



June 2022

What is Quantitative Tightening?

Conventional monetary policy involves adjusting the federal funds rate to achieve its dual mandate of stable inflation and full employment. Quantitative tightening (QT) and quantitative easing (QE) are additional monetary policy tools used by the Federal Reserve Bank that complement its conventional policy tools. QE and QT are part of the Fed's Open Market Operations (OMO), a set of less conventional monetary policies, where the Federal Reserve buys and sells Treasury and other fixed income securities to adjust reserve balances and short-term interest rates to stimulate or slow the economy, lending, and labor markets. QE was introduced in the U.S. in 2008 to help the economy recover from the Great Recession. It ended in 2014. QT has only been used in the U.S. once from 2017-2019.

QE, also referred to as bond buying, occurs when a central bank buys fixed income securities from banks and other market participants, mainly U.S. Treasury bonds to increase financial market liquidity and mortgage-backed securities to hold mortgage rates down, supporting the housing market. The Fed buys securities from banks by adding credit to their reserve accounts, essentially "creating" money. Banks can theoretically lend more as a result.

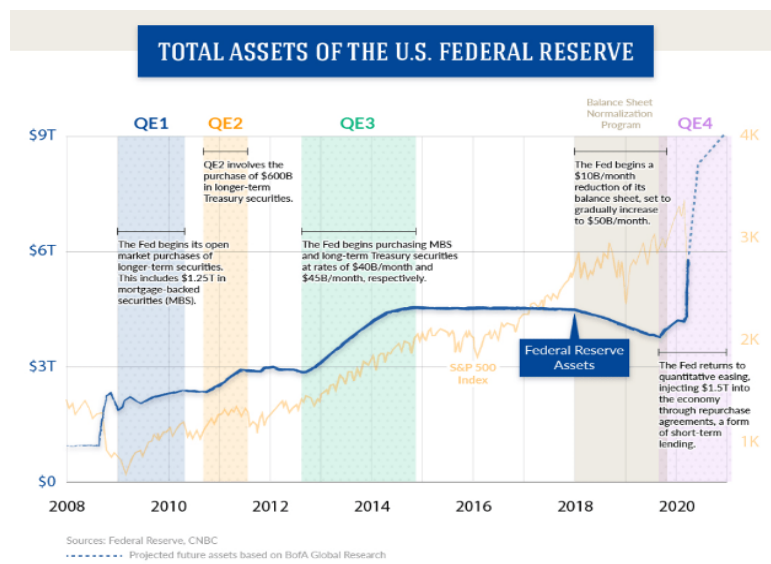
In contrast, QT occurs when the Federal Reserve either lets bonds mature and roll off its balance sheet, also referred to as balance sheet "unwinding" or "normalization" or actively sells bond holdings in the secondary market. The Federal Reserve engaged in its first, and only, QT from 2017-2019. The program resulted in a \$640 billion reduction, or 16% of the balance sheet.



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The markets were shocked by this program and by December 2018, there were concerns the Fed decreased bank reserves too drastically. Stocks and bonds both dropped meaningfully within three months, and the U.S. dollar strengthened, pressuring borrowers. By March 2019, QT was abandoned.



The graph above depicts the Federal Reserve's assets throughout its history of OMOs. As of May 2022, the Fed's balance sheet is about \$8.9 trillion or 37% of nominal GDP. The Fed announced in April that its second QT program ever was starting in June 2022. The current plan is a reduction of \$47.5 billion per month for 3 months and then at a maximum pace of \$95 billion per month until the reserves are somewhat above the level the Fed deems "ample" to prevent another liquidity crunch. These amounts are monthly caps so actual balance sheet run-off may be slower. Nonetheless, the total amount of balance sheet reduction is a record liquidity drain, double the size of the last QT cycle. Federal Reserve Chairman Jerome Powell told Congress in March 2022 that the process would take about three years with \$3 trillion in reductions.

As the goal of QT is to take money (i.e., financial excesses and liquidity) out of the banking system and financial markets, QT will put more upward pressure on interest rates, making borrowing more expensive and tighten financial conditions which reduces economic activity. Federal Reserve governors are suggesting QT will not have much effect on the broader economy, with St. Louis Fed President Jim Bullard stating, "one may view the effects of unwinding the balance sheet as relatively minor". But if the expansion of the balance sheet decreases long-term interest rates and enhances liquidity and growth, then the contraction of the Federal Reserve's balance sheet should have at least a reverse effect equal in magnitude, if not greater.

The implications for asset prices are significant. Higher interest rates lead to higher financing costs and tighter liquidity conditions. Almost every risk asset including equities, real estate, commodities, and venture capital is impacted by QT as valuations, cash flows and discount rates change.