

Kevin Warsh vs. the Fed's balance sheet

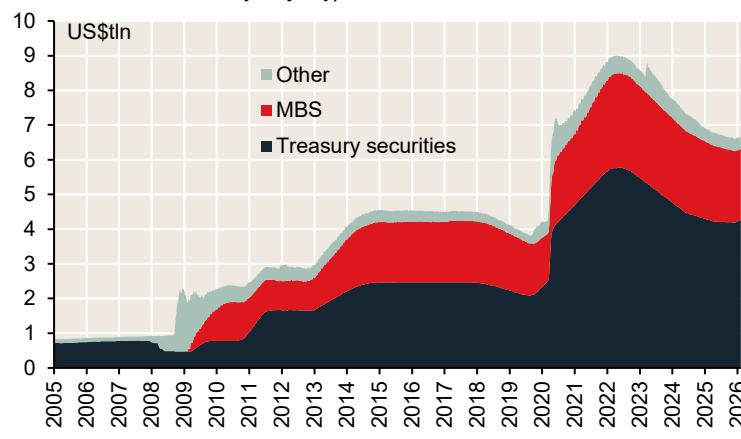
By Taylor Schleich & Ethan Currie

Kevin Warsh's nomination for Fed Chair last month was somewhat curious. While the ex-Fed Governor has recently advocated for lower rates (due to an expected AI-driven productivity boom), his reputation as a steadfast hawk runs counter to Trump's unrelenting desire for lower interest rates. And even as his hawkish policy rate stance moderated, his views on balance sheet policy haven't wavered. To him, the Fed's balance sheet is excessively large, distorting markets, incentivizing and enabling government borrowing and contributing to economic imbalances. In this *Market View*, we explore the evolution of the Fed's balance sheet and offer alternative perspective on some of Warsh's views. We also judge the practicality and likelihood of major reforms to Fed balance sheet policy.

In summary, we view the scope for major further reductions to the Fed's balance sheet as limited under the current regulatory framework.

Chart 1: At \$6.6 trillion, the Fed does own a lot of assets...

Federal Reserve assets by major type



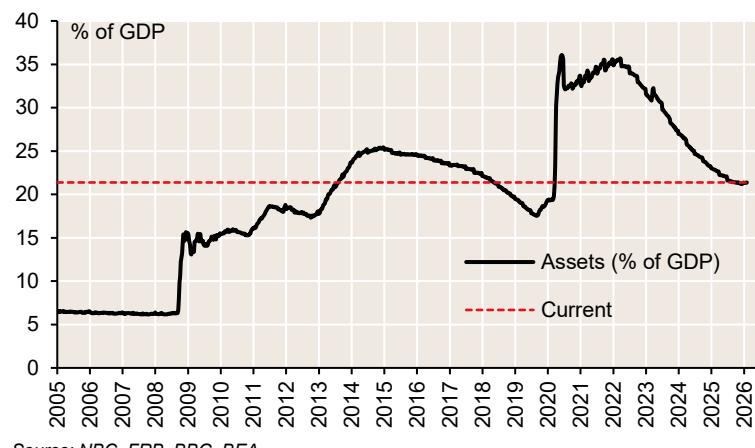
Source: NBC, FRB, BBG

There's no denying the Fed balance sheet is large at more than \$6.5 trillion but that's down from an even larger \$9 trillion after a material QT effort. While today's asset base is about 50% higher vs. pre-pandemic, the growth looks far less significant scaled to GDP. Compositionally, the decision to end QT last year didn't stop MBS roll-off. Even under status quo policy, MBS pullback will continue.

Financial market deregulation—reducing the demand for reserves and allowing banks to absorb the Fed's Treasuries—would create scope to lessen the FOMC's portfolio. Still, there are risks when the most stable and predictable buyer/holder of Treasuries is replaced by riskier entities. The likely result is higher term premiums and long-term borrowing costs. This can be partially mitigated by lower policy rates but pass through to the long end is limited. Any associated upward pressure on (mortgage) rates is unlikely to sit well with the President. There's also the practical constraint that balance sheet decisions, like rate decisions, are voted on. While there are FOMC participants sympathetic to his view, it's not clear there's appetite for wholly reforming balance sheet policy. More realistic near-term changes under Warsh could involve testing a slower purchase pace (to keep reserves ample) or focusing reinvestment buying on shorter-term debt. We don't expect the central bank to restart QT.

Chart 2: ...though it's much less striking scaled to GDP

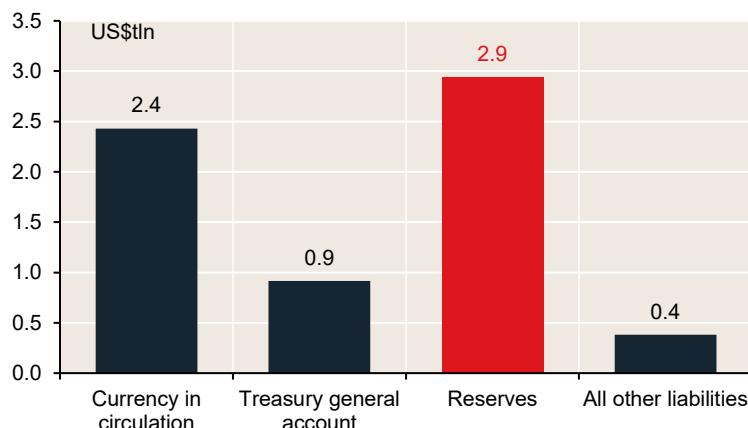
Federal Reserve assets as a share of GDP



Source: NBC, FRB, BBG, BEA

Chart 3: Fed assets are dictated by their liabilities...

Breakdown of Federal Reserve liabilities

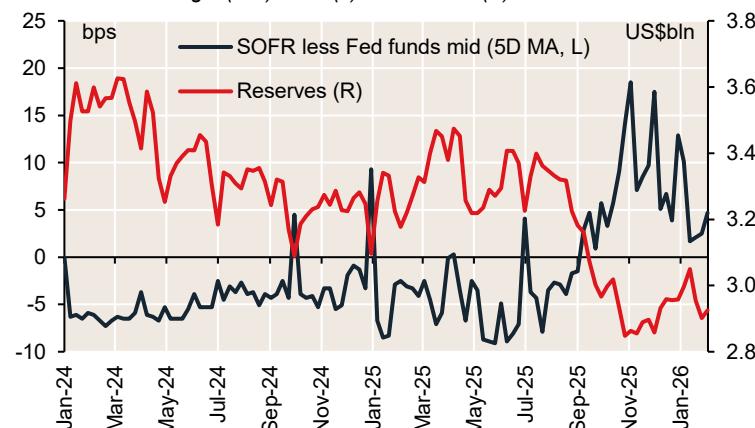


Source: NBC, FRB, BBG | Note: Data as of 11-Feb.

Ultimately, it's the Fed's liabilities that drive their assets. Currency demand grows with the economy and the TGA is dictated by the Treasury. Together, these necessitate a Fed balance sheet of at least \$3.3 tn. But it's reserves that were the guiding light for balance sheet policy in recent years. As those fell in 2025, repo market pressure accumulated (much like in 2019) prompting the Fed to stop QT. Without reducing the demand for reserves (chiefly, through regulation), scope for further asset run-off is limited unless the Fed becomes comfortable with greater volatility in funding markets.

Chart 4: ...and reserve shrinkage led to funding pressures

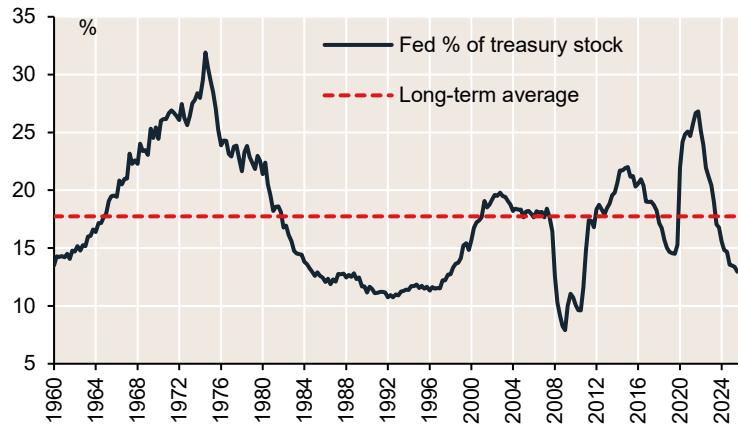
SOFR-fed funds target (mid) basis (L) vs. reserves (R)



Source: NBC, FRB, BBG

**Chart 5: Fed share of Treasury market not historically large...**

Share of Treasury market held by monetary authority (i.e., the Fed)

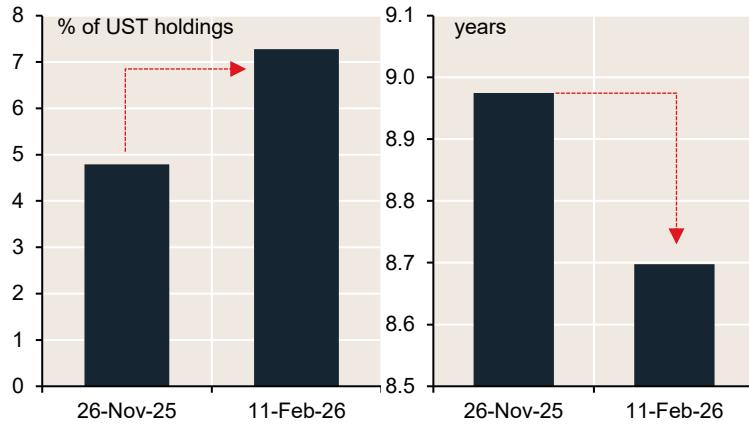


Source: NBC, BBG, FRB | Note: Latest data = Q3:2025

The Fed's Treasury portfolio has doubled from 2019, but their share of the market has shrunk (as outstandings increased even faster). Today, the Fed owns <15% of USTs, below the long-run average. However, they do disproportionately hold longer-term debt. Warsh/other balance sheet hawks have a legitimate gripe here as in theory, this disproportionately compresses long-term yields.

Chart 7-8: ...but that's started to change, albeit modestly

T-bill share of Fed UST holdings (L), WAT of Fed UST holdings (R)

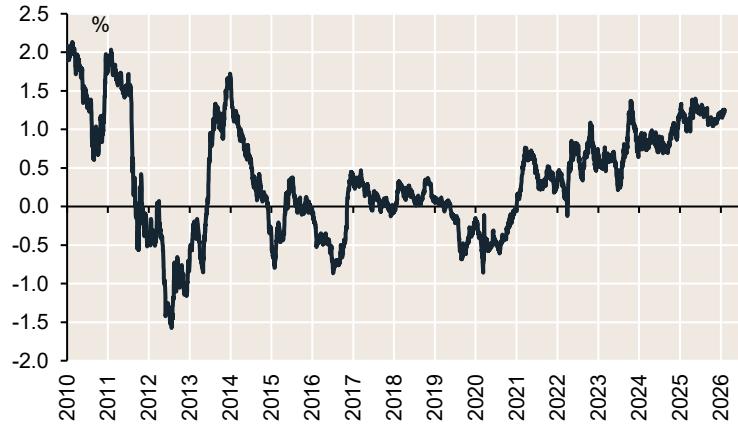


Source: NBC, NY Fed | Note: WAT = weighted average term

Since QT ended, outright UST buying has all been in T-bills, lowering the duration of the Fed's portfolio. While we don't think Warsh will shrink the balance sheet much more, this strategy could be used more (e.g., reinvest UST proceeds in shorter-term debt vs. proportionately on the curve). Moreover, *all* proceeds from the Fed's MBS portfolio are now being invested in bills. So, the FOMC is already reducing its market footprint, even if gradually. A more aggressive stance/abrupt change under Warsh risks pushing yields/mortgage rates higher... a potential issue for President Trump.

Chart 11: Term premia are already elevated

San Francisco Fed 10-year term premium

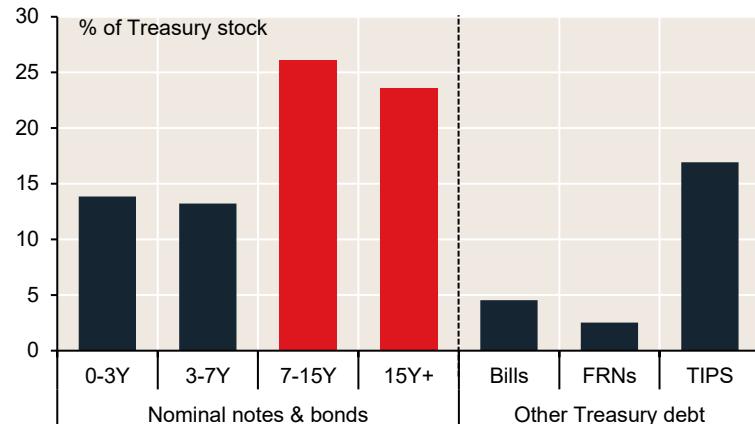


Source: NBC, BBG, SF Fed

Warsh's balance sheet stance leaves risks to long-term yields skewed higher, even if he's more willing to ease the policy rate. And even if regulatory reform adds bank capacity to hold USTs, losing the most stable buyer/holder could add to bond market volatility. Yields/term premia are already high vs. the post-GFC period, and we assume Trump's tolerance for rising borrowing costs is low. If yields jumped on balance sheet changes, political pressure/noise would likely follow, adding further risk to the term premia. We assume Warsh prefers to avoid the 'Powell treatment'. In the past, markets have been spooked by major perceived changes to balance sheet policy (see: the taper tantrum). If Warsh were to reform balance sheet policy, markets may push back hard, at least initially.

Chart 6: ...though their footprint is bigger out the curve...

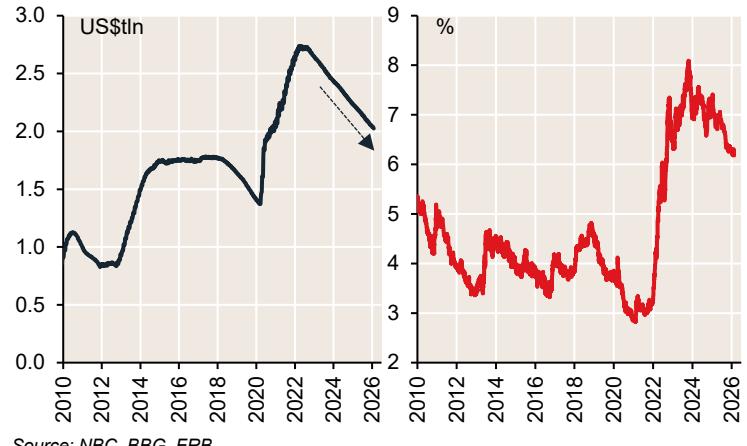
Share of Treasury market held by the Fed, by term to maturity and debt type



Source: NBC, BBG

Chart 9-10: The Fed's MBS portfolio will continue to shrink

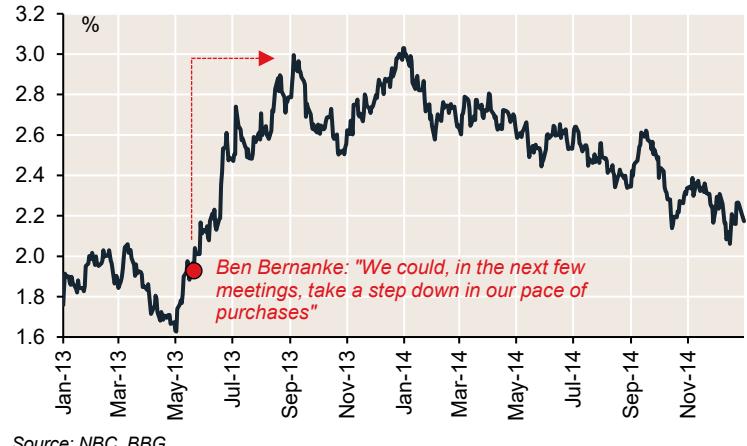
Fed MBS holdings (L) and average 30-year mortgage rate (R)



Source: NBC, BBG, FRB

Chart 12: History offers a warning of communication risk

10-year U.S. Treasury yield: 2013-14



Source: NBC, BBG



Economics and Strategy

Subscribe to our publications: NBC_EconomicsStrategy@nbc.ca

To contact us:

514-879-2529

Stéfane Marion

Chief Economist and Strategist
stefane.marion@nbc.ca

Matthieu Arseneau

Deputy Chief Economist
matthieu.arseneau@nbc.ca

Jocelyn Paquet

Senior Economist
jocelyn.paquet@nbc.ca

Kyle Dahms

Senior Economist
kyle.dahms@nbc.ca

Alexandra Ducharme

Senior Economist
alexandra.ducharme@nbc.ca

Daren King, CFA

Senior Economist
daren.king@nbc.ca

Warren Lovely

Chief Rates and Public Sector Strategist
warren.lovely@nbc.ca

Taylor Schleich

Rates Strategist
taylor.Schleich@nbc.ca

Ethan Currie

Strategist
ethan.currie@nbc.ca

Angelo Katsoras

Geopolitical Analyst
angelo.katsoras@nbc.ca

Nathalie Girard

Senior Coordinator
n.girard@nbc.ca

Giuseppe Saltarelli

Desktop Publisher
giuseppe.saltarelli@nbc.ca

General: This Report was prepared by National Bank Financial, Inc. (NBF), (a Canadian investment dealer, member of CIRO), an indirect wholly owned subsidiary of National Bank of Canada. National Bank of Canada is a public company listed on the Toronto Stock Exchange.

The particulars contained herein were obtained from sources which we believe to be reliable but are not guaranteed by us and may be incomplete and may be subject to change without notice. The information is current as of the date of this document. Neither the author nor NBF assumes any obligation to update the information or advise on further developments relating to the topics or securities discussed. The opinions expressed are based upon the author(s) analysis and interpretation of these particulars and are not to be construed as a solicitation or offer to buy or sell the securities mentioned herein, and nothing in this Report constitutes a representation that any investment strategy or recommendation contained herein is suitable or appropriate to a recipient's individual circumstances. In all cases, investors should conduct their own investigation and analysis of such information before taking or omitting to take any action in relation to securities or markets that are analyzed in this Report. The Report alone is not intended to form the basis for an investment decision, or to replace any due diligence or analytical work required by you in making an investment decision.

This Report is for distribution only under such circumstances as may be permitted by applicable law. This Report is not directed at you if NBF or any affiliate distributing this Report is prohibited or restricted by any legislation or regulation in any jurisdiction from making it available to you. You should satisfy yourself before reading it that NBF is permitted to provide this Report to you under relevant legislation and regulations.

National Bank of Canada Financial Markets is a trade name used by National Bank Financial and National Bank of Canada Financial Inc.

Canadian Residents: NBF or its affiliates may engage in any trading strategies described herein for their own account or on a discretionary basis on behalf of certain clients and as market conditions change, may amend or change investment strategy including full and complete divestment. The trading interests of NBF and its affiliates may also be contrary to any opinions expressed in this Report.

NBF or its affiliates often act as financial advisor, agent or underwriter for certain issuers mentioned herein and may receive remuneration for its services. As well NBF and its affiliates and/or their officers, directors, representatives, associates, may have a position in the securities mentioned herein and may make purchases and/or sales of these securities from time to time in the open market or otherwise. NBF and its affiliates may make a market in securities mentioned in this Report. This Report may not be independent of the proprietary interests of NBF and its affiliates.

This Report is not considered a research product under Canadian law and regulation, and consequently is not governed by Canadian rules applicable to the publication and distribution of Research Reports, including relevant restrictions or disclosures required to be included in research Reports.

UK Residents: This Report is a marketing document. This Report has not been prepared in accordance with EU legal requirements designed to promote the independence of investment research and it is not subject to any prohibition on dealing ahead of the dissemination of investment research. In respect of the distribution of this Report to UK residents, NBF has approved the contents (including, where necessary, for the purposes of Section 21(1) of the Financial Services and Markets Act 2000). This Report is for information purposes only and does not constitute a personal recommendation, or investment, legal or tax advice. NBF and/or its parent and/or any companies within or affiliates of the National Bank of Canada group and/or any of their directors, officers and employees may have or may have had interests or long or short positions in, and may at any time make purchases and/or sales as principal or agent, or may act or may have acted as market maker in the relevant investments or related investments discussed in this Report, or may act or have acted as investment and/or commercial banker with respect hereto. The value of investments, and the income derived from them, can go down as well as up and you may not get back the amount invested. Past performance is not a guide to future performance. If an investment is denominated in a foreign currency, rates of exchange may have an adverse effect on the value of the investment. Investments which are illiquid may be difficult to sell or realise; it may also be difficult to obtain reliable information about their value or the extent of the risks to which they are exposed. Certain transactions, including those involving futures, swaps, and other derivatives, give rise to substantial risk and are not suitable for all investors. The investments contained in this Report are not available to retail customers and this Report is not for distribution to retail clients (within the meaning of the rules of the Financial Conduct Authority). Persons who are retail clients should not act or rely upon the information in this Report. This Report does not constitute or form part of any offer for sale or subscription or solicitation of any offer to buy or subscribe for the securities described herein nor shall it or any part of it form the basis of or be relied on in connection with any contract or commitment whatsoever.

This information is only for distribution to Eligible Counterparties and Professional Clients in the United Kingdom within the meaning of the rules of the Financial Conduct Authority. NBF is authorised and regulated by the Financial Conduct Authority and has its registered office at 70 St. Mary Axe, London, EC3A 8BE.

NBF is not authorised by the Prudential Regulation Authority and the Financial Conduct Authority to accept deposits in the United Kingdom.

EU Residents: With respect to the distribution of this report in the member states of the European Union ("EU") and the European Economic Area ("EEA") by NBC Paris, the contents of this report are for information purposes only and do not constitute investment advice, investment research, financial analysis or other forms of general recommendation relating to transactions in financial instruments within the meaning of Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 ("MiFID 2"). This report is intended only for professional investors and eligible counterparties within the meaning of MiFID 2 and its contents have not been reviewed or approved by any EU/EEA authority. NBC Paris is an investment firm authorised by the French Prudential Control and Resolution Authority ("ACPR") to provide investment services in France and has passported its investment services throughout the EU/EEA under the freedom to provide services and has its registered office at 8 avenue Percier, 75008 Paris, France. "NBC Financial Markets, a subsidiary of National Bank of Canada" is a trade name used by NBC Paris S.A.

NBF is not authorised to provide investment services in the EU/EEA.

U.S. Residents: With respect to the distribution of this report in the United States of America, National Bank of Canada Financial Inc. ("NBCFI") which is regulated by the Financial Industry Regulatory Authority (FINRA) and a member of the Securities Investor Protection Corporation (SIPC), an affiliate of NBF, accepts responsibility for its contents, subject to any terms set out above. To make further inquiry related to this report, or to effect any transaction, United States residents should contact their NBCFI registered representative.

This report is not a research report and is intended for Major U.S. Institutional Investors only. This report is not subject to U.S. independence and disclosure standards applicable to research reports.

HK Residents: With respect to the distribution of this report in Hong Kong by NBC Financial Markets Asia Limited ("NBCFMA") which is licensed by the Securities and Futures Commission ("SFC") to conduct Type 1 (dealing in securities) and Type 3 (leveraged foreign exchange trading) regulated activities, the contents of this report are solely for informational purposes. It has not been approved by, reviewed by, verified by or filed with any regulator in Hong Kong. Nothing herein is a recommendation, advice, offer or solicitation to buy or sell a product or service, nor an official confirmation of any transaction. None of the products issuers, NBCFMA or its affiliates or other persons or entities named herein are obliged to notify you of changes to any information and none of the foregoing assume any loss suffered by you in reliance of such information.

The content of this report may contain information about investment products which are not authorized by SFC for offering to the public in Hong Kong and such information will only be available to, those persons who are Professional Investors (as defined in the Securities and Futures Ordinance of Hong Kong ("SFO")). If you are in any doubt as to your status you should consult a financial adviser or contact us. This material is not meant to be marketing materials and is not intended for public distribution. Please note that neither this material nor the product referred to is authorized for sale by SFC. Please refer to product prospectus for full details.

There may be conflicts of interest relating to NBCFMA or its affiliates' businesses. These activities and interests include potential multiple advisory, transactional and financial and other interests in securities and instruments that may be purchased or sold by NBCFMA or its affiliates, or in other investment vehicles which are managed by NBCFMA or its affiliates that may purchase or sell such securities and instruments.

No other entity within the National Bank of Canada group, including National Bank of Canada and National Bank Financial Inc, is licensed or registered with the SFC. Accordingly, such entities and their employees are not permitted and do not intend to: (i) carry on a business in any regulated activity in Hong Kong; (ii) hold themselves out as carrying on a business in any regulated activity in Hong Kong; or (iii) actively market their services to the Hong Kong public.

Copyright: This Report may not be reproduced in whole or in part, or further distributed or published or referred to in any manner whatsoever, nor may the information, opinions or conclusions contained in it be referred to without in each case the prior express written consent of NBF.