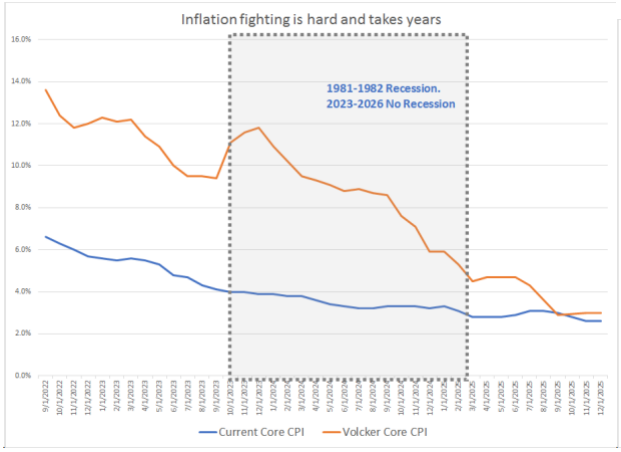
The Damped Spring Report

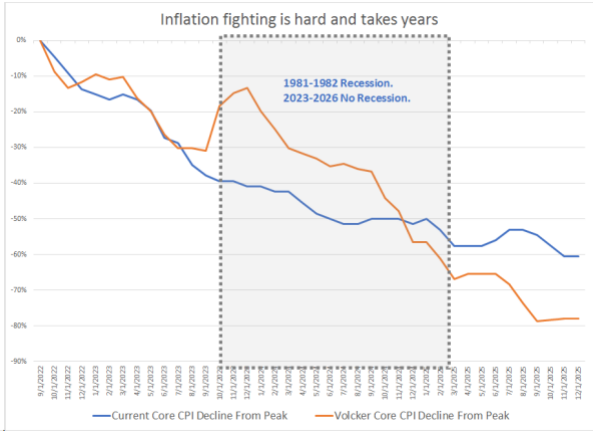
"Shifts in growth, inflation, risk premium and positioning all lead to opportunities in markets"

2/2/2026

Dear Fed Chair Nominee Warsh,

Congratulations on your nomination. You will soon assume leadership of an institution that has yet to succeed in achieving its inflation mandate. Thankfully, the economy has avoided a recession, but progress on inflation has been frustratingly slow. However, the path has been steady and consistent with the pace of disinflation during the Volcker years. The current situation is not a disaster.





Unfortunately, the Fed you inherit has a deep and flawed bias about how to finish the job. The Fed's balance sheet policy has been an abject disaster, constantly undermining its efforts to normalize the economy. During the entire decline in inflation, the Fed has, and continues, to undermine its effort due to its institutional failure to understand its balance sheet.

The Fed's current path makes further progress on inflation difficult and will prevent the institution from normalizing its policy rate while providing combustible tinder for inflation to reignite. In this report, we provide a template for how to reduce the Fed's balance sheet while ensuring the policy rate corridor can be enforced without undue stress on the financial system. If the institutional bias can be corrected, we think short term rates can be lower, bond yield curves steeper and healthier, and economic growth and inflation at sustainable levels.

Dear Treasury Secretary Bessent

You have been a strong advocate for normalizing the Fed's and Treasury's balance sheet, and, with your colleague Stephen Miran, quite correct in accusing the Yellen Treasury of using issuance policy to manage monetary conditions. Your predecessor undermined the Fed. We hope you chose to aid the Fed. With a new Chair who at least questions common wisdom about the size of the balance sheet, we look forward to your coordination with the Chair to normalize both the Fed's balance sheet and the aggregate balance sheet of the U.S. Government.

This task requires issuance of long duration Treasuries sold to the private sector to climb steadily over the next few years. Demand for Treasuries is strong today and additional duration issuance can easily be absorbed. In fact, a credible Fed chair who, instead of flooding the market with reserves at any signs of repo market stress, actually fixes the problem that causes the stress will give much greater confidence to Treasury investors.

This week, the TBAC and Treasury meet as part of the Quarterly Refunding process. While we expect no change in coupon issuance, we certainly would be disappointed if Treasury decides to delay or reverse its plans responsibly to issue duration to the private sector. Given the actions of the current Fed, which increase the balance sheet and refuse to take any action to change its reinvestment policy, the kindling for an inflationary monetary easing is in place. We hope and expect you do not ignite this tinderbox this week and instead take steps to prevent the fire.

In this DSR we will

- **Provide a template for better Fed balance sheet policy.**
- **Review the track record of the Fed's current balance sheet policy, identifying its fundamental misunderstanding of the balance sheet policy impact, why the focus on bank reserves has been such a heavy focus of major voices on the Fed, and how simply addressing the actual problem (instead of narrow-mindedly treating the symptom) will lead to better outcomes.**
- **Provide our regular analysis of the QRA, despite its high likelihood of being of no market consequence.**

A better balance sheet.

For those who do not need a review of the concepts of balance sheet policy and the mistakes and conceptual errors that are driving the current Fed balance sheet policy, we will cut to the chase and not bury the lede.

Without taking a view on whether Fed policy should be tighter or easier, we think the Fed's balance sheet management has been far too easy and has blocked the

path to target inflation. As the balance sheet policy has been too easy, the Fed has been forced to keep short term interest rates well above neutral.

We think the balance sheet policy is poor due to a narrow group of four repo market and plumbing experts at the Fed, who we refer to as the "Repo Gang." The Repo Gang is excellent at the narrow job of paying attention to the overnight rate and repo market conditions, but that myopia has dominated the balance sheet policy by using a blunt tool of reserve management to solve a modest money market problem which can be easily solved by simple regulation and a tiering of interest on reserve balances.

Put simply, we think the emergency RMO announced in December was a horrible idea and we think a solution exists in which the SOMA portfolio can fall by close to $1TN without threatening the Fed Funds target range. We recognize that forcing the private sector to absorb $1TN of SOMA assets over the next year or two would be a tightening but believe that tightening can be offset by more aggressive rate cuts than the current consensus. **Essentially, the plan reduces the balance sheet, does not threaten either side of the target Fed Funds range and allows the Fed to cut the Fed Funds rate more deeply and closer to neutral.** Most importantly, our plan addresses the biggest problem in the money markets - the uneven distribution of reserves in the banking system, which is mostly the root cause for the sloppy solution of ending QT and emergency RMO balance sheet expansion that the Repo Gang of Four implemented.

We suggest that the Fed:

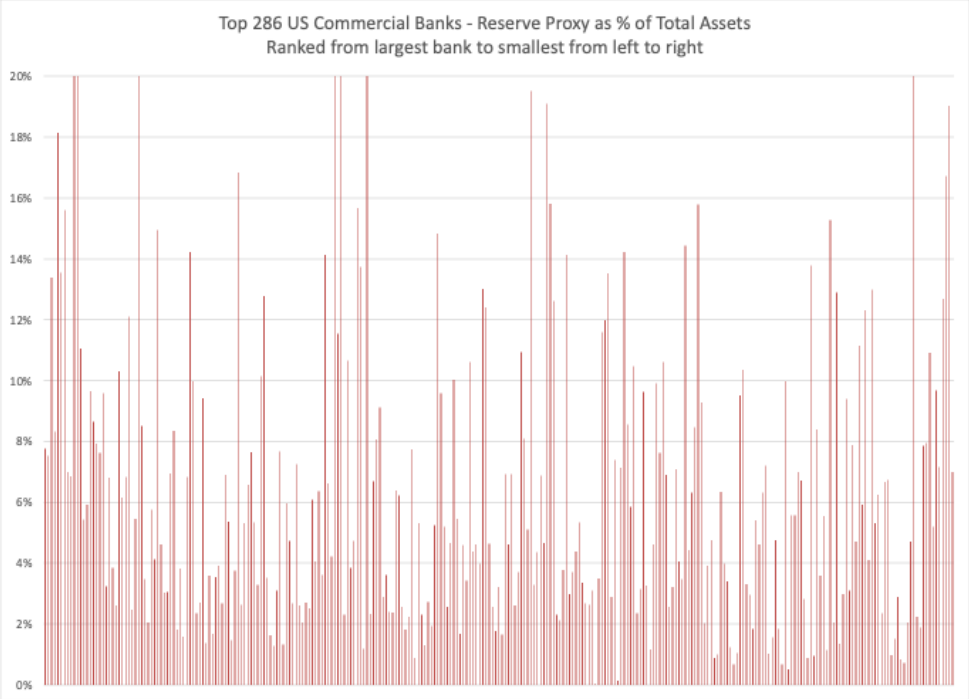
- To avoid stress to the top end of the Fed Fund's rate, immediately institute a minimum reserve requirement. This would ironically place pressure on the Fed to increase reserves and increase its balance sheet but does so in a targeted way that, unlike the current sloppy shotgun way, will be effective.
- Immediately institutes zero interest on reserves balances over a maximum, which will create significant supply of reserves that can be offset by ending RMOs and restarting QT runoff, thus, reducing reserves substantially.
- Over time lower the maximum reserves amount, resulting in further penalties for holding excess reserves and drive them slowly out of the system in tandem with ongoing balance sheet runoff.

We suggest the Fed and Treasury coordinate such that:

- Treasury begins terming out its bills financing, which mechanically reduces the needed size of the TGA. Treasury changes its TGA policy to ignore bills held by the Fed for purposes of its 5-day rule, thus reducing the size of the TGA. By reducing the TGA liability, the Fed can runoff more of its balance sheet.
- Treasury and Fed coordinate to pass stable coin legislation that encourages Currency in Circulation repatriation as foreign holders of CIC buy stable coins and the flow provides bids for SOMA holdings and deficit financing. The CIC decline will allow for the SOMA portfolio to shrink.

We estimate that the combination of TGA, Reserves, and CIC reductions will allow the Fed to shrink its SOMA portfolio by over $1TN over the next two years, and the tightening influence can be offset by an extra 25-50bp Fed Funds rate cuts. All this can happen while solving the uneven distribution of reserves problem and protecting the Fed Target Range from undue fluctuations in the money markets.

Specifically, regarding the bank reserves situation, we have modeled the reserve balances of 95% of the US banking system and 100% of the largest 286 Commercial Banks and notice the uneven distribution of reserves. **This is the threat to the Fed Funds Target Rate Corridor:**



In our analysis, the current Fed has allowed as many as 162 banks to operate with "scarce" reserves while the largest 50 or so banks are massively over reserved. We caveat our work in that we have used a proxy for reserves. The Fed has a more precise knowledge of bank-by-bank reserves, but the picture and scale is well modelled with our proxy.

Instead of addressing the actual problem, the Repo Gang has flooded the system with reserves by ending QT runoff and beginning emergency reserve management operations. This action certainly does "save the repo market," but does not address its root cause. Solving the actual problem will preserve and strengthen repo market stability while also enabling a substantial runoff of the Fed balance sheet. A 6% minimum reserve requirement and a zero IORB for reserves over 10% would allow QT runoff to drain roughly $600BN of reserves and shrink the SOMA portfolio by that same amount.

	Impact on Reserves of various minimums or caps						
	5%	6%	7%	8%	9%	10%	11%
Number of banks above	143	121	93	76	67	54	44
Number of banks below	140	162	190	207	216	229	239
$BN's Excess of Banks currently above	1413	1198	991	824	729	644	563
$BN's Scare of banks cuurrently below	-39	-61	-89	-159	-300	-451	-606
6% floor and 10% zero IORB penalty rate		-61				644	584

Total Net Reserve reduction

By using a corridor of a minimum reserve requirement (6% in our chart) (which forces banks to add reserves), and a maximum reserve threshold (10% in our chart) above which IORB is not paid (which forces these banks to buy the Fed's SOMA runoff) We recognize the accounting is more complicated but end result is the same, the Fed can "regulate" away uneven distributions of reserves. This would allow for massive reduction in the Fed's balance sheet and a much healthier repo market.

While we are confident that this is a better policy than the Fed's current plan, we recognize the fear that is partly instilled by the highly internally credible Repo Gang and partly harks back to the repo crisis of 2019 and so we do not expect any action at all. Yes, the solution is right in front of us and the Fed has been unable to see it and is likely not going to see it. They are blind.

While most Fed observers are wondering if Nominee Warsh can convince the voters to reduce Fed Funds by 25 or 50bp, we hope that he will be able to convince the Repo Gang to realize how narrow and poor their balance sheet solutions have been to date. This is a much harder lift we know, but if not a new Fed chair to break up the internal group think, then who?

A Review of the Fed's Balance Sheet Policy

Before diving into the Fed's misunderstanding of its balance sheet and how that misunderstanding has undermined its policy objectives for three years, it may be helpful to provide our framework for usage of the balance sheet for monetary policy goals. Skip ahead if you have read our work and understand our framework.

How does QE impact financial markets and the economy?

Let us start by defining QE and how it works and posit that QT, if executed in the exact same way, has the exact opposite effect. Firstly, QE is the limited case of the Fed making large scale asset purchases. It is not other programs, although, as we will cover, other programs do have impact on financial markets and the economy. The Fed has done QE of this form during the GFC and during COVID. They are not doing QE today despite recently deciding to increase their balance sheet.

QE works based on a simple mechanism: It lowers long-term interest rates available to the private sector by buying long-term bonds with bank reserves. This

is where things get confusing. When we say it lowers long-term interest rates, we are referring to lowering rates versus what they would have been if the Fed did not act. The market decides what long-term interest rates "should be" based on expectations for growth and inflation and a "free market" risk premium. The Fed enters with QE, and all those things move around. If the Fed action increases growth and inflation expectations, interest rate levels rise not fall. If the Fed action fails to increase expectations or is not large enough and disappointment leads to decreases in expectations, interest rates can fall. BUT what matters is that the Fed's actions without question reduce risk premiums. That is the key mechanism. Lower risk premiums than market participants would otherwise require results in those who want to consume or invest in the real economy being motivated to do so by artificially low interest rates. That is the mechanism of QE, and the mechanism of QT, done as outright large-scale asset sales, is the opposite.

QE also has an effect that gets far more attention than deserved in our estimation but is central to the Fed's misunderstanding. When the Fed does QE, they pay for the assets they buy with bank reserves. Bank reserves have a key function in the banking system for settling interbank transactions and at one time had an important function in the fractional reserve system which resulted in bank lending to the private sector being limited on occasion by the number of reserves provided to the system by the Fed.

QE also has an impact on the money markets. While many want to narrow this impact to bank reserves, we do not think that is a sound high level concept. QE results in the private sector owning less bonds and having more cash. Ignore for the moment the details of the plumbing and who gets the cash and what kind of cash is provided. The existence of that cash depresses money market rates. This creates a problem for the Fed because controlling the overnight rate on cash is the Fed's primary monetary policy tool. QE causes difficulty in setting the lower bound on Fed Funds. QT causes difficulty in setting the upper bound on Fed Fund in the exact opposite way.

A track record of balance sheet policy missteps.

One thing that has continuously puzzled us about the Fed is that the institution clearly understands the beneficial policy impact of QE: Do a ton of QE and you succeed in offsetting tightened financial conditions and perhaps ease financial conditions to such a level that the nominal economy recovers. The mystery is why they refuse to accept QT as the virtual opposite. Since QE ended, the Fed has completely lost the plot. Here are the key points:

- The Fed's original sin was handing the monetary policy tool of QT to Treasury. By using runoff, the Fed turned a powerful tool for monetary policy over to Treasury and, while inflation was extremely high, the Fed allowed Treasury to mute QT and delay its impact by issuing bills to the private sector to repay runoff instead of forcing the private sector to absorb duration. Remember, QE removed duration from the private sector where QT (because it was done via runoff and bills issuance) did not do the exact

opposite. It did essentially nothing. By doing nothing, it has required the Fed Funds rate to remain high.

- The other big mistake has been the focus on reserves as a metric for when QT should end, which is the institutional bias and misunderstanding we cover in this note.

When all you have is a hammer, everything looks like a nail.

The ability to transmit desired monetary policy by controlling the overnight interest rate is the most critical real-world function of the Fed. While most focus on the economic outlooks, reaction function, potential political bias, and the policy statement, down in the weeds the Fed exerts its power every single day by setting the interest rate they desire. It is critical to maintain the interest rate that markets actually experience within the range of the policy target. The Fed has deep experience and a dedicated staff to fulfill this role. There are four people who have the experience to make sure this mission is fulfilled:

- Roberto Perli is the balance sheet manager at the NYFRB
- Lorie Logan is the Dallas Fed President. She preceded Robert Perli in his role and was a dedicated member of the NYFRB staff for over a decade before her elevation to Fed President.
- Beth Hammack is the Cleveland Fed President and has spent decades deep in the weeds of the money markets in the most senior role in that area at Goldman Sachs.
- Alberto Musalem is the St Louis Fed President and worked at the NYFRB as well as holding market-facing roles at Tudor Investments and other private sector financial institutions.

This is a highly credible and competent group. Unfortunately, their credibility within the Fed is the actual problem. When a highly competent and credible group is mistaken, those who are unable to challenge the group due to the weediness of the topic are led astray. We think this Repo Gang is excellent but is blind to the thing they are unable to consider. They are left unchallenged by their peers who, while not blind to the wider bigger picture, are unable to connect the weedy to the big picture.

The Repo Gang see signs of stress in the weeds and know that, in the 1/100 chance that a crisis is imminent, they must act to eliminate the stress. The consequence of that is a bloated balance sheet that prevents the monetary policy posture from achieving its goal. By myopically flooding the system with reserves they bluntly solve the rate corridor "symptom," while not addressing the actual root problem of uneven reserves and, ironically, undermining the intended policy transmission. They declare victory as the RMOs place the overnight rate more securely within the target range yet miss the big picture entirely.

QRA Preview

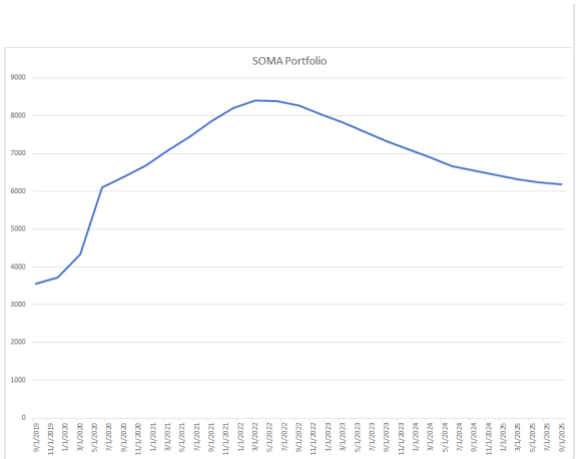
Why is QRA important?

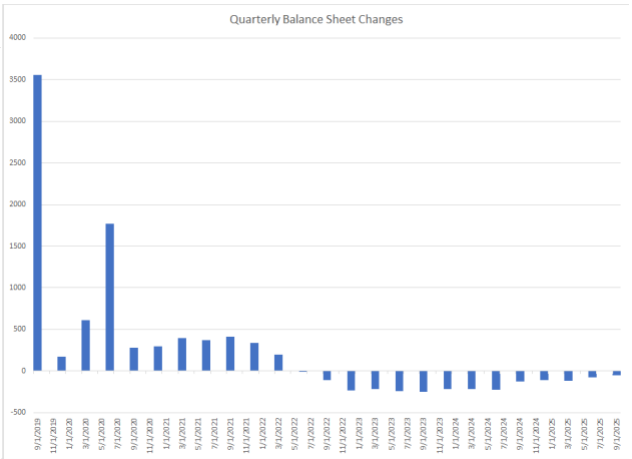
For over three years, the Damped Spring Report has focused on Treasury Issuance. We did this because the Fed handed the monetary policy impact of QT to Treasury when it decided to use runoff instead of outright sales to reduce the Fed balance sheet.

While QE and QT are relatively new monetary policy tools, the impact of both are obvious. While some may doubt the economic impact of this lever, the mechanics cannot be clearer. QE

- Increases bank reserves, which may result in an easing, allowing banks to provide credit.
- Uses bank reserves to reduce the amount of duration risk in the private sector, which affects asset prices.

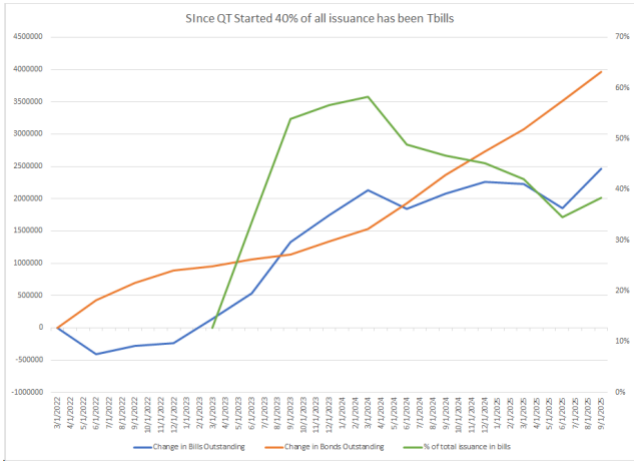
The Fed accomplishes these two things by buying Treasuries and US Guaranteed MBS. For QT to be the opposite of QE, the Fed must sell Treasuries and MBS. However, that is not what they chose to do. Before we jump into runoff, QE happened in the past at a very rapid pace, with lots and lots of bond buying and reserve creation. QT has been done at a much slower pace. Notice QE was done in huge size and rapidly. In just two years, the Fed bought $4.8TN of bonds, including $3.5TN in one quarter alone. Since QE ended, the Fed has reduced its bond holdings by only$ 2.2TN and has done that over 3.5 Years. The pace of QE and QE matters a lot.



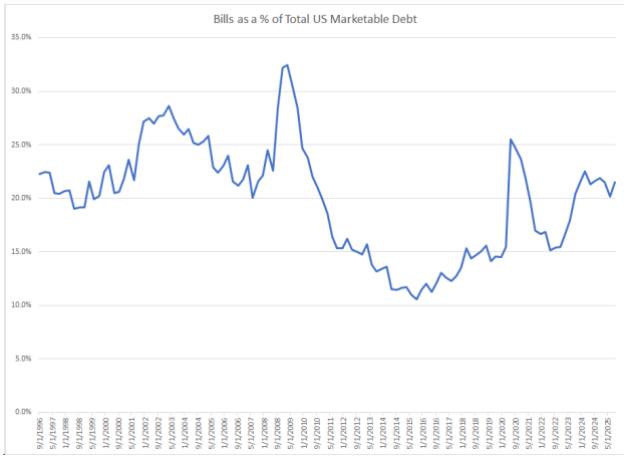


It is not just the pace that matters, however; the method matters as well. There are two. The first is to make outright sales, which is the literal reverse of QE. The second is to use runoff, in which the Fed allows maturing bonds to mature without reinvesting the proceeds. Runoff has the same mechanics in terms of one of two functional aspects of QE in that reserves are reduced by runoff. However, the second functional aspect of QT is dependent on Treasury actions. Runoff proceeds are provided by Treasury paying off the principal of its debt and paying it off by

issuing new debt to the private sector. This is why the QRA matters. Treasury chooses what bills, notes, or bonds the private sector buys. Unlike in "Fed managed" QT, whereby the Fed chooses to sell its bonds to the private sector, runoff hands that decision to Treasury. Treasury has chosen to issue bills. That decision effectively muted QT's second lever, that of forcing the private sector to assume duration risk. The combination of the extremely slow pace and the choice by Treasury to issue bills has delivered absolutely no tightening monetary impact of QT. Because this happened, for five years inflation has remained well above target and asset prices have remained elevated, causing further benefit for the wealthiest amongst us at the expense of the rest of us. QRA matters because the impact of QT depends on the choices made by Treasury as they alone hold the monetary lever of QT.



The fact that QT is over is somewhat irrelevant. Treasury remains in charge and, so far, has chosen to do nothing to allow the QT that has occurred to flow through to the economy. How, may you ask? It is simple: Treasury has decided to allow bills outstanding to remain elevated versus any history when the economy was strong.



QRA Primer

For those of you who have followed our work over the years, feel free to skip to the good stuff below. But as this is fairly arcane wonky stuff, we thought we would provide some background on the Treasury issuance process.

Why does Treasury issue debt?

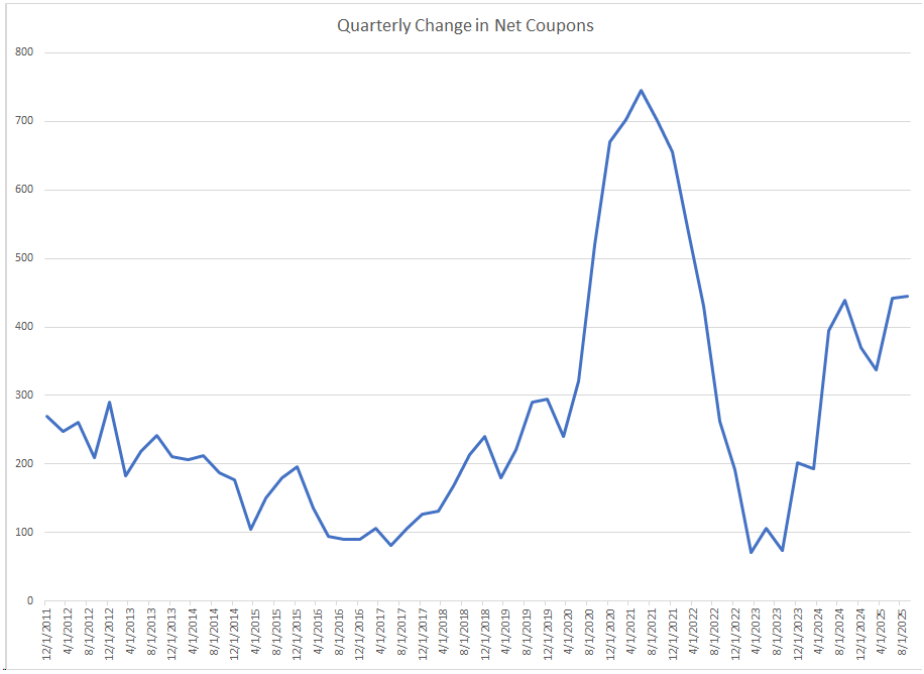
Pretty basic question. Treasury issues debt to pay the nations obligations. Because the nation is in debt and runs a large deficit every year, Treasury must issue new debt to fund the deficit for the year and to refinance maturities of existing debt. Maturities happen every month. In the 2026 fiscal year, $2.8TN private sector coupon debt will come due. Bills come due all the time because they range in maturity from weeks to 364 days. Over the course of the next twelve months $6.4TN of bills will mature, with a substantial portion of the $6.4TN maturing multiple times over that period. Even without running a deficit, the US government needs to issue $9.2TN of obligations over the next twelve months on net. In addition, the nation will run a deficit. Third party estimates of the budget deficit for 2026 range from $1.75TN to $2.1TN. The big moving part for that fairly wide range is whether tariffs will be collected or not. Picking the baseline expectation for a 2026 deficit of $1.84TN, Treasury would have to issue $11.04TN of debt in 2026.

Those are the big deal reasons why Treasury issues debt. During QT (which is now ended), Treasury also had to issue debt to the private sector to pay back the Fed. That is no longer a thing. However, Treasury has also decided to buy back some of its old debt that has become illiquid. That debt buyback causes Treasury to issue more new debt. The net issuance of debt is zero, but the gross issuance of debt is now likely to add $180BN to the auctioned debt in 2026. Lastly, Treasury must maintain some flexibility in case an exogenous event like 9/11 happens again and the debt markets are temporarily closed. Treasury keeps $850BN in its checking account - called the Treasury General Account, for just this occasion and, while that account is likely to stay at $850BN in 2026, it is also likely to grow in later years. To keep money in the checking account, Treasury must issue more debt. In the tables below, we will show the financing needs of the government with the moving parts of Deficit, Maturities, Buybacks, and TGA changes. The maturities are not really moving parts as they can be calculated by looking at outstanding debt. As bills mature and roll constantly within a year, for simplicity we will only consider net bills issuance.

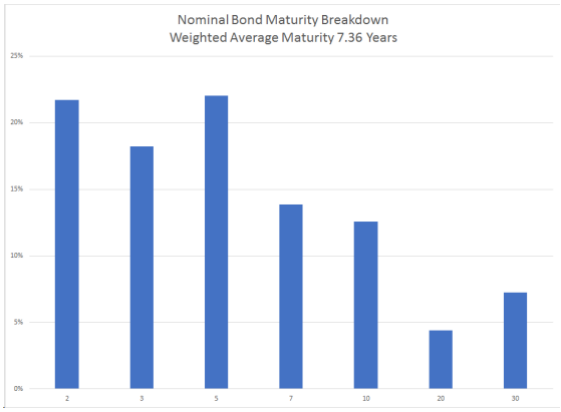
How does Treasury choose what to issue?

So that is the big reveal of the Quarterly Refunding Announcement. Because Treasury has $11TN of debt to issue every year, they want to prepare the markets well ahead of time. Treasury has told markets what they plan to issue, including the specific tenors, security types, and date of every coupon auction well in advance. They do it quarterly and, if necessary, revise already announced plans for the next 2 months and announce plans for the following quarter. On Wednesday, we will know with virtual certainty what coupon notes and bonds will be issued as far out as April of 2026. Treasury has released this information for decades on a

quarterly basis. Because of this high lead time, Treasury can literally never time markets. They are the opposite of day traders. They are a constant presence in the bond market attempting to have the minimal market impact while also issuing an enormous amount of debt. Treasury's expressed goal is to be regular and predictable. What they cannot control is the budget deficit. During periods of time when Treasury's estimates for the deficit are too low, they may issue some bills to bide time. When their estimate is too high, they may have to issue fewer bills than planned. Those wiggles almost never impact the coupon auction calendar. Obviously during COVID in 2Q20, those rules did not apply, but, by and large, the coupon schedule is set in stone. While coupon auction sizes are scheduled with meaningful advanced notice, the size of the coupon auctions does change somewhat. During QE, when the Fed was active in buying bonds, Treasury issued a ton. When the Fed shifted to QT, Treasury massively slowed issuance of coupon debt and completely muted the QT impact, as mentioned above. Lately, the net coupon issuance has fluctuated around $400BN per quarter due primarily to gross issuance that has been fixed at $4391BN per year and a noisy maturity schedule of existing bonds.



So, as you may notice, we think Treasury actively administered monetary policy by choosing to offset QT with bills issuance and starving the market of coupon issuance. However, the reality is the deficit has just been too large to keep net coupon issuance at the lows shown above. The big question that this DSR will deal with is whether the time has come for Treasury to issue more coupons and fewer bills than they have over the past few years. Before we leave this discussion, Treasury not only has to decide how big the coupon auctions are in an absolute sense but also what maturities they should issue. Here is what Treasury currently issues in nominal bonds:



We have described the decisions Treasury makes. How many bills and coupons should Treasury issue at auction to fund the government's needs is one decision. Within that decision about the coupon auction size is the matter of what maturities they should issue. While the second issue is interesting, it really does not change dramatically and is more tweaky. What does change is the overall amount of coupons.

The process for choosing is to consult with the Treasury Borrowing Advisory Committee. On Tuesday, February 3, that committee will meet with Treasury. The committee is composed of market participants, including primary dealers, pension funds, insurance companies, mutual funds, and hedge funds. These folks help assess end client demand for coupons in general and maturities specifically. Treasury provides deficit estimates and influences the coupon quantity overall. Treasury then announces the likely issuance schedule on Wednesday morning.

QRA Preview

Big deal moving parts

The major moving part of the funding decision is the deficit. Due to ongoing uncertainty about the amount of tariffs that will be collected and the legality of the current tariffs, there is a broad range of potential outcomes for the deficit on this issue alone. In FY26, the range of budget estimates from independent sources is $1.75TN to $2.1TN. More broadly, including both tariff revenues and potential extensions of OBBB laws, total deficits over the next three years ranges from $5.25TN to $6.95TN.

The other major moving part is extremely difficult to estimate and not worth guessing in the near term for insight on the QRA. Clearly, the various economic outcomes and fiscal policy decisions could result in a smaller or larger deficits.

Wonky but big deal issues facing Treasury

MBS Reinvestment in bills

Because the Fed decided to increase bills buying by $200BN per year simply due to MBS runoff and signaled a permanent reserve maintenance operation and topped

that off with $160BN of "emergency" reserve maintenance, Treasury is going to have the benefit of lower funding needs from the Private Sector. This could allow them flexibility to reduce coupon issuance, particularly as the Fed will be buying about one-third of typical bills issuance Treasury may worry about starving the market for bills. On the other hand, as mentioned above, reducing coupon issuance will "term in the debt" and is against everything Treasury has criticized the past administration for doing. We suspect they will not reduce coupons. There are plenty of bills outstanding for the private sector and starving the private sector of coupons would be a much greater risk.

Sizable maturities

Another big deal wonky item is the exceptionally large pending maturities. During Covid from mid-2020 through to the end of QE in 1Q22, Treasury pounded the 5Y maturity point with tons of issuance. Over the next two years that paper comes due. This is actually a positive for Treasury because a bond coming due creates mechanical demand for new bonds. Below you will see that sizable maturities lower the net supply that must be absorbed by the private sector, allowing Treasury to increase gross coupons with perhaps less risk than in the past few years.

Projections

To visualize the pressures on Treasury on both size of financing needs and composition, we started with three deficit scenarios provided by the Committee for a Responsible Budget. We added specific data on maturities, buybacks, and Fed purchases and for this chart kept Gross Auction Sizes constant.

Deficit Scenarios Assuming no change in coupon auction sizes ALL result in a shortening of Treasury Outstanding WAM

	CFRB Baseline With Tariffs			CFRB Baseline			CFRB Alternative			
	2026 Total	2027 Total	2028 Total	2026 Total	2027 Total	2028 Total	2026 Total	2027 Total	2028 Total	Notes
Deficit Projection CFRB Baseline	1,750	1,700	1,800	1,840	1,955	2,160	2,100	2,350	2,500	Various third party deficit estimates
Maturing Ex Soma	2,791	3,123	3,050	2,791	3,123	3,050	2,791	3,123	3,050	
Current Coupon Buy Back	180	240	240	180	240	240	180	240	240	Assumes steady increase in liqudity buybacks
TGA Change	0	25	50	0	25	50	0	25	50	Assumes some increase in TGA due to increasing Bills
SOMA QT	10	0	0	10	0	0	10	0	0	
Gross Financing Needs	4,731	5,088	5,140	4,821	5,343	5,500	5,081	5,738	5,840	
New Fed Purchases										
MBS Run off Reinvestment	167	200	200	167	200	200	167	200	200	Assumes announced MBS Runoff Reinvestment in Bills
Reserve Maintenance	300	60	75	300	60	75	300	60	75	Assumes reserve maintenance bills purchase start 10/2026
Private Sector Gross Financing Needs	4,264	4,828	4,865	4,354	5,083	5,225	4,614	5,478	5,565	
Private Sector Gross Coupon Assumption	4,391	4,391	4,391	4,391	4,391	4,391	4,391	4,391	4,391	No Change in Gross Private sector Auction Sizes
Private Sector Total Net Issuance	1,473	1,705	1,815	1,563	1,960	2,175	1,823	2,355	2,515	
Net Bills	(127)	437	474	(37)	692	834	223	1,087	1,174	
Net Coupons	1,600	1,268	1,341	1,600	1,268	1,341	1,600	1,268	1,341	
Net Private Sector New Bills Financing as % of Total Private Sector	-3%	9%	9%	-1%	13%	15%	4%	19%	20%	In all Scenarios the private sector gets some new bills issuance and all "Term Out the Private Sector Held Debt
Fed + Private Sector Net Bills	340	697	749	430	952	1,109	690	1,347	1,449	
Private Sector Net Coupons	1,600	1,268	1,341	1,600	1,268	1,341	1,600	1,268	1,341	
Total Net issuance Fed + Private Sector	1,940	1,965	2,090	2,030	2,220	2,450	2,290	2,615	2,790	
Total Bills Issuance Fed + Private Sector as % of Total Issuance	18%	35%	36%	21%	43%	45%	30%	52%	52%	In All Scenarios the Aggregate Treasury Issuance "Terms in" the debt. In back years very aggressive "Terming in" Occurs in all scenarios

The big takeaway is that keeping auction sizes constant will explode overall bills usage by 2027 in all budget scenarios.

Recognizing that excessive bills issuance could result in lack of access to bills markets in an exogenous crisis, potential distortions in the yield curve, and weakness in the currency markets, we have made sensible auction size changes in the table below. In this table the NET auction sizes are not increased much due to sizable maturities and the bills market held by the private sector continues to grow modestly. In all our scenarios of auction increases and budget outcomes, Treasury avoids terming in its debt. While no real progress is made to "term out" the debt, which may one day be desired, the current situation does not worsen.

Deficit Scenarios and Sensible Auction Size Increases to avoid Shirnking the US Overall Issued DEBT WAM

	CFRB Baseline With Tariffs			CFRB Baseline			CFRB Alternative			
	2026 Total	2027 Total	2028 Total	2026 Total	2027 Total	2028 Total	2026 Total	2027 Total	2028 Total	Notes
Deficit Projection CFRB Baseline	1,750	1,700	1,800	1,840	1,955	2,160	2,100	2,350	2,500	Various third party deficit estimates
Maturing Ex Soma	2,791	3,123	3,050	2,791	3,123	3,050	2,791	3,123	3,050	
Current Coupon Buy Back	180	240	240	180	240	240	180	240	240	Assumes steady increase in liqudity buybacks
TGA Change	0	25	50	0	25	50	0	25	50	Assumes some increase in TGA due to increasing Bills
SOMA QT	10	0	0	10	0	0	10	0	0	
Gross Financing Needs	4,731	5,088	5,140	4,821	5,343	5,500	5,081	5,738	5,840	
New Fed Purchases										
MBS Run off Reinvestment	167	200	200	167	200	200	167	200	200	Assumes announced MBS Runoff Reinvestment in Bills
Reserve Maintenance	300	60	75	300	60	75	300	60	75	Assumes reserve maintenance bills purchase start 10/2026
Private Sector Gross Financing Needs	4,264	4,828	4,865	4,354	5,083	5,225	4,614	5,478	5,565	
Private Sector Gross Coupon Assumption	4,391	4,791	4,791	4,591	4,891	4,891	4,591	5,191	5,191	Auctions increased in 2026 or 2027 depending on Budget
Private Sector Total Net Issuance	1,473	1,705	1,815	1,563	1,960	2,175	1,823	2,355	2,515	
Net Bills	(127)	37	74	(237)	192	334	23	287	374	
Net Coupons	1,600	1,668	1,741	1,800	1,768	1,841	1,800	2,068	2,141	
Net Private Sector New Bills Financing as % of Total Private Sector	-3%	1%	1%	-5%	4%	6%	0%	5%	6%	By increasing Coupon Auctions sizes bills outstanding in the private sector is contained
Fed + Private Sector Net Bills	340	297	349	230	452	609	490	547	649	
Private Sector Net Coupons	1,600	1,668	1,741	1,800	1,768	1,841	1,800	2,068	2,141	
Total Net issuance Fed + Private Sector	1,940	1,965	2,090	2,030	2,220	2,450	2,290	2,615	2,790	
Total Bills Issuance Fed + Private Sector as % of Total Issuance	18%	15%	17%	11%	20%	25%	21%	21%	23%	By increasing Coupon Auction Sizes Modest Lengthening in Treasury Outstanding WAM can occur

Drilling down into a summary (a less but still messy chart) the red row is our "recommendation" for Treasury auction increases based on budget outcomes. In the most optimistic budget scenario where tariffs remain a high source of income, we think that the auction sizes can remain in place for the next three quarters and then a one-time increase of 10% can deal with the next three years. If tariff revenue is much lower than current levels or the budget deficit widens for any reason at all, Treasury likely needs to step up auction sizes in 2Q26 and again in 2027.

Deficit Scenarios and Sensible Auction Size Increases to avoid Shrinking the US Overall Issued DEBT WAM

	CFRB Baseline With Tariffs			CFRB Baseline			CFRB Alternative			
	2026 Total	2027 Total	2028 Total	2026 Total	2027 Total	2028 Total	2026 Total	2027 Total	2028 Total	Notes
Deficit Projection CFRB Baseline	1,750	1,700	1,800	1,840	1,955	2,160	2,100	2,350	2,500	Various third party deficit estimates
Gross Financing Needs	4,731	5,088	5,140	4,821	5,343	5,500	5,081	5,738	5,840	
Private Sector Gross Coupon Assumption	4,391	4,791	4,791	4,591	4,891	4,891	4,591	5,191	5,191	Auctions increased in 2026 or 2027 depending on Budget
YOY Coupon Auction Increase from Today	-	400	-	200	500	-	200	800	-	We think Coupon Auctions sizes are going up. But not this QRA
Net Private Sector New Bills Financing as % of Total Private Sector	4%	1%	1%	1%	4%	6%	6%	5%	6%	By increasing Coupon Auctions sizes bills outstanding in the private sector is contained
Total Bills Issuance Fed + Private Sector as % of Total Issuance	18%	15%	17%	11%	20%	25%	21%	21%	23%	By increasing Coupon Auction Sizes Modest Lengthening in Treasury Outstanding WAM can occur

Terming out the debt.

Will Treasury term out the debt? As we have shown above, Treasury debt outstanding has shifted since before COVID, from mid-teens % bills to 22% today. While that is not deeply concerning - over the long history Treasury bills percentage has been higher, high percentages have typically occurred when economic conditions were very weak and immediate spending was needed to offset this weakness, requiring funding with the most liquid form of debt. Today conditions are nothing like weak. The modern Treasury has targeted 15-20% bills percentage. Heading in that direction would require increasing gross coupon issuance.

While Treasury is unable to pursue market timing strategies, market pricing and expectations may encourage Treasury to delay terming out the debt on the margin while also discouraging them from aggressively betting on such expectations. Most importantly, Treasury's actions also affect economic outcomes. Activist Treasury Issuance can be a monetary policy lever. Issuing proportionately more duration can slow an economy due to a rise in long-term interest rates affecting the cost of long-term borrowing in the private sector and asset prices falling can reduce demand from the wealth effect. The opposite impact can occur by favoring bills issuance. Of course, inflation is also affected, particularly when bills issuance is used to be stimulative to growth when inflation is nowhere near target. Ironically, choosing bills in the hope that growth rises will increase future interest costs over time and make terming out the debt (when and if it is finally done) more expensive than going when conditions are strong. As Treasury's job is different than the Fed's job, Treasury may stimulate when the Fed explicitly wants to tighten. This bills driven stimulation clearly happened during the Yellen Treasury as bills issuance ran well above target for the entire last two years of the administration. Today the Bessent Treasury, which harshly criticized the prior administration and has been saddled with the higher-than-normal bills percentage created by that policy, also thinks that interest rates should be brought down by Fed rate cuts. If rates do fall, that will lower the deficit and favor delaying issuance until rate cuts are pushed though. The desire to time markets (despite it being essentially impossible) and the desire to maintain strong asset prices and stimulate the economy ahead of the mid-terms may cause Treasury to maintain its high bills usage. Nonetheless, given the scenario charts above, Treasury risks not only being wrong on market timing but a deficit-driven explosion in bills issuance percentages.

Fed Reinvestment policy impacts

The Fed has already taken steps to reduce the duration it holds by adding $200BN a year in bills purchases, the $160BN of emergency RMO, and an unknown amount of RMO after Tax Day. This step alone will shift its balance sheet meaningfully closer toward their steady state goal (see below). However, the Fed is also considering other reinvestment policy tweaks that will further shorten their WAM. If the Fed pursues further reinvestment changes, it will further "term in" the Treasury debt outstanding unless Treasury shifts more coupon issuance to the private sector.

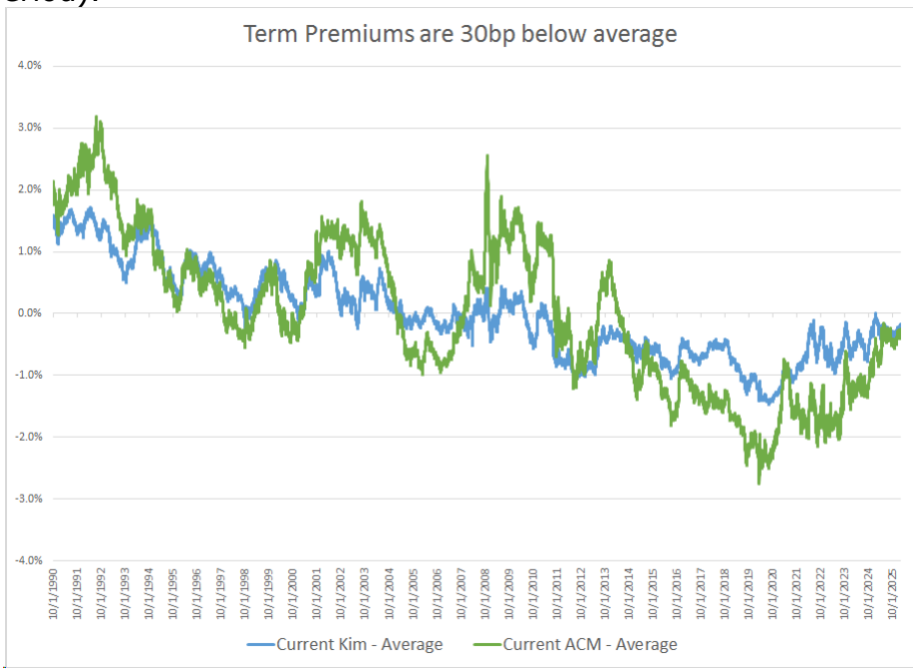
What is the pricing

Again, when issuing $4.4TN in coupon debt and rolling $6.4TN bills multiple times per year, Treasury is selling debt almost every day in huge size. They get what the market pays and cannot market time. Nonetheless, it does make sense to at least look at pricing.

Current trough market-based interest rate expectations for the Fed policy rate are roughly 3%. This expectation includes a full understanding that the Trump administration wants interest rates lower and is replacing Powell by the June meeting with someone that is highly likely to either follow the administration's wishes or at least is dovish themselves. One might think that the short-term interest rate market would be troughing at a much lower level given the rhetoric. But for whatever reason, expectations are for 100bp of cuts only.

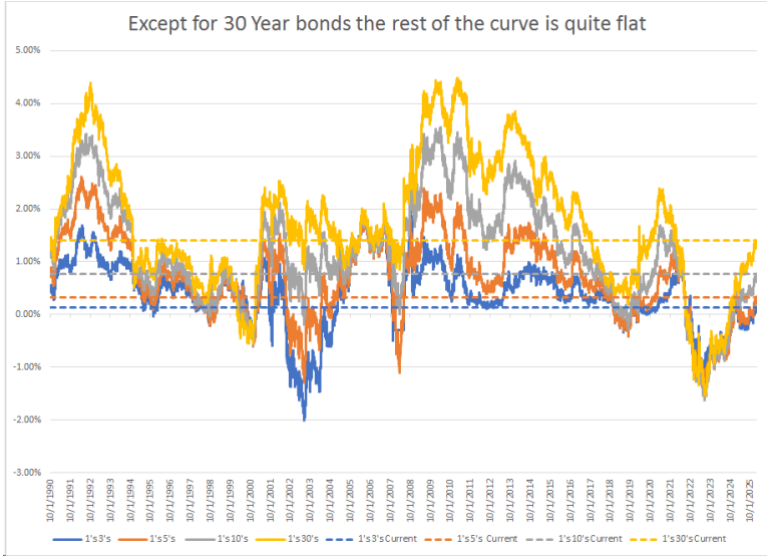
The bills market does not seem particularly attractive given this pricing. On the other hand, the entire curve out almost to 10 years is currently yielding less than 4%. Except for the long end of the curve, the rest of the curve is a relative bargain for the issuer.

Term premium, which attempts to capture the exact benefit of extending duration issuance, is 40bp below average and suggest that this is a rather good time to increase coupon auction sizes (though not as good as during the QE fueled COVID recession period).

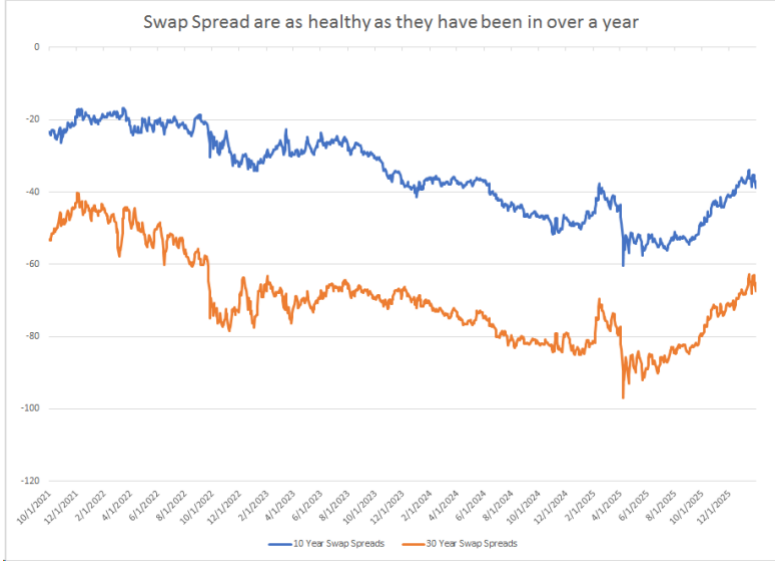


Other relative value measures of the attractiveness of issuing coupons versus bills include simple steepness of the yield curve measures.

Except for the 30Y, which are about normal steepness, shorter coupon issuance points are a fairly good bargain as well.



Swap spread suggest the basis market can absorbs more cash coupon Treasuries:



It is important to also scale the risk of increasing or decreasing coupon issuance. Even in our most conservative case of coupon issuance increase based on a quite pessimistic fiscal deficit outlook, we estimate Treasury would only issue $800BN in additional coupon debt per year. If Treasury were dead wrong and "should" have waited for lower yields, the cost of terming out the debt early using an aggressive assumption of 100bp of bad timing would result in an $8BN per year mistake. **There really is NO economic incentive for timing the market that matters**

to the US Government. On the other hand, the risk of running excessive bills outstanding is that when emergency bills issuance is necessary that the bills market charges a lot for that financing.

Market expectations

Markets expect that the QRA will be a non-event and that is our central case as well. Auction sizes have been stable for over a year, and expectations are they will stay exactly the same size for the next time period. This will be revealed on Wednesday at 8:30AM.

TBAC RECOMMENDED US TREASURY FINANCING SCHEDULE FOR NOVEMBER 2025-JANUARY 2026 QUARTER

*** BILLIONS OF DOLLARS**

	Auction Month	2-Year Notes	3-Year Notes	5-Year Notes	7-Year Notes	10-Year Notes	20-Year Bonds	30-Year Bonds	5-Year TIPS	10-Year TIPS	30-Year TIPS	2-Year FRN
Historical Reference	May-25	69	58	70	44	42	16	25		18		28
	Jun-25	69	58	70	44	39	13	22	23			28
	Jul-25	69	58	70	44	39	13	22		21		30
	Aug-25	69	58	70	44	42	16	25			8	28
	Sep-25	69	58	70	44	39	13	22		19		28
	Oct-25	69	58	70	44	39	13	22	26			30
Recommendations for this Refunding	Nov-25	69	58	70	44	42	16	25		19		28
	Dec-25	69	58	70	44	39	13	22	24			28
	Jan-26	69	58	70	44	39	13	22		21		30
Provisional Indications for Next Refunding	Feb-26	*69*	*58*	*70*	*44*	*42*	*16*	*25*			*9*	*28*
	Mar-26	*69*	*58*	*70*	*44*	*39*	*13*	*22*		*19*		*28*
	Apr-26	*69*	*58*	*70*	*44*	*39*	*13*	*22*	*26*			*30*

Furthermore, the guidance language changed just slightly last quarter. We do not expect it to change on Wednesday but there could be modest change in the details. Certainty of a plan to increase is unlikely given the uncertainty around tariff revenue but we will pay attention. The language currently reads, as follows:

"Looking ahead, Treasury has begun to preliminarily consider future increases to nominal coupon and FRN auction sizes, with a focus on evaluating trends in structural demand and assessing potential costs and risks of various issuance profiles."

Possible Outcomes, Implications, and Market Reactions

QRA Coupon Auction sizes and language changes 8:30AM 2/4/2025						
	Likelihood	Implications	Stocks	10's	Gold	DXY
Auctions sizes decreased	<1% Chance	Treasury is willing to run at higher than Yellen bills ratio	Buy	Buy	Aggressive Buy	Aggressive Sell
Auction sizes left the same no change in language	>88% Chance	No policy implication but likely modestly bullish bonds given the upcoming large maturities	Neutral	Modest buy	Neutral	Neutral
Auction sizes left the same with change in language	<10% Chance	Pretty big deal for assets and term premiums as it recognizes the future and policymakers want to avoid overuse of bills	Sell	Sell	Sell	Buy
Auction sizes increased	<1% Chance	Absolute Shock to markets. "Sell All Assets"	Aggressive Sell	Aggressive Sell	Aggressive Sell	Buy

Synthesis

The Fed should, but almost definitely will not, shift its balance sheet policy toward tightening by implementing the DS Plan or something similar. The Repo Gang is a tough nut for the new Fed Chair to crack, and he likely does not even know the impact. If they all wise up, the tightening of runoff, if done with thoughtful easing, can normalize the Fed's balance sheet, keep the overnight rate within the Fed's policy target range, and resolve the big problem of uneven distribution of reserves. This week's QRA is unlikely to have a market impact as Treasury has yet to commit to terming out the debt and tariff uncertainty remains, which heavily affects budget deficit projections.

Current Portfolio and Performance

	Assumed Portfolio size	$ 100,000,000					
	LTD P/L	$ 67,093,207					
	Total Return	67.09%		YTD Return in excess of cash		-2.21%	
	Today's Date	2/2/2026		Portfolio Created		4/15/2019	
Date	Position	Entry Price	Amount	Worst case loss	MTM	P/L	Open/Closed
1/9/2026	SPX 3/31/2026 6800 Put	116.04	170	$ 1,972,680	89.35	$ (453,730)	Open
1/22/2026	QQQ 3/31/2026 680 Calls	1.80	5556	$ 1,000,000	1.77	$ (16,667)	Open
1/29/2026	SPX 7320 April 17 2026 Call	53.40	105	$ 560,700	46.25	$ (75,075)	Open
1/29/2026	SPX US 9/18/26 P6800/6000 Put Spread	140.00	105	$ 1,470,000	138.15	$ (19,425)	Open
1/30/2026	SPX 3/31/2026 6575/6475/6375 Put Butterfly	2.60	1923	$ 500,000	2.60	$ -	Open
7/3/2025	SFRM6	96.62	2800	$ 2,000,000	96.54	$ (336,000)	Open
9/18/2025	SFRM6 (paired with SPX Call spread)	96.79	1600		96.54	$ (992,000)	Open
1/29/2026	ZNH26 111/110 Put Spread 3/27/26	0.30	7883	$ 2,340,266	0.30	$ -	Open
1/23/2026	GCH 2/24/2026 5000/5100 Call Spread	40.00	-42	$ 250,000	16.55	$ 97,708	Open
1/30/2026	GCH 2/24/2026 4800/4700 Put Spread	28.00	-42		58.50	$ (128,100)	Open
			Initial Risk	10.1%		8.29%	