



# How The Coming Debt Ceiling Debacle Blew Up The Fed's QT, And What Happens Next



BY TYLER DURDEN

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By now everyone knows that for the past year has seen the Fed unleash an unprecedented crusade against not only runaway inflation - having been responsible for the surge in prices in the first place thanks to trillions in post-covid "MMT" helicopter money - and employment - hoping to contained the soaring inflation by means of a broad economic recession - but has also targeted prices of equities and bonds, i.e., risk assets, which after a decade of merciless and relentless asset bubble blowing have been suddenly forsaken by the money printing institution of the US which has been doing everything in its power to hammer every rally and crush animal spirits (if only for the time being, a time when weekly angry phone calls from the senile occupant in the White House demanding the Fed make everyone equally poor impinge on the Fed's true first commandment which is to make a handful of people very rich while monetizing the US debt in the meantime).

In its determined pursuit of lower asset prices, the Fed has been engaged in the fastest rate hiking campaign since Volcker broke the back of double digit inflation 40 years ago. But as rate hikes are about to downshift again to 25bps, before hitting pause (and going into reverse in the second half of '23 according to the market if not the Fed) the Fed is left with another, more powerful tool to crush risk prices: QT, the same Quantitative Tightening that Goldman's head of hedge fund sales last week said that "[While All Attention Is On Rates, The Real Risk Is That Global QT Is Just Starting.](#)"

Understandably, the fact that QT may stick for a long time even as the Fed's rate hikes end (and reverse), is keeping traders on edge. Indeed, while we disagree with Goldman on most thing, we certainly are sympathetic that while rates may come and go (and rise or fall), what happens in the market is mostly a function of QE (or, as the case may be, QT).

That's hardly news; however, what virtually nobody knows is that the coming debt ceiling fight is about to throw the Fed's entire carefully scripted balance sheet reduction into a tailspin, and that's because while attention over the past year has traditionally focused on one particular Fed balance sheet liability - namely reserves - and to a lesser extent the balance of the overnight reverse repos (including foreign) parked at the Fed on any given day - **the one Fed liability that is about to pay an especially prominent role when it comes to overall system liquidity over the next 9 months is the Treasury General Account**, or how much cash the US Treasury parks at the Fed on any given day. A summarized snapshot of the Fed's balance sheet liabilities (including the 4th big one, currency in circulation, which at least is much more stable and only knows how to grow at a steady, if slow, pace), is shown below courtesy of the Fed's [latest H.4.1 statement](#):

H.4.1  
5. Consolidated Statement of Condition of All Federal Reserve Banks (continued)  
Millions of dollars

Assets, liabilities, and capital	Eliminations from consolidation	Wednesday Jan 11, 2023	Change since	
			Wednesday Jan 4, 2023	Wednesday Jan 12, 2022
<b>Liabilities</b>				
Federal Reserve notes, net of F.R. Bank holdings		2,248,874	- 8,758	+ 65,574
Reverse repurchase agreements <sup>1</sup>		2,547,806	- 14,077	+ 685,761
Deposits	(0)	3,667,709	+ 23,211	-1,005,373
Term deposits held by depository institutions		0	0	0
Other deposits held by depository institutions		3,116,831	+ 74,902	- 812,102
U.S. Treasury, General Account		346,426	- 33,194	- 143,253
Foreign official		8,935	0	+ 3,745
Other <sup>2</sup>	(0)	195,517	- 18,497	- 53,763
Deferred availability cash items	(0)	224	- 91	+ 43
Treasury contributions to credit facilities <sup>3</sup>		15,347	0	- 5,911
Other liabilities and accrued dividends <sup>4</sup>		-13,198	+ 872	- 21,112
<b>Total liabilities</b>	(0)	<b>8,466,761</b>	<b>+ 1,155</b>	<b>- 281,020</b>
<b>Capital accounts</b>				
Capital paid in		35,041	+ 3	+ 1,329
Surplus		6,785	0	0
Other capital accounts		0	0	0
<b>Total capital</b>		<b>41,826</b>	<b>+ 3</b>	<b>+ 1,329</b>

Note: Components may not sum to totals because of rounding.

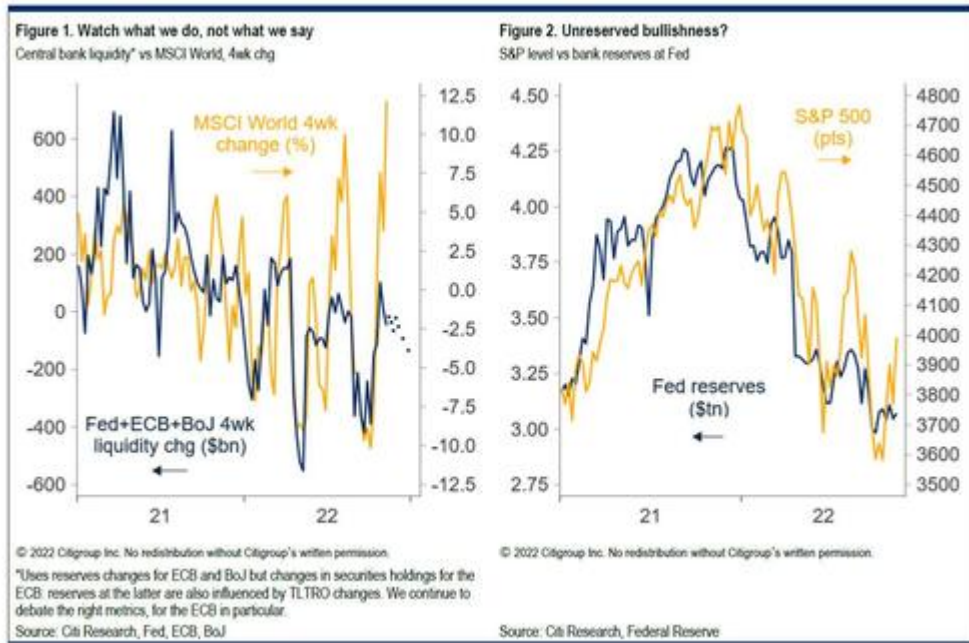
When it comes to Fed liabilities, the market has traditionally cared almost entirely about reserves and for good reason: for the past two years, the amount of weekly reserves has correlated to the market cap of US equities with an uncanny precision of almost 1.00.



In this case, one can safely argue that correlation indeed means causation, as none other than Matt King has done. Here is what the Citi credit legend wrote in September eyeing the latest changes in the Fed's balance sheet, and explaining why contrary to some residual focus on the overall level of the Fed's balance sheet, what matters is almost exclusively reserves, to wit:

As we have long maintained, you get a much better explanation for market moves, especially in risk assets, if you think in terms of changes in central bank liquidity. Just as central bank actions speak louder than their words, so too do the charts. Usually we look

at central bank liquidity globally, with a large number of central banks, and over 6m or 12m time periods: the shorter-term moves tend to be noisy. But over the past couple of years, the gyrations in major central bank balance sheets have been so large relative to other forms of money creation that even short-term correlations have been quite obvious (Figure 1). Since the Fed is the principal source of such short-term fluctuations, **you can do quite a good job explaining market moves using reserves at the Fed alone** (Figure 2).

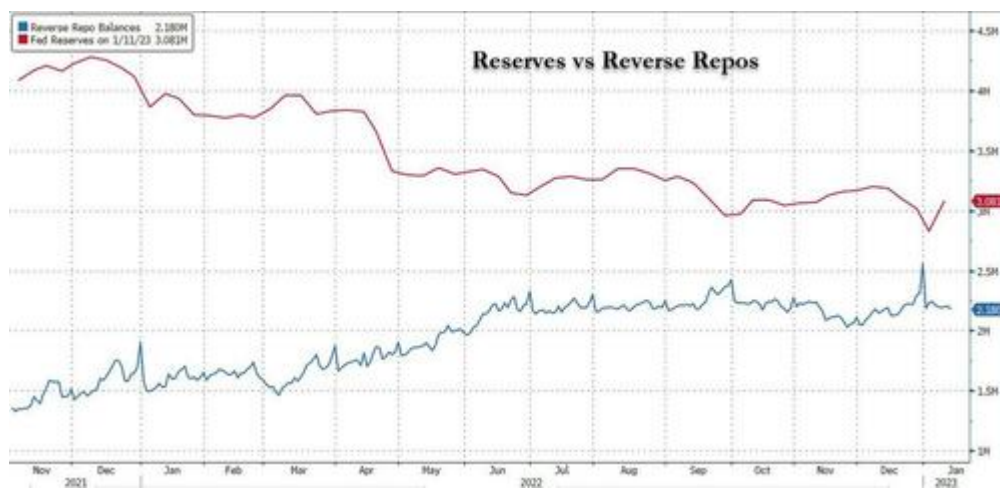


Yes, the Fed's reserves - all \$3.1 trillion of them - are without a doubt the biggest causative factor when it comes to i) high-powered liquidity sloshing through the system, and ii) asset price changes and levels not only on a monthly but even weekly basis as shown in the chart below (and if you don't believe us, read any recent note from Matt King).



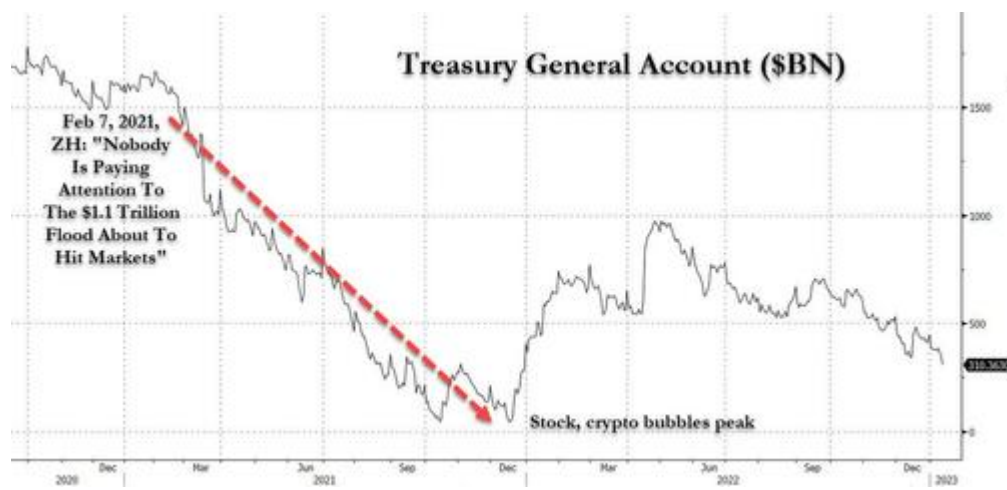
But there's more.

Sometimes, when trying to gauge what happens next to the Fed's reserves, one should look at the Fed's reverse repos, a form of money that is more inert and thus "lower-powered" than reserves, yet still packs plenty of "potential (liquidity) energy", which can easily be converted into "kinetic energy" if repos are converted into reserves or other forms of money (such as TGA). One of the bigger mysteries over the past 8 months, or since the start of QT in May 2022, is why the Fed's reverse repos have been so stubbornly sticky instead of declining much more rapidly as the Fed and many outside strategists had expected they would. We won't go into that here as an explanation would require at least one full article, but we will point out that repos and reserves tend to be inversely correlated, and any drop (or jump) in reverse repos is matched by an almost identical jump (or drop) in reserves.



And then there is the Treasury General Account, or the cash held by the Fed on behalf of the Treasury (think of it as Janet Yellen's piggybank), and which we profiled first back in February 2021 in "[Mind-Boggling Liquidity: Nobody Is Paying Attention To The \\$1.1 Trillion Flood About To Hit Markets](#)", which alongside QE, **was a principal driver behind the gargantuan equity returns in 2021 and the massive asset bubble that peaked in late 2021 (the first trading day of 2022 was the all time high in the S&P)**, right around the time the almost empty TGA was refilled by almost half a trillion dollars in just a few weeks, draining massive liquidity from the market and marking the peak of both the crypto and stock market bubbles (for now).





Why this very long (and boring) lesson in modern-day finance? Well, because as we explain below, what is about to happen is about to detail the Fed's plan to gradually keep draining liquidity from the market via QT, and it's all because of the near-term dynamics (read the next 9 months) linked to the coming Debt Ceiling fiasco.

What do we mean by this? Well, in a nutshell, while QT continues at its scheduled pace of \$95BN per month (\$60BN in TSYs, \$35BN in MBS), the debt ceiling is about to spark an accelerated drain of the Treasury Cash, i.e., the TGA, as Janet Yellen releases as much cash as she can rapidly to fund the Treasury's various debt ceiling *Extraordinary Measures*, which will in turn **serve as a liquidity boost to the market, more than offsetting any reserve drain weakness that Powell may have penciled in previously and effectively serving to spark a rally in risk assets until the debt ceiling issue is resolved some time in Q3, or early Q4!**

But wait, how is that possible at a time when consensus on Wall Street is that H1 will see stocks slump and surge in H2? Well, as usual, consensus is wrong, and that's a point which none other than that "other" famous former Fed repo guru (no, not Zoltan) BofA Mark Cabana writes about in his latest rates weekly note (available to pro subs), in which he says that the **most common front-end question from clients so far in '23 is how to make sense of debt limit (DL), TGA, reserves, & ON RRP? Or, as he explains, clients are essentially asking how the debt limit & QT liquidity drain will impact 3 key Fed liabilities: TGA, reserves, & ON RRP.**

Cabana's short answer: **from now until DL resolution = QT will largely be neutralized by lower TGA while reserves & ON RRP will both decline modestly. Post DL resolution = ON RRP should drop sharply with bill supply wave & reserves modestly lower but no scarcity in '23.**

In other words, any hopes the Fed may have had that the ongoing QT drain will keep a lid on stocks has just been crushed by the roughly \$400BN in cash the Treasury will dump on short notice in the coming months as the DL debate comes to a head.

Let's go over the dynamics.

Starting at the top, i.e., before the DL extraordinary measure mechanics kick in, Cabana writes that to date, the Fed QT has been largely absorbed by lower TGA, while reserves have fallen to lesser extent, something we have repeatedly pointed out.

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Once again a reminder that it's not the total Fed balance sheet (reserves + reverse repo + currency) that matters, it's just the reserves. And the question is why are repos shifting into reserves yet

10:29 AM · Sep 16, 2022

As an aside, the Fed's overnight repo (ON RRP) grew since Fed QT because of what Cabana dubs "rich bills / low supply / Fed hike uncertainty." And indeed, since the start of QT at end May, the Fed's balance sheet has shrunk \$406BN, while TGA has fallen \$422BN and reserves have declined \$273BN. Offsetting these declines ON RRP has grown \$234BN & other Fed liabilities (mostly currency) have grown by a modest \$55BN.

The TGA - which is the big variable in question - has fallen due to constraints the Treasury faces as a result of the DL. As we explained last week, and as Janet Yellen confirmed two days later, the Treasury was only \$59BN away from hitting the debt limit on Jan 19, and had chosen to lower its cash balance rather than employ extraordinary measures so far (that has changed now that Yellen officially triggered extraordinary measures). That said, the TGA will fall more - and more rapidly - into the DL X-date. Reserves, of course, are also lower because of the Fed QT & bank deposit outflows, or as Cabana puts it, "bank deposits have lagged Fed rate hikes & depositors have left. Deposit competition increased & some moved into MMF."

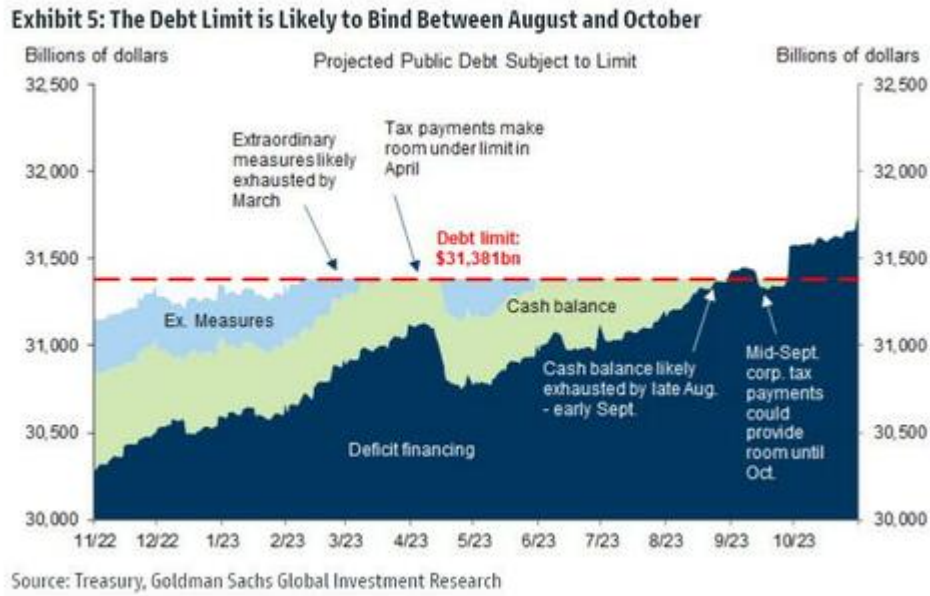
Next, a quick primer on Fed liabilities and balance sheet mechanics.

As the BofA strategist points out, QT matters not only for the total stock of privately held Treasuries the market needs to absorb, but it is also important for the distribution of Fed liabilities. Here, Cabana agrees with us that there are only 3 key pieces of Fed liabilities that are (the most) relevant: i) reserves, ii) ON RRP and iii) TGA.

Next, let's break the Fed balance sheet liability outlook into two parts: **i) pre-DL resolution, and ii) post-DL resolution.**

- Pre-DL, the Fed will see much lower TGA and a very modest drop in reserves and ON RRP.
- Post-DL will see higher TGA, much lower ON RRP and stable reserves. The post-DL ON RRP drop will be due to more supply & cheaper bills.

Here, BofA like [Goldman](#) assumes **the Debt Limit X-date is August/September and any resolution will go down to the wire, in other words do not expect any Congressional deal before Sept, or even October.**



Next let's look at these two parts in more detail, starting with the pre-DL resolution, when we expect lower TGA, modest drops in reserves & ON RRP.

According to Cabana calculations, in the Pre-DL resolution phase, **TGA will decline \$400BN between now and August.** This is critical, because holding all else constant, **ON RRP + reserves should increase by the same amount, even as the Fed QT still drains liquidity.** Cabana further details his treatment of TGA + on-going Fed QT / currency growth as follows:

- **TGA reduction:** The BofA analysis suggests that **changes in TGA are largely absorbed by changes in reserves (not ON RRP).** The bank assumes that 95% of the TGA decline will be reflected in higher reserves which will receive the bulk of the benefits from the TSY's accelerated TGA drain (95% of \$400b = **\$380b**). The logic for this is that **TGA outflow represents payments to individuals & business, which then likely end as deposits.** This implies that reserves should grow as a result of the TGA decline. Meanwhile, ON RRP absorbs the remaining 5% or \$20b in TGA outflows due to QT mechanics.
- **Fed QT / currency growth:** Over the same period, the bank also expects the Fed's balance sheet to decline \$630b from QT. Reserves should absorb 75% of the decline from QT (\$473b) and ON RRP absorbs the remaining 25% (\$158b) as has been the case to date; it also assumes ongoing Fed currency & other liability growth which reduces reserves more than ON RRP. After accounting for the decline in the TGA, on net, **the Fed's balance sheet is \$630b lower: \$400b has been absorbed by the TGA, \$93b by reserves and \$138b from ON RRP** (actual reserve reduction is slightly higher due to currency growth. On net TGA absorbs most Fed QT pre DL resolution, reserves & ON RRP absorb less).

#### **Post-DL resolution: higher TGA, sharply lower ON RRP, stable reserves**

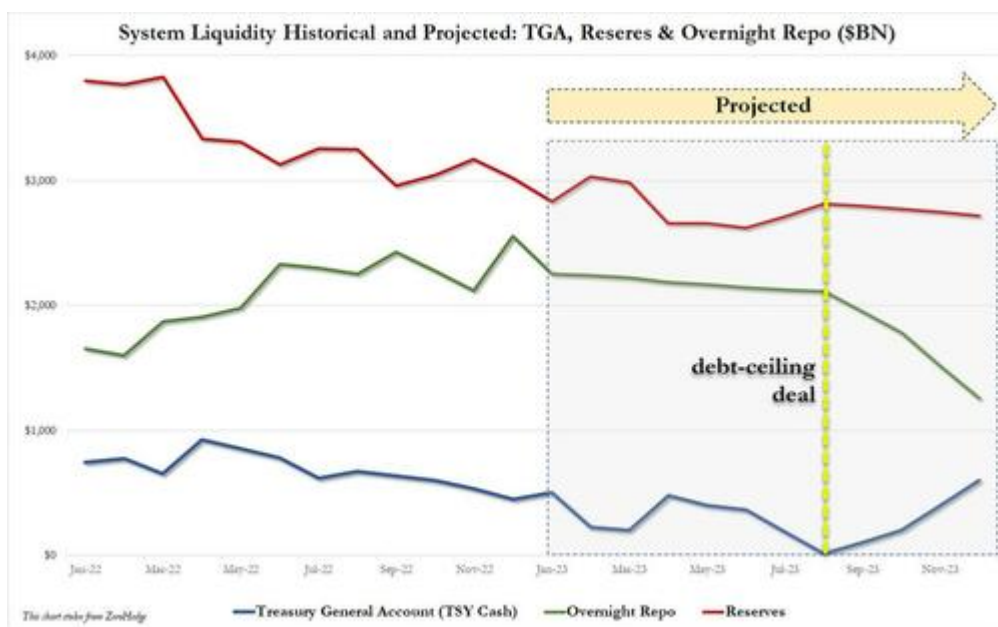
At some point in September or October, after the mandatory near-default scare, Congress will reach a debt ceiling deal after much posturing, one which will increase the Debt Limit by **a large enough amount to allow for a full replenishment of TGA back to \$600BN by end '23.** Post-DL resolution, Cabana expects a very large surge in bill supply to replenish TGA, which will cheapen bills. The bill cheapening should finally encourage money market funds to extend out of ON RRP & capture positive bill "term premium", something they have refused to do so far. As such, in Cabana's post-DL forecast, **he expects the TGA rebuild & ongoing QT to drain ON RRP/reserves in a 90/10 ratio.** In this scenario, if one assumes TGA rises \$600BN post debt limit this should drain \$540b from ON RRP & \$60b from reserves. And since there is more than \$2 trillion in overnight repo, all of which is inert and has zero impact on risk assets, even the post-DL Fed balance sheet drain will be mostly neutral on risk assets! Here is Cabana:

We assume 90% of the drain comes out of ON RRP due to the large bill supply wave. Bills should cheapen enough to be attractive relative to ON RRP allowing MMF to shift allocations from ON RRP out the curve. A Fed pause would also help MMF extend due to lower interest rate uncertainty.

Between the assumed August Debt Limit resolution and a year end, Cabana assumes QT lowers the Fed balance sheet by another \$300BN; using his 90/10 ratio, Cabana projects this will drain \$270 from ON RRP but **only \$30BN from reserves.** On net, post DL resolution, **the former NY Fed repo guru expects to see ON RRP decline sharply by \$810b while reserves fall a much more modest \$90b.**

**Cabana's bottom line** is that while the Fed's balance sheet is indeed likely to decline by nearly \$1tn in '23, as expected assuming a \$95BN decline in assets monthly, most of this decline will come from ON RRP. And narrowing it down even further, pre-debt limit deal, most of Fed B/S decline will come from the lower TGA as the Treasury drains its cash to fund the various Extraordinary Measures. Then, after the DL deal is done, the Fed B/S reduction and the TGA rebuild will draw heavily on ON RRP as reserves once again dip only modestly.

Here is a visual snapshot of historical **and projected** changes among these key liquidity drivers. Not the stability of Fed reserves (red), the drop in TGA into the Aug/Sep DL deal, and the sharp rebound after coupled by the plunge in ON RRP.



Said otherwise, as a result of the debt limit fight and the accelerated Treasury cash drain over the next few months, reserves (so important for risk prices) should drop only modestly and as Cabana concludes, "reserve scarcity likely won't happen in 2023." It also means that any market assumptions that risk assets will be hit by a sharp drop in Fed reserves, or QT in general, are wrong and will lead to a repricing higher in stocks once markets realize the impact of the debt limit on Fed liabilities, *an impact what will be magnified if the Fed pauses its tightening campaign, and certainly if it starts easing in the coming months.*

Which, incidentally, is what we said last week...

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There is \$346BN in cash parked at the Treasury. This will now be drained rapid offset the debt ceiling, creating a QE-like liquidity boost to assets over the next months.

2:01 PM · Jan 13, 2023

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... and is also precisely what TS Lombard's Steven Blitz said in a note released today:

Treasury Secretary Yellen kicked off this latest round of debt ceiling workarounds by announcing that the ceiling has been hit and extraordinary measures are now being taken to push out the cash-exhaustion date to June 2023. Protracted arguments will now ensue with opponents frozen in their positions, power politics at its best, with threats for budget/debt Armageddon. The "Freedom Caucus" held up McCarthy's Speakership, in part, to ensure they had this moment to impose their budgetary will. The nation has been here many times before. **The real story in the coming months, during which net new Treasury issuance drops to zero and Treasury's balances at the Fed are run down, is that whatever constraining impact current QT has had (very little), it will be gone, rendered moot. Count this as one more easing of financial conditions, with the FOMC losing further control of its narrative (We are still restrictive!!!!).**

Some more math from Blitz on why the debt limit dance will translate into a sharp slowdown in net new issuance:

In 2019, the last debt ceiling waltz, Treasury issued no new debt from February through August and the 10Y Treasury yield dropped from 2.8% to 1.5% -- with QT going full bore at the time (\$30bn/month of maturing debt to be financed by the public). Because the economy was slowing, the Fed dropped QT to \$15bn/month in May (10Y was at 2.3%) and stopped after September. **At present, QT is \$60bn/month with the estimated deficit of \$900bn for 2023FY. With debt ceiling in place, the public goes from financing \$135bn/month to \$60bn/month.** This is not entirely correct for each month because Treasury financing needs are seasonal -- typically being lowest in Q2 (April tax payments). This monthly average calculation does, however, serve to make the point -- **markets will find themselves having to take down more than half as much UST as before, and this is less than what they need to buy. As in 2019, I would expect yields to fall, aided now as then, by expanding signs of weaker growth.**

Lower yields, of course, means easier financial conditions, means more upside for "growth" themes. As for when the bulk of this sharp TGA easing will take place, the answer is **very soon**:

As of Wednesday Jan 11, Treasury had \$346bn on deposit at the Fed. **This will be drawn down at a fast pace in the short term (tax refunds begin going out in February), and then stabilize in April when tax revenue comes in.** Declining Treasury deposits at the Fed reduces a liability on the Fed's balance sheet and thereby reduces the need to manage bank reserves, or reverses with money funds, **in order to have \$60bn fewer liabilities to match the aimed \$60bn decline in assets.** A potential further complication for the Fed in its management of QT is that **commercial banks could, in the face of a weakening economy, decide to raise the level of their assets (reserves) on deposit at the Fed.**

TS Lombard's bottom line echoes Cabana's namely that while the debt ceiling will create a lot of political drama it will get resolved with some renewed budgetary discipline; but **the real story will be a further easing of financial conditions at the back end of the yield curve because Treasury net new issuance drops to zero.** The markets will need at least the \$60bn/month the Fed will no longer be buying, and probably more than that. And while the Fed could expand QT in response, that is unlikely (in fact, if Pozsar is correct, not only will the Fed not boost its QT but will in fact, [move to relaunch QE as the year progresses](#)) given how they are capping the rise in the funds rate and allowing financial conditions to ease.

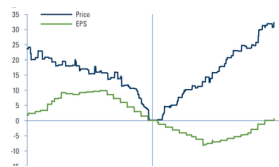


Bottom line: if it was the Fed's plan to hammer stock prices in 2023 similar to the pounding they took in 2022, it will have its work cut out for it, first because it is already being forced to pause its rate hikes by the slowdown in the economy, and second because the adverse impact of QT - which is the real risk-asset monetary policy transmission mechanism - is about to be nullified by the rapid cash drain at the Treasury.

More in the full notes from [BofA](#) and [TS Lombard](#), both available to professional subs.

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