**Lethame Capital Management**

Technology : Research : Investing

# Is the Fed "Stimulating Into a Bubble"?

- **The Fed is freezing balance-sheet runoff on December 1 and reinvesting maturing agency Mortgage-Backed Securities into Treasury bills. That shifts duration shorter and stabilises reserves; In our opinion it is not the same thing as reopening the monetary floodgates.**
- **Governor Christopher Waller's July speech is the best guide to understanding the modern Fed balance sheet: it's big three liabilities (currency, the Treasury General Account, and bank reserves) mean the balance sheet will structurally remain well above pre-GFC norms.**
- **Ray Dalio's view[1] is that the Fed may be "stimulating into a bubble." Perhaps in asset-pricing terms that risk exists, but conflating QE with credit creation misses the accounting: QE swaps assets; deficits create net financial assets; private bank lending creates private debt.**

## Start with the T-accounts

Neoclassical economics treats "money" as neutral and banks as mere intermediaries. By contrast viewed through the lens of Double-entry bookkeeping a very different story is revealed:

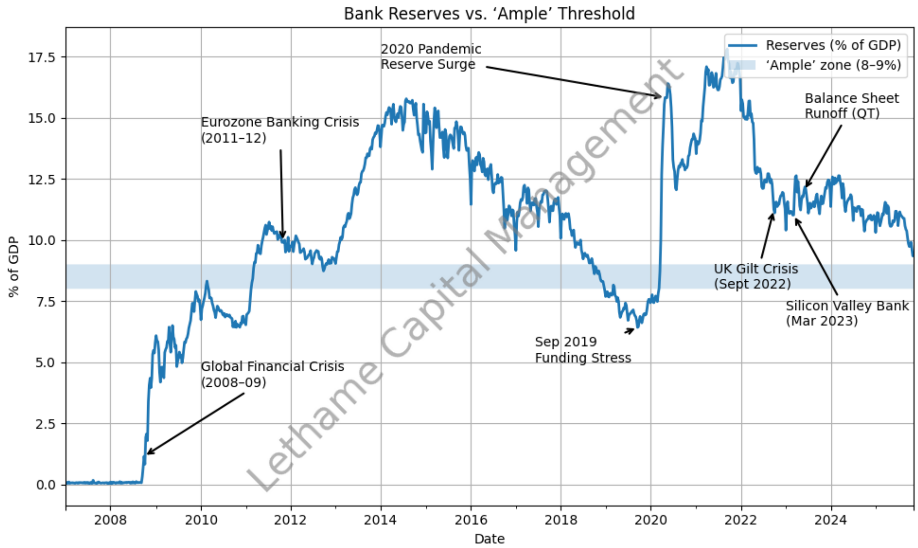
- **Private bank lending** creates a new **loan (asset)** and a **deposit (liability)** simultaneously. The borrower's balance sheet expands with new private debt; the private sector's net financial assets **do not** change.
- **Government deficits** create a **Treasury liability** (a reserve balance or security) and a **private-sector asset**. The private sector's net financial assets **DO** rise by the size of the deficit.
- **Quantitative Easing (Q.E.)** is a **portfolio swap**: the Fed buys a security from the private sector and pays with reserves. The private sector's aggregate net financial assets are unchanged.

If it isn't considered in these terms, it's easy to confuse "more reserves" with "more debt" or to conclude that the Fed is now in "stimulus mode".

## Waller's road map: why the Fed's balance sheet won't go "back to 2007"

In an excellent speech in July[2], Governor Christopher Waller stepped through in great detail why the size of the Fed's balance sheet is today ~20%+ of GDP rather than the ~6% level that was considered "normal" pre-GFC. Waller highlights that there are **three big liabilities** that dominate the Fed's balance sheet: (i) **currency in circulation**, (ii) the **Treasury General Account** (The Treasury's bank account at the Fed), and (iii) **bank reserves**. The amount of Currency and the size of the Treasury General Account are driven largely by public demand for notes and coins and cash-management by the US Treasury (tax receipts in, expenditure out) — and is therefore not a decision of the Fed. Reserves, on the other hand, are the instruments the Fed uses under the "**ample-reserves"** regime described by Waller. Together the make-up of these three components means the Fed's balance sheet will now and in the future be at a structurally larger level than before 2008.

Specifically in the speech Waller defines the "**ample threshold**" as the minimum level of reserve balances required for the U.S. banking system to function smoothly without strains in money markets. Drawing on the 2019 repo-market episode—when reserves fell below 8 percent of nominal GDP and funding pressures abruptly surfaced—Waller argues that reserves must remain comfortably above this level to avoid destabilizing competition for liquidity. Because banks' demand for high-quality liquid assets has risen significantly since the Global Financial Crisis, he places the practical threshold nearer 9 percent of GDP. Below this point, stresses predictably emerge; above it, money-market rates remain well-behaved, and the Federal Reserve can operate its floor system without daily interventions. Crucially, this threshold applies to **reserves**, not the total balance-sheet size, meaning the Fed adjusts the balance sheet as needed to keep reserves from drifting beneath the ample zone.




Waller's key point is that in its **"ample-reserves"** framework, paying interest on reserves and holding short-maturity Treasuries against them can make the system more stable **without** adding net assets to the private sector. The Fed passes through Treasury interest to banks while keeping payment plumbing smooth. The point being the  composition (duration) of the Fed's assets matters as much as size.

## What the Fed actually announced

At it's October 29 meeting the Fed[3]:

- **Cut the policy rate by 25 bps** (to a 3.75%–4.00% target range).
- **Decided to end balance-sheet runoff** on December 1**.**
- Announced that it would **keep its agency Mortgage Backed Security portfolio in run off**, but **reinvest the proceeds into Treasury bills[4]**, nudging the overall portfolio toward Treasuries and a shorter weighted-average maturity.

Powell also explained[5] that with a frozen balance sheet, **non-reserve liabilities (like currency) will keep growing**, so **reserves will continue drifting lower** as a proportion for a while; but later, it will be necessary for the Fed to **add reserves gradually** to keep them "ample" relative to the banking system's size, as outlined by Waller. Translating this with a double-entry accounting lens: the Fed is changing the **mix and term** of assets it holds against its liabilities—not adding new private-sector net financial assets. It's a **plumbing and duration** operation.

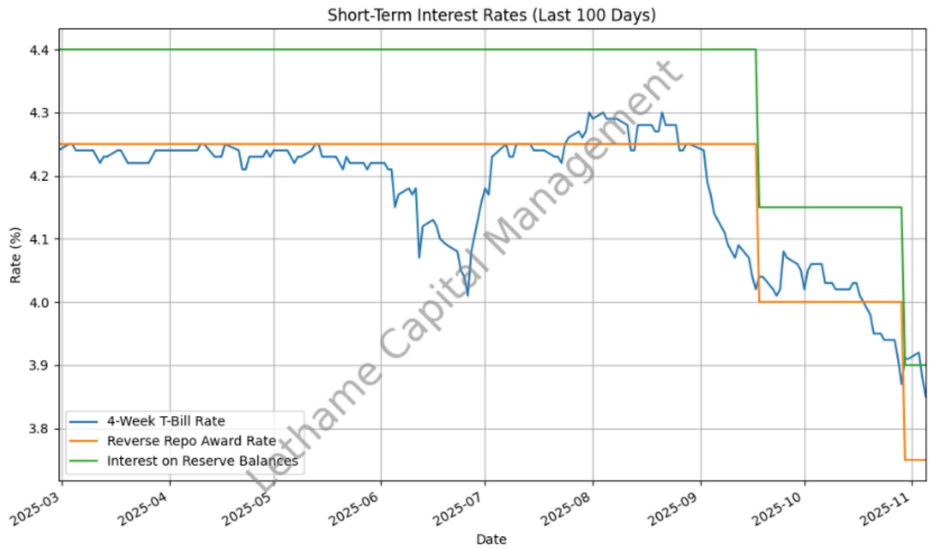
## "Stimulating into a bubble"? Respectfully: that's not how the accounting works

Ray Dalio argues the Fed may be "Stimulating into a Bubble". With the greatest respect Dalio's track record and market instincts, and it is clear market pricing of risk assets is certainly frothy. But in relation to the nature of money, his claim blurs categories:

- **QE vs. credit**: QE **replaces** a bond on a money dealer's balance sheet with reserve's (and now, via reinvestment, with T-bills). The result is a change in **liquidity and duration**, not the creation of new private credit. Banks don't suddenly find more capital or risk appetite because their **settlement asset** changed form.
- **Public vs. private debt**: Government deficits increase private-sector Net Financial Assets; **private** lending increases **private** debt and is cash-flow constrained. Lumping both types of "debt" together misses that the state is an issuer of the net financial assets to the system, while the money that banks issuer is *matched* by private liabilities – Net Financial Assets are unchanged.
- It is certainly true that Asset prices can rise when duration is shortened and term premia fall; but that's a **portfolio-rebalancing** channel. It Is very different from claiming the Fed is **restarting credit growth**. If equities are bubbly—we don't believe it can necessarily be blamed on "Government money printing."

## What actually changes for markets now

- **Duration drain:** Reinvesting MBS into T-bills shifts the Fed's balance sheet closer to the front end of the yield curve, marginally pressuring **term premia** lower and improving **collateral** availability in T-bills. It has been evident that as bank reserves as a percent of GDP have approached the threshold the market appears to be increasingly willing to pay a premium for T-bills, the market exhibits stress, illustrating its sometimes-irrational demand for "pristine collateral" (see: "Short-Term Interest Rates (last 100 days)"). The "duration drain" can support risk assets at the margin, but the move is more consistent with Waller's desire to match shorter liabilities with shorter assets.




- **Reserves path:** Even with the balance sheet "frozen," reserves will **initially drift down** as currency grows; ultimately, the Fed may **add reserves** to keep them ample. That is a **technical add**, not a macro bazooka.
- **Income distribution:** QE/QT tweaks **who** earns interest (banks on reserves vs. investors on Treasuries) and the **maturity** they hold. It does **not** change private-sector net financial assets the way fiscal deficits do. Waller explicitly frames reserves as a pass-through of Treasury interest when the Fed holds bills against them.

## Conclusion (from a double-entry realist)

If the objective is to avoid repeating the 2019 funding squeeze, the decision to stop QT **when money-market tensions appear** and to shorten duration is sensible plumbing. But if the objective is to "cool a bubble in asset market" then **the lever is in our opinion about fiscal policy and macroprudential policies**, not the Fed's portfolio mix. The **driver of private balance-sheet expansion** is **private credit plus fiscal transfers**; QE mostly shuffles duration and term premia.

There may be a bubble. But describing this step as "stimulating" it obscures the crucial accounting difference between **state money** and **bank credit**. To manage bubbles, **focus on prudential tools and fiscal settings**, not on mislabelling a reinvestment tweak as "money printing."

## References

[1] **Dalio, Ray. 2025.** *"Stimulating Into a Bubble."* https://www.linkedin.com/
[2] **Waller, Christopher J. 2025.** *"Demystifying the Federal Reserve's Balance Sheet."* https://www.federalreserve.gov
[3] **Reuters. 2025.** *"Federal Reserve to End Quantitative Tightening on December 1."* News report, https://www.reuters.com
[3] **Federal Reserve Bank of New York. 2025.** *"Operating Policy: Reinvestment of Treasury and Agency Principal Payments."* https://newyorkfed.org
[5] **Powell, Jerome H. 2025.** *Press Conference Transcript, October 29, 2025.* Board of Governors of the Federal Reserve System. https://www.federalreserve.gov