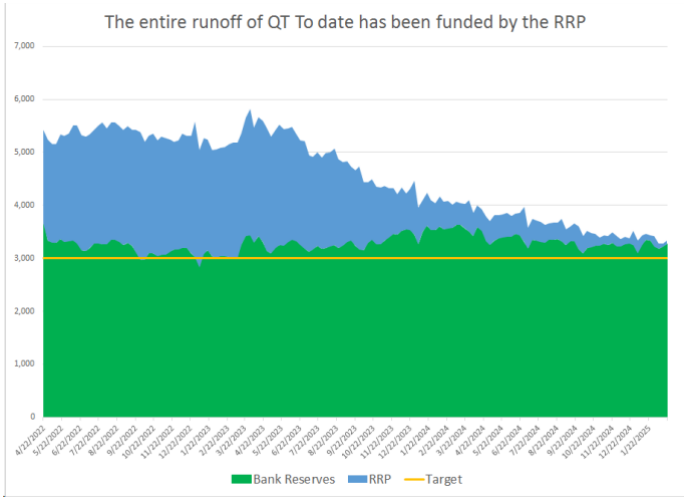
The SOMA portfolio has fallen in size since QT started, dropping by $2TN in just under 3 years. That is a meaningful accomplishment:



However, the decrease in size was done through runoff, which enabled Treasury to manage monetary policy versus other central banks who have directly sold assets to the marketplace. Treasury chose to fund the runoff and the broader economy with bills far in excess of any norm, which served to mitigate the monetary tightening of QT:

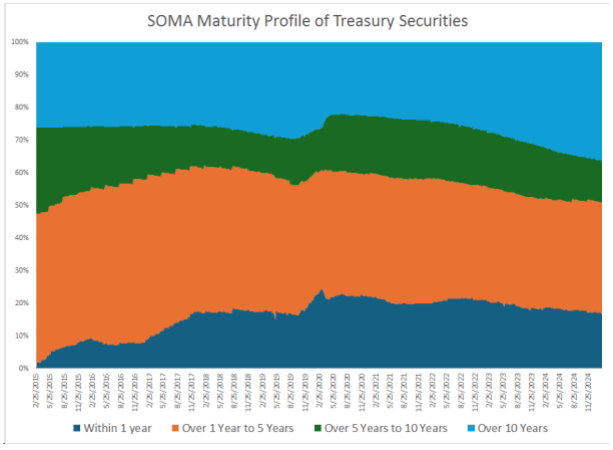


In fact, all of the runoff was funded by the RRP facility. While somewhat fungible, RRP investors were happy to buy the roughly $1.4TN excess bills issued by Treasury. Bank Reserves have hardly moved since QT started:

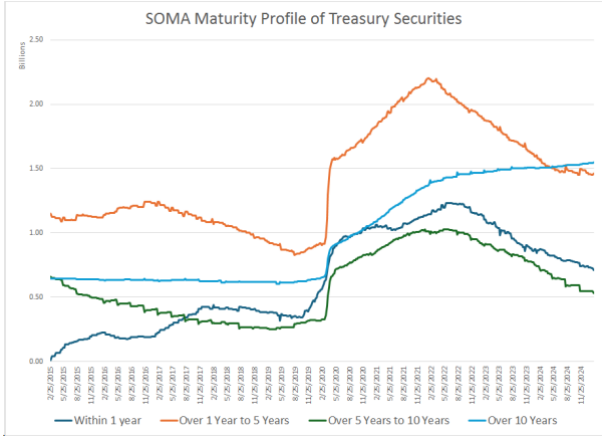


Despite the muting of QT's monetary impact, the good news is that total liquidity is approaching the Fed's target of roughly $3TN of Reserves. With $45BN of SOMA portfolio running off monthly, the remaining $340BN should be drained over the next 7 months. Later in this article, we address the potential need to pause QT during the Debt Ceiling crisis and whether the $3TN target should be adjusted to reach ample reserves given the complicating factor of uneven distribution of reserves. Nonetheless, it is notable that QT is near its goal.

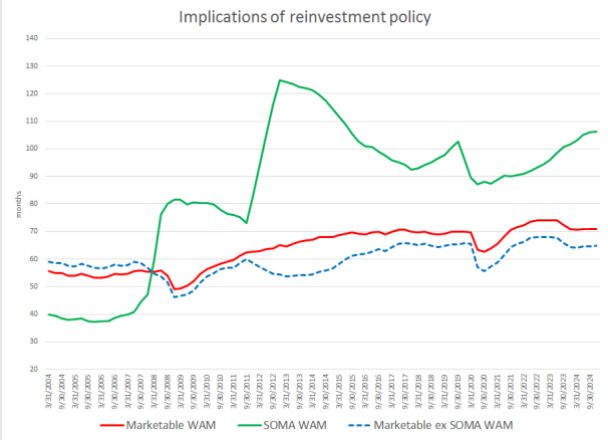
Unfortunately, the success of the runoff cannot be determined simply by looking at the quantity of the SOMA holdings. Each month, the Fed reinvests proceeds of maturities above the cap in add-on purchase at each Treasury auction. That reinvestment process ensures the Fed's participation in the auctions in a proportional way relative to issuance amounts. However, it has led to an odd outcome. While the Fed has said it desires to reduce the duration of its SOMA Treasuries, the reinvestment plan has increased the WAM and duration. The share of 10Y and longer bonds has increased:



In quantity, 10Y holdings have stayed steady as the 10Y securities bought during QE shortened in maturity and were replaced by longer bonds:



The reinvestment policy has led to the SOMA portfolio's WAM to extend far longer than the existing outstanding government debt and that has extended the government debt WAM without requiring that Treasury tap the private sector for duration. Essentially, the reinvestment policy muted QT as well:



The Drumbeat of QT2.0 was heard when the Fed made this statement in its recent minutes:

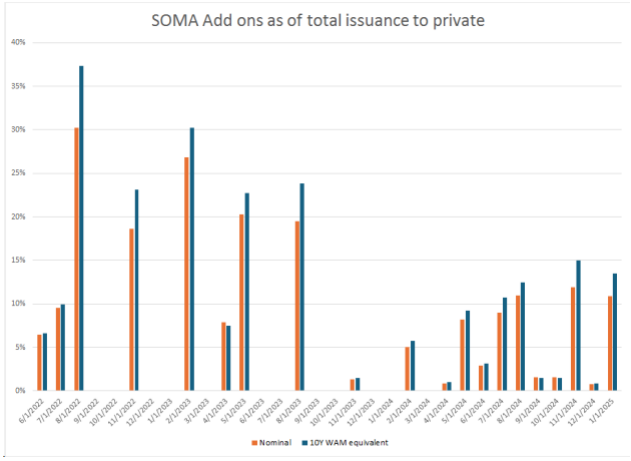
> Regarding the composition of secondary-market purchases of Treasury securities that would occur once the process of reducing the size of the Federal Reserve's holdings of securities had come to an end, many participants expressed the view that it would be appropriate to structure purchases in a way that moved the maturity composition of the SOMA portfolio closer to that of the outstanding stock of Treasury debt while also minimizing the risk of disruptions to the market.

We expect the reinvestment policy change mentioned above to be implemented at the Fed's May meeting. Its goal will be to converge the green line in the chart above to the red line. That would be a reduction of the SOMA portfolio's WAM from 106 months to 71, assuming no change in the Treasury's issuance composition to both the private sector and add-ons by the Fed. The private sector will have to

absorb that duration. **Based on the destination, the private sector would have to absorb $1.28TN of 10Y WAM.**

What does changing the reinvestment policy do?

$1.28TN in 10Y is a big number. But hold on: that's the destination for the balance sheet and all that is being changed is the reinvestment. To see the impact, we need to model the reinvestment flows. Those reinvestment flows will also change by $25BN once QT ends this summer:



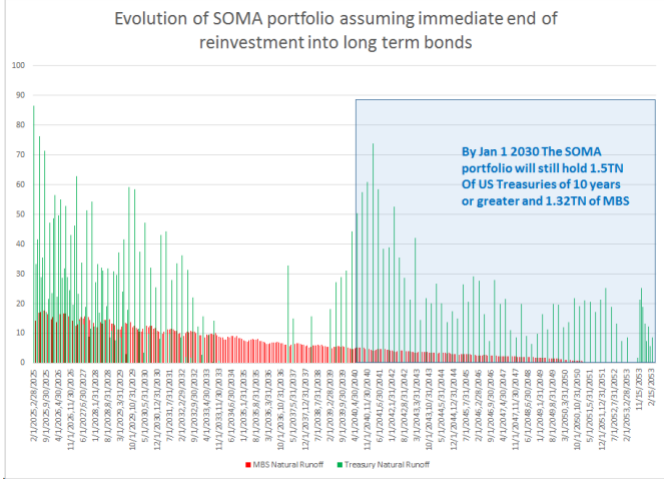
Since QT started, the original caps resulted in many months where the SOMA portfolio required no reinvestment of proceeds. Lately, as QT caps were lowered, the reinvestment has been more consistent; because of the timing and available maturities during QE, there will always be some variance. Once QT ends, the reinvestment will also rise due to no more caps. We estimate ongoing reinvestment at 15% on average per month of existing gross auction amounts, assuming gross auction sizes are stable. Furthermore, we assume bills auction sizes won't grow.

The monthly WAM auctioned by Treasury averages 7.62 Years on gross notional of $335BN. That is composed of $131BN of 7Y and longer notes, bonds, and TIPS with a WAM of 14.2 Years, and $204BN of 5Y and shorter with a WAM of 3.4 Years.

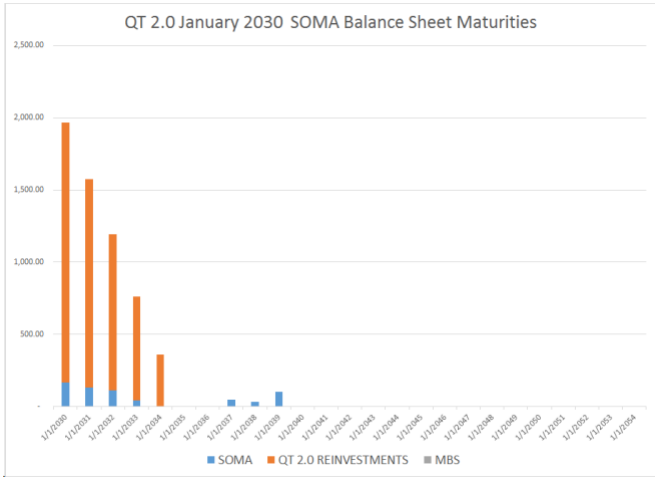
Using the old reinvestment policy, each month the Fed would purchase $19.7BN of 7Y and greater Treasuries. If the Fed switches that to 5Y and under notes and TIPS, it will reduce WAM purchase by $19.7BN*(14.2-3.4)/10 or $21.2BN 10Y WAM equivalent. If the Fed only buys bills, this pace would be greater. **By changing the reinvestment policy in this way, it will take the Fed 5 years to get its Treasury holding WAM to its desired target while also pushing $21.2BN 10Y WAM equivalent onto the private sector.** If the Fed only buys bills, this pace would be greater. However, given the destination it makes sense to buy out to 5Y. Implementing the plan for reinvestment described here would make a big shift in SOMA portfolio's WAM over the next five years and modestly tighten financial conditions on the long end, which perhaps could be offset with cutting short rates. However, the balance sheet would remain an issue.

Lower WAM but still a lot of MBS and long-term bonds.

Assuming the Fed implements the change in reinvestment described above, the WAM of the Treasury SOMA portfolio would shrink to match the outstanding US debt. However, the MBS portfolio would still be quite large. In addition, the SOMA Treasuries portfolio would still own a lot of 10Y and longer Treasuries. In the minutes, the Fed also mentioned that it may switch to bills. If so, that may muck up the WAM picture, and, if desired, enable the Fed to achieve its WAM goal sooner:



If the economy remains strong, with sticky inflation and term premiums that remain well below normal despite having risen, it is an opportune time to act more aggressively. Shifting the reinvestment policy is a good start. The next step that would also result in tightening of financial conditions and the ability for the Fed to cut rates further, would be to sell $20BN of 10Y and longer Treasuries and $20BN MBS per month from the SOMA portfolio in the secondary market while bidding for short term notes, either as add ons or in the secondary market to be reserves neutral. If that were implemented in May in 5Y, the SOMA portfolio would be well positioned for the next crisis with no MBS and almost no Treasuries longer than 5Y.

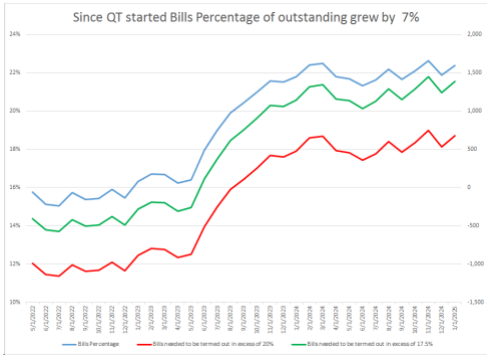


Scope of DS QT2.0 Plan

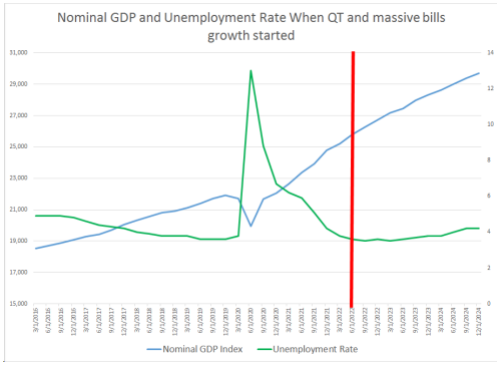
The full implementation of our plan would result in the continued runoff of $20BN MBS, a $20BN reduction of 10Y WAM reinvestment, $20BN of outright Treasury sales and $20BN of MBS sales. We understand that sounds like a lot. However, the plan is 100% bank reserves neutral because proceeds from all runoff and sales are invested in short term notes and bills. When compared to Treasury net issuance for funding the budget deficit, it is roughly half of the total and so it is not nothing. Ironically, it is essentially equal to the original QT amounts. That QT1.0 was muted by the bills issuance and subsequent RRP drain; QT2.0 would do the tightening anticipated 3 years ago. That tightening would absolutely impact the market, which would have consequences for the economy. At the end of this report, we will assess market and economic impacts. Regardless, the Fed's balance sheet needs more work to be done, and the first Drumbeat has been heard.

Treasury Issuance

We do not understand why Treasury decided to issue bills so aggressively from June 2022 as the means of financing QT and the large budget deficit:



Despite an equity and bond selloff in 2022, the economy was booming. We have been asking Treasury why they eased and we will ask future Treasury Secretaries why they attempt to manage monetary policy:



We don't know why Treasury used issued bills so aggressively for the last three years, but we do have high confidence that the choices made have resulted in inflation remaining well above target for five years. Both the Fed and Treasury are

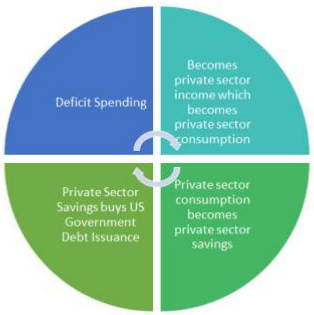
in **no** position to buy bonds (in the case of the Fed) or to fund the deficit with bills (in the case of Treasury). Both Treasury and the Fed must consider further selling in duration to prepare for a future slowdown before it is too late.

The auction sizes fallacy

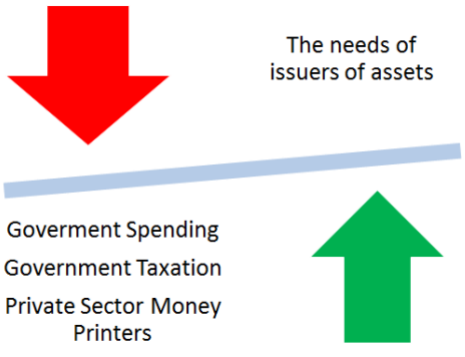
Those who have recently come upon the impact of the QRA and Treasury issuance in general have focused on bills auction amounts or coupon auction sizes. We have been working on this topic since our founding, and we often use auction sizes as a short cut. In this section, we will more fully detail our framework for Treasury issuance. The point of this section is that shifts in aggregate private sector risk in outstanding Treasuries impact curve shape and term premium and that the quantity of issuance is much less important.

A country that prints its own currency self-funds its deficit

Until a country is unable to issue debt in its own currency (which is not the case today nor likely to be in this decade for the U.S.), the following "circle of life" holds:



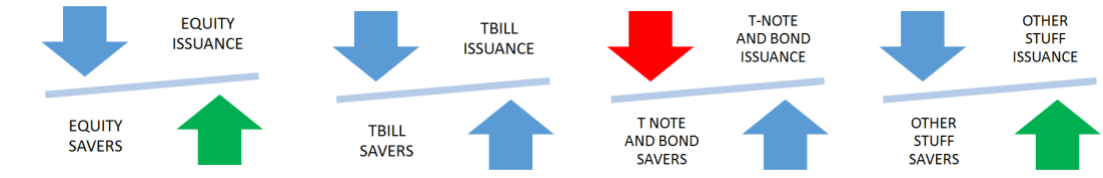
But this circle of life only applies to government deficit funding. It fits into a much larger balance between savers and borrowers:



All the money and credit that exists currently supports all the assets that exist. Each and every day, private sector credit is created or destroyed. Each and every day, the government spends, taxes and issues and retires obligations. Each and every day, the private sector consumes, earns income, pays taxes, invests or

disinvests, borrows or pays off borrowings, and expands or shrinks businesses in the real economy.

Broadly speaking, there is equilibrium between money and credit creation and the needs of the real economy. On occasion, one or more of these factors can change rapidly. It is our view that QT in 2022 created a disequilibrium in which the Fed needed to reduce its asset holdings. That resulted in a broad selloff in all assets for nine months. However, Treasury seems to have decided to mute that impact by funding QT with low-risk bills. Since that decision, markets have exploded higher, and inflation has remained well above target. What Treasury did was starve the long end for assets. Great demand for long-term Treasuries was not met with supply and term premiums consequently remained quite low. This leads us to a different concept. What matters at the asset level is the supply and demand for each asset. It is our belief that the note and bond markets are undersupplied, resulting in excess demand for equity and other stuff while the bills market is oversupplied but also has essentially infinite demand:



The whole point of this conceptual review is that, regardless of the size of the deficit, Treasury has undersupplied the note and bond markets by oversupplying bills. If the deficit grows or shrinks, that will have an impact on savings overall, but the savings and spending is self-funding as in the circle of life. It is possible that higher deficits could result in crowding out (in which savers can't hold as much of the other stuff given the demand to allocate to Treasuries) or perhaps the opposite (where the sizable deficit causes portfolio overload and investors flee to non-governmental assets), but all of that is investor preference as the circle of life identity and all other equilibriums balance. The prices can change but an equilibrium is found.

Policymakers at the Fed and Treasury have undersupplied the bond market with duration and appear to be reversing course. Until the Fed uses outright sales and seizes control back from Treasury, Treasury will continue to hold the lever. The deficit size doesn't much matter for asset prices. What matters is how the aggregate risk of duration the private sector is asked to absorb changes.

If the deficit falls a lot and Treasury keeps duration auction sizes the same, that will create a disequilibrium and result in term premium expansion. If the deficit rises and Treasury keeps duration auction sizes the same, that will further starve savers for duration and result in assets remaining elevated and perhaps even more so.

Debt Ceiling and end of QT 1.0

This statement was released in the recent FOMC minutes:

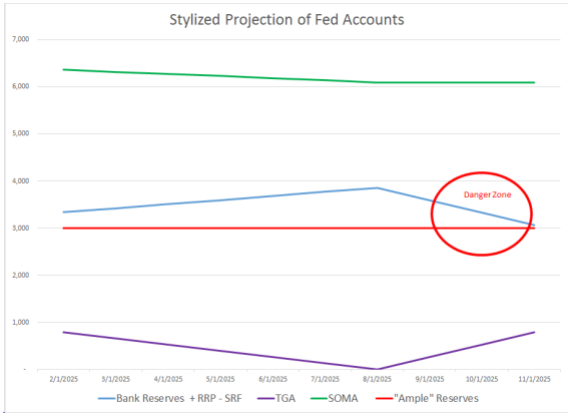
> Regarding the potential for significant swings in reserves over coming months related to debt ceiling dynamics, various participants noted that it may be appropriate to consider pausing or slowing balance sheet runoff until the resolution of this event. Several participants also expressed support for the Desk's future consideration of possible ways to improve the efficacy of the SRF.

Over the next six months, assuming no change in QT, the Fed balance sheet will shrink by $280BN. Since before QT was formally announced, our prediction for the end of QT was summer 2025. It was basic math, combined with a preannounced target of roughly $3TN of reserves, that informed our prediction. However, we agree with the Fed that as reserves become less abundant (and "ample" reserves is not a simple thing to estimate), the Debt Ceiling situation is something that will absolutely create Bank Reserve volatility.

Path of Reserves during TGA spenddown and subsequent rebuild

The mechanics of the Debt Ceiling have an impact on the Fed accounts. As extraordinary measures are exhausted, the government funds itself by spending its checking account at the Fed, the Treasury General Account ("TGA"). Our estimate for when the government runs the TGA to zero is mid-August. The TGA will first fall and then rise during the April and June tax periods, and then fall again until it reaches zero in August. We presume that before the government defaults, the Republicans (who can act completely unilaterally without Democrat interference) can resolve their internal difference and agree to lift the Debt Ceiling. Nonetheless, until that happens, the impact on the Fed accounts can be predicted.

As QT continues at roughly $45BN/month due to $25BN of Treasury runoff and an approximation of $20BN of MBS runoff, that puts downward pressure on the liability side of the Fed's balance sheet, which, in turn, largely reduces RRP and Bank Reserves. This is totally normal and desired. However, the TGA spend down places substantial upward pressure on RRP + Bank Reserves over the next six months. We suspect that all the upward pressure will find its way to the RRP, but that is uncertain. Then, when the Debt Ceiling is lifted, the TGA will be rapidly rebuilt over three months or less, which will drain RRP+ Reserves. The Fed is concerned that the slow build and sudden drain while QT continues will cause stress right as the Fed achieves its ample reserve target. This is shown in this stylized chart, which smooths the timing of tax flows:



Why stop QT now – Uneven distribution of reserves

The good news is QT has largely succeeded in reducing liquidity by draining the RRP but has not reduced reserves at all. So, the question is: why stop QT now at all, given reserves are not yet being tapped? We aren't sure and neither is the Fed. There are a few questions that stand out to us:

- What level of systemwide reserves is necessary?
- QT has essentially only drained the RRP. If the RRP is fully drained, what impact will that have on managing the policy rate and on banks access to reserves?
- Given the extremely uneven distribution of reserves across individual banks, should the Fed maintain a buffer of excess reserves for the system to ensure that individual banks which may have scarce reserves can borrow reserves within the banking system during periods of stress? How big should that buffer be? It costs the Fed IORB interest to maintain the buffer.
- Are there regulatory changes that can "correct" uneven distributions of reserves? Does the SFR and discount window obviate the need for a reserve buffer?

Why do reserves matter at all?

Perhaps it's worthwhile to start with this question. Feel free to skip if you would like. Since 2020, banks have not been required to hold bank reserves at all. Essentially, new factors were considered more important than bank reserves to assess the health of banks. The implication is that healthy banks can print money without constraint from bank reserve requirements. That enabled banks to lever up and buy MBS and Treasuries during Covid and continues to enable banks to create deposits out of thin air. However, bank reserves are absolutely necessary for the banking system and for individual banks for two reasons:

- Every single inter-bank and private sector bank to Fed transaction settles by exchanging bank reserves.
- Banks reserves are High Quality Liquid Assets, which are Tier 1 balance sheet assets, along with other sovereign debt. While the reserve requirement doesn't exist, the Liquidity Coverage Ratio ("LCR") is the new measure which constrains bank leverage.

Each day, bank clients and the bank itself engage in transactions. When those transactions are with counterparties that are either the Fed or another bank's client, the transaction involves a swap of deposits. The "Buyer" sends a deposit from his bank to the "Seller," who increases her deposit at her bank. The Buyer bank transfers a bank reserve to the Seller Bank. Without adequate reserves to make that transaction, the Buyer banks would need to borrow reserves temporarily. This all needs to happen during the day of the transaction. A bank that is solvent and has lots of liquid collateral can easily borrow reserves and settle the

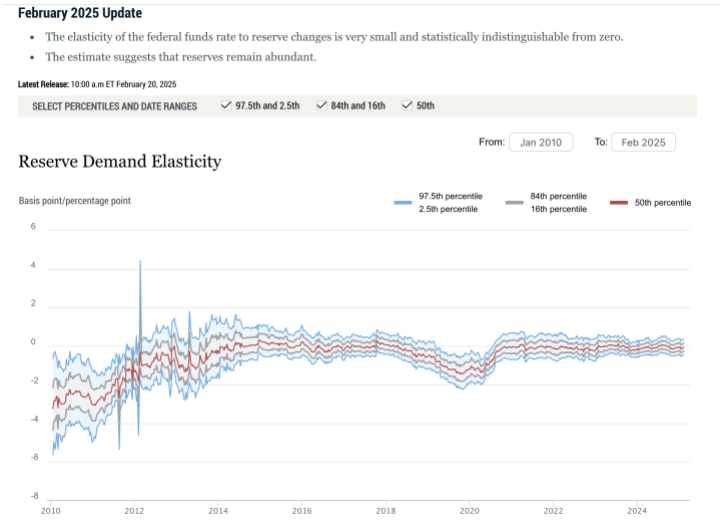
transaction. If a bank has a very illiquid balance sheet and/or is near insolvency, they may not be able to settle the transaction, which would cause a crisis for that bank. The LCR is meant to be high enough that regardless of the reserves a bank holds, the bank should be able to borrow reserves to manage 30 days of volatile reserve balance demands.

If it were costless to have excess reserves to all involved, one might ask why not demand higher reserve balances. The problem is that it isn't costless. The Fed must pay interest on reserve balances to maintain the desired policy rate and banks don't want to hold reserves because they have a very low ROE unless levered. Given the desire for ROE, banks with excess reserves may lever up and that would have monetary policy consequences.

Bank reserves are the grease that makes the interbank transaction machine run smoothly. Finding the ample level of systemwide and individual bank reserves depends on transaction volume and size in the interbank market.

Are systemwide reserves ample yet?

This is the big question, and I think it is clear that reserves remain abundant. There is zero stress in the funding markets besides normal end of period hijinx. The Fed has an excellent monitor for bank reserves. The basic idea of the model is that if the banking system or a few individual banks in the system were experiencing inadequate reserves, they would have to regularly borrow reserves and then pay them back, which would create changes in the market in which reserves are borrowed and lent. The Fed's model quantifies that relationship and as of last Thursday deems systemwide reserves to be "abundant."

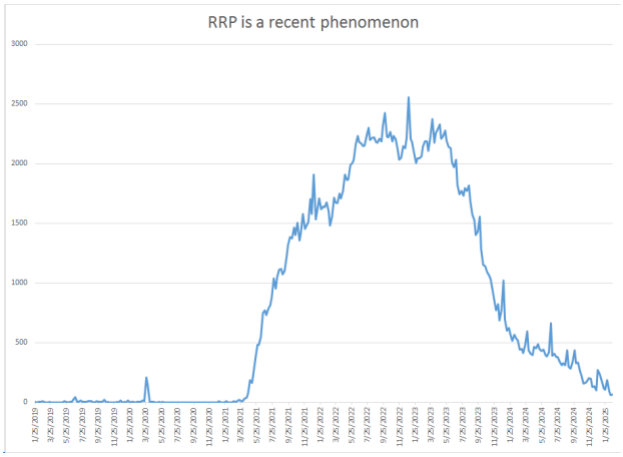


We are not sure that this measure tells the whole story, primarily due to the uneven distribution of reserves, which could create sudden and nonlinear responses. However, we also see the Standing Repo Facility and the destigmatization of the discount window to provide deep sources of reserve borrowing to individual banks.

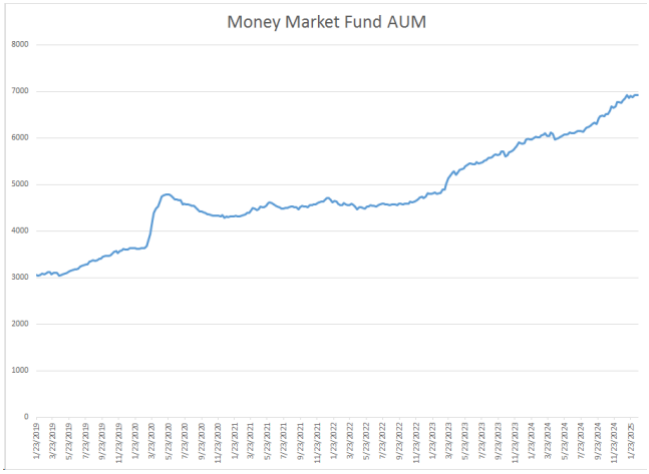
Our view is that, absent the Debt Ceiling nonsense (which, once resolved, will no longer be a source of reserve volatility), QT should continue to drain reserves until greater evidence exists that reserves are nearing ample. **We suspect that QT could continue into early 2026. Our prediction that QT would end this summer was built on the guidance by the Fed on reserve levels. We think they can and will revise that guidance lower and continue QT after a possible pause. While the reserve volatility inherent in the Debt Ceiling nonsense is cause for concern, we don't expect a pause in QT.**

How is RRP going to zero likely to play out?

The RRP going to zero gets far more focus than perhaps it should. It is certainly an outcome of both the initial size of the QE and fiscal spending policies during Covid and the bills funding of the QT since 2022.



It is relevant as a measure of reserves abundance. Remember that money market funds ("MMFs") grew substantially as interest rates rose and QE-financed spending flooded the private sector with cash bank deposits that needed a home. But QT has done very little to reduce MMF assets. All it has done is drained the RRP while the cash in MMFs replaced the RRP asset they lost with bills that Treasury sold.



The RRP is almost certain to go to zero after the Debt Ceiling is resolved, assuming QT either isn't paused or is restarted. At that point, it is a mechanical certainty that any additional QT runoff will impact other Fed accounts.

QT reduces the size of the Fed's assets, specifically the SOMA portfolio. If Fed assets fall, this must cause either the size of its liabilities (primarily TGA, RRP, and Bank Reserves) to fall or another asset to rise or some combination of both. As shown in the charts above, the decline in SOMA asset has resulted in RRP falling. All other accounts remain basically where they were. The RRP liability is now effectively zero. The TGA is kept at a statutory level, which ironically is so high due to heavy bill maturities every week, which is part of the cost of issuing such a high proportion of bills, and which is not likely to fall soon. Reserves will likely absorb any further QT. However, to the extent that a particular bank has its clients take down the Treasury issuance that pays back the Fed in QT Runoff, it is possible that the bank runs out of reserves. If so, they first would likely borrow reserves in the interbank market. If that market was unable to provide reserves at an attractive level, the bank's next stop would be one of two Fed programs in place for just this event. The Standing Repo Facility and the Discount Window provide reserves with different collateral requirements and different mechanics. If a reserve-strapped bank tapped those programs, it's liability would show up as an asset on the Fed's balance sheet and QT would reduce one asset and add another, leaving the liability side flat.

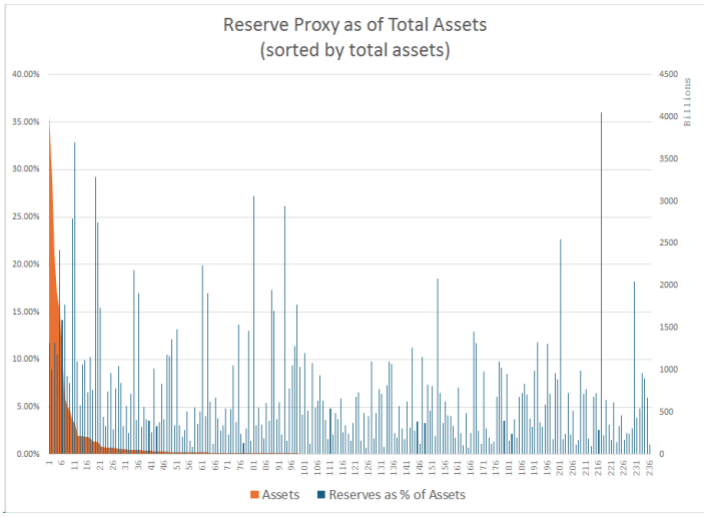
A positive RRP provides a bid for bills and/or leverage for private sector repo, which enables Treasury issuance to pay back the Fed without tapping reserves. A zero RRP means QT taps reserves. A zero RRP in no way causes a problem if reserves are abundant and evenly distributed, i.e., no bank would face a problem settling client transactions. Even if a bank did face problems because it had scarce reserves, it is highly likely that those banks with abundant reserves would be happy to lend them given, they would earn more than what they are paid by the Fed. **We understand that facing a zero RRP is not something we have experienced yet. However, even though reserves are unevenly distributed, we believe the excess reserves held by many banks (including our largest banks) will offer tremendous liquidity for those banks that could struggle. Frankly those banks that could struggle also probably understand their clients and are highly unlikely to be hit by QT-oriented transactions. Our expectation is that RRP goes to zero, reserves will begin to shrink and not a single bank will be forced to use the discount window or the SRF in 2025.**

Uneven Distribution of Reserves.

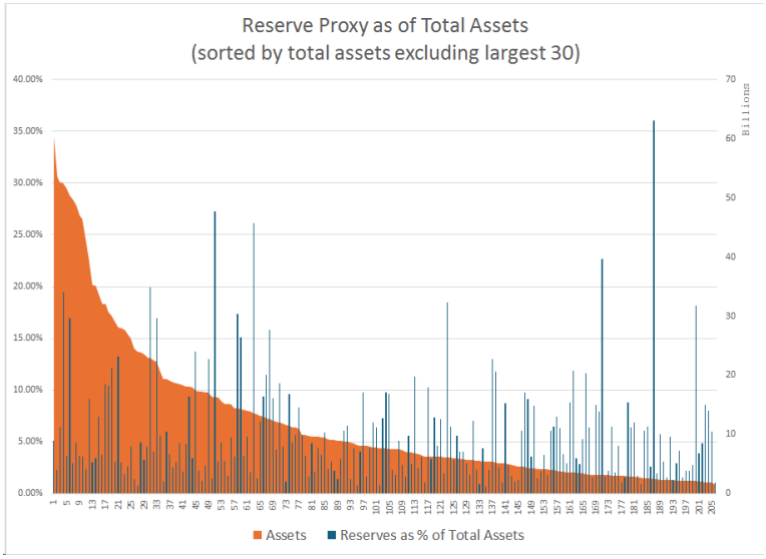
We are not bank analysts and have no edge in assessing banks for solvency. This section assumes bank regulators, depositors, debtors, and equity investors are focused on banks that are an insolvency threat. We are focused on liquidity in particular the possibility that a bank with low reserves is forced to borrow reserves in the interbank market or directly from the Fed in order to settle the transaction of their clients on a particular day or over a series of days. We think a bank run or liquidation caused by insolvency is not a monetary policy issue. We think a bank run or liquidation caused by illiquidity and inability to borrow reserves is a concern

for the Fed as a monetary policy matter. The uneven distribution of reserves in the US banking systems arose from the various transactions and client migrations that have occurred in the past.

We have built a bottoms-up look which covers 92% of the total assets and reserves for the US banking system. As seen below, bank reserves are unevenly distributed. While the biggest banks have well over 5% reserves, smaller banks have uneven amounts:



When excluding the Top 30 Banks one can see more detail. However, these are smallish banks. Only some of them have lowish reserves:



It useful to consider what sort of transaction a bank of this size would do in a day or even over a month that would result in a significant reserve transfer. The total assets of this cohort are less than $100BN. Is there a serious likelihood such a bank is going to have to transfer a $10BN deposit or make a $10BN dollar loan? While reserves are uneven, the potential for a transaction assuming these banks

are solvent (such that they would be forced to tap SFR or discount window) seems very low and certainly doesn't justify a significant buffer of reserves across the entire banking system. If that buffer was $200BN above "ample," then, at current interest rates, the IOBR less the SOMA portfolio return would be roughly $4BN a year. This seems expensive, given that the Discount Window and SRF exist for insurance purposes.

Regulatory action to address reserves distribution

For individual banks, the level of reserves for solvent banks seems to turn on the potential for a sizeable transaction to occur by surprise and the ease in which reserves to settle that transaction can be borrowed interbank or via access to the discount window and SRF. We advocate a review of reserves for this purpose, while of course recognizing the LCR provides active constraints on bank activity. SLR Reform is also possible to make holding reserves more attractive, which we would encourage thinking about as well. We are not sure there is a problem today with uneven reserve distribution, but believe it is worth looking at carefully. We do not consider uneven distribution to be a legitimate reason to slow or stop QT, even if the RRP is at zero, due to no sign of stress and the mechanisms to address stress if it were to occur.

Interplay of Treasury and the Fed

As the last three years have taught us, the decisions made by Treasury have a meaningful impact on QT via runoff. We remain a strong advocate for the Fed to manage monetary policy by using outright sales. We also think it is necessary for the Fed to commence outright sales to get its balance sheet well past the destination mentioned in the minutes and to a place where it holds no mortgages and no long-term maturity bonds. Until it does, price discovery in long-term asset markets will be distorted and stimulative. The step to change reinvestment is a good one. However, we must point out that the monetary impact of the change can once again be entirely muted by Treasury if it chooses.

An example: Currently, the monthly 30Y auction averages $23BN in gross proceeds sold to the private sector. The Fed adds on at, say 10%, resulting in $25.3BN issued. If the Fed decides to not add on, Treasury has a choice to make. If Treasury increases auction sizes to $25.3BN, its aggregate WAM remains the same. If, however, Treasury does not increase auction sizes, its WAM shortens, and Treasury mutes the monetary policy impact of the reinvestment shift. That may be fine for the Fed (which will achieve its goal regarding WAM of its balance sheet), but it simply pushes Treasury deeper in the hole in relation to terming out its debt. If the Fed does implement this reinvestment shift, we will be very focused on Treasury and whether Bessent, like Yellen, decides to manage monetary policy or increases auction sizes in order to enable the Fed do its job.

We think Treasury needs to reduce its dependence on bills. We think Treasury needs to begin acting once QT ends and has $1.4TN of bills to extend. We estimate the impact of the reinvestment shift to be $250BN of 10Y WAM extension. Will

Treasury let this occur or will it find itself a year from now a further $1.65BN deeper in the hole? Is this Treasury Yellen 2.0 or Bessent 1.0?

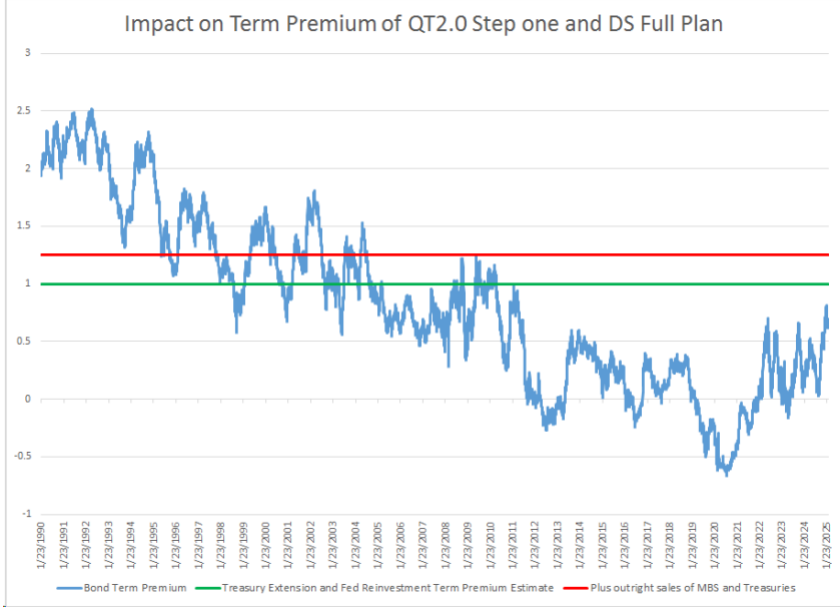
Economic impact

We estimate that if the Fed makes the first step it has discussed in QT2.0 and Treasury slowly terms out the $1.4TN excess bills over the next four years, a twist or roughly $210BN 10Y WAM versus cash per quarter will need to be absorbed by markets. If the Fed wants (or needs) monetary policy reasons to go farther, outright sales of $20bn of MBS and $20BN of long-term bonds need to be sold and $40BN of bills and short-term notes must be purchased per month. That would increase the total to $330BN 10Y WAM.

Both the economy and markets remain robust with solid real growth and inflation that has come down a lot but remains sticky. Asset prices are elevated across the board while Treasury term premiums have risen and stabilized at higher levels but remains quite low. Market conditions are favorable and this tightening of financial conditions, if implemented, will likely be well absorbed and allow the Fed to cut short-term rates which have impacted certain cohorts meaningfully.

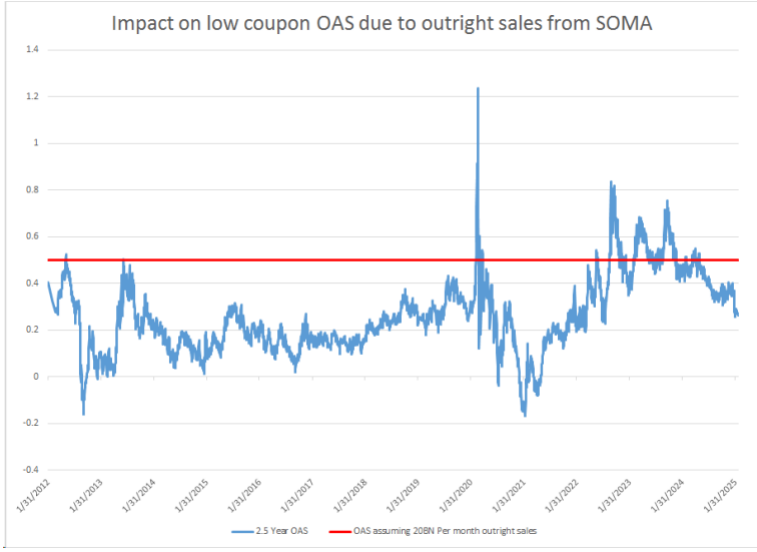
Market impact

We estimate that the first step of QT2.0 (Reinvestment plus 4-year Treasury plan to extend debt) will increase term premiums by 35bp on long-term assets, which would be low relative to the pre-QE era but higher than today. Adding outright sales would increase term premiums over time by 25bp.



In aggregate, that tightening of financial conditions would also allow the Fed to cut Fed Funds more aggressively than currently priced and perhaps the impact on 10Y notes will be modest as the rise in term premium would be offset by a lower expected Fed rate path.

In addition to increasing Treasury term premium, we expect the DS QT2.0 Plan would add 25bp of OAS spread to the low-coupon mortgage market:



Synthesis

The Drumbeats of QT2.0 have begun. We expect the Fed will rapidly implement a change in its reinvestment plan and encourage the Fed to consider outright sales and ongoing QT after the Debt Ceiling is resolved. Treasury could actively mute the monetary impact of the shift in the reinvestment plan, and we will be quite interested in their response, given Bessent's past criticism of those sorts of actions. On the other hand, if the Administration succeeds in reducing the deficit, we expect Treasury to maintain coupon sizes, which will begin the process of terming out the debt. If they fail to reduce the deficit, auctions are sizes are going up. We remain bullish two-year notes and bearish equities and assets as a whole. All these central bank and Treasury flows are slow-moving and take years to have an impact. However, we consider last week an inflection point that shifts policymaker stance on long-term assets prices from supportive to a solid headwind.

Current Portfolio and Performance

	Assumed Portfolio size	$ 100,000,000					
	LTD P/L	$ 67,597,083					
	Total Return	67.60%		YTD Return in excess of cash		-2.46%	
	Today's Date	2/23/2025		Portfolio Created		4/15/2019	
Date	Position	Entry Price	Amount	Worst case loss	MTM	P/L	Open/Closed
1/22/2025	SPX Put Butterfly for 3/31/24 Strikes 5665/5565/5465	1.90	1316	$ 250,000	2.25	$ 46,053	Open
2/5/2025	SPX 3/21/25 5800/5500 Put Spread	22.90	873	$ 2,000,000	23.00	$ 8,734	Open
2/5/2025	NDX 3/21/25 20500/19500 Put spread	97.70	205	$ 2,000,000	85.00	$ (259,980)	Open
1/15/2025	ZB 111/107 Put Spread Expiry 2/21/25 (covered 107)	0.80	1255	$ 1,000,000	-	$ (1,000,000)	Open
1/27/2025	ZB 111 3/21/2025 Puts	0.83	2415	$ 2,000,000	0.13	$ (1,698,113)	Open
2/5/2025	ZN 108.5 Put 3/21/2025	0.47	2133	$ 1,000,000	0.27	$ (433,333)	Open
2/12/2025	ZB 109 3/21/2025 Puts	0.30	-2415	$ -	0.06	$ 566,016	Open
2/12/2025	ZN 107 Put 3/21/2025	0.30	-2133		1/32	$ 566,578	Open
2/12/2025	SFRM6 Starter Positon	95.92	1600	$ 1,000,000	96.16	$ 960,000	Open
2/10/2025	GCJ 3/26/25 2850 Put	29.2	86	$ 250,000	19	$ (87,329)	Open
1/22/2025	"Sell All Assets" Short SPY	604.95	-16505		599.94	$ 82,688	Open
1/22/2025	"Sell All Assets" Short TLT	88.14	-136550		89.61	$ (200,728)	Open
1/22/2025	"Sell All Assets" Short TIP	107.62	-93231		108.92	$ (121,201)	Open
1/22/2025	"Sell All Assets" Short GLD	255.70	-15730	$ 1,000,000	270.74	$ (236,580)	Open
1/22/2025	"Sell All Assets" Short GSG	22.70	-175208		22.70	$ 88	Open
			Risk	11.500%		10.2%	