OCTOBER 24, 2025

WEEKLY ECONOMIC COMMENTARY

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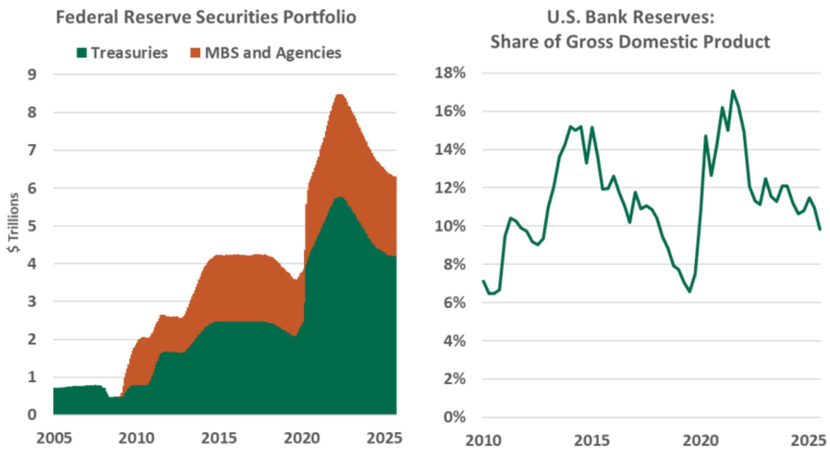
We were gripped by last week's news of an old-fashioned heist at the Louvre. Despite world-class security, thieves dressed as museum workers made off with eight priceless historical artifacts. Detectives are searching frantically to determine where the goods have gone.

A different sort of disappearing act has played out in plain sight for the past three years. Over $2.2 trillion dollars have gone missing from the Federal Reserve's balance sheet. Though the rundown has been quiet, it was no heist: the pace was well communicated. Now, an end is in sight, with the Fed's balance sheet approaching a steady state.

Central bank purchases of securities in a crisis, or quantitative easing (QE), are still a relatively new tactic. They were first widely deployed in the Global Financial Crisis, then again in the pandemic. The first recourse in a crisis is to cut interest rates, but when rates hit zero, asset purchases offer an alternative form of support. When investors are reeling, the purchases can be a powerful intervention to backstop fixed income markets. QE maintains liquidity and encourages investors to stay in the markets for riskier assets.



Sources: Federal Reserve, Bureau of Economic Analysis, Haver Analytics

Crises eventually subside, and then the central bank is left holding a large quantity of assets. Once conditions are stable, they begin depleting those assets through quantitative tightening (QT). Under QT, when a bond held by the central bank reaches maturity, its principal is not reinvested. The balance sheet entry is deleted, and the total portfolio value declines. Money is not physically destroyed, but the overall liquidity in the financial system is reduced.

Whereas the emergency intervention of QE is stimulative, the impact of QT is hard to observe. Amid a crisis, policymakers may err on the side of doing too much, creating more liquidity than the system needs. While those excess funds are evaporating, financial conditions show little change. And thus, two trillion dollars can disappear without consequence.

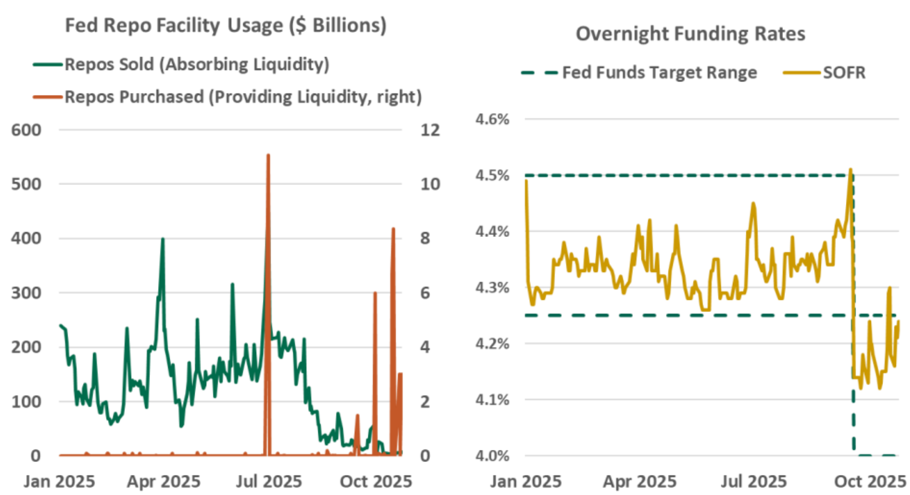
Last week, Fed Chair Jerome Powell gave a speech on the balance sheet. While not offering a specific plan for ending QT, the content of the speech made it clear that the Board is working on an approach to be announced soon. Powell recapped the pandemic-era QE and did not back down from addressing its critics. Perhaps QE could have ended sooner, but the Fed did not want to spark volatility in a vulnerable economy. Perhaps the Fed did not need to purchase over $1.3 trillion of mortgage-backed securities (MBS), but those were allowable assets to acquire as the Fed sought to keep financial conditions easy.

Powell's key takeaway from the pandemic QE and QT was that the Fed "can be more nimble in our use of the balance sheet." Bond markets are now familiar with this tool and can adapt quickly to the Fed's strategies.

The Fed has remained cautious about the timing and announcements of its QT decisions: first, when to start as to not upset markets, and later, when to cease runoff. The Fed has only one prior interval to QT to study, and that episode went too far. On September 17, 2019, as GFC-era assets were in gradual runoff, interbank lending reached an unexpected shortfall. The Secured Overnight Funding Rate (SOFR), reflecting market pricing for overnight lending, spiked by nearly three percentage points. The Fed rapidly switched from QT to QE, and SOFR calmed.

To prevent recurrence, the Fed launched the standing repurchase facility (SRF) to allow quick borrowing. If funding markets are tight and overnight rates are rising, the SRF allows banks to pledge their U.S. Treasury assets to borrow directly from the Fed, at the top end of the Fed Funds target range.

Asset purchases allow the Fed to support markets when interest rates can't go any lower.



Sources: Federal Reserve, Haver Analytics

The timing of Powell's speech was driven by daily market observations. Strain is evident, suggesting the time is right to stop draining liquidity.

The Fed's overnight reverse repurchase (ONRRP) facility was a pandemic workhorse. As savings rose, excess cash flowed into money market funds, who could earn a safe return placing these monies with the Fed each day. ONRRP utilization thus provided a ready measure of excess liquidity, exceeding $2.3 trillion in September 2022. Now, the ONRRP is holding near zero.

Draws on the SRF have increased, suggesting some overnight funding gaps have emerged. Similarly, banks can draw upon the Fed's discount window to borrow directly; its usage has come back to life from zero in recent weeks.

These shifts are not signs of stress; shortfalls have been minor, and relief systems are working as intended. However, we can be certain the era of excess liquidity has ended. Fed speakers have characterized the pandemic-stimulated economy as one of "abundant reserves," with bank reserves elevated beyond their natural level. The Fed is targeting an environment of "ample reserves." The boundary between "abundant" and "ample" has never been defined. However, the 2019 shock is illustrative. Bank reserves as a share of nominal gross domestic product had trended down from 15% to a low of 6.5% when markets seized. The Fed is unlikely to go that low again. The decline to roughly below 10% today is likely consistent with "ample" reserves.

Reserves in the U.S. banking system have gone from abundant to ample.

And while he left this point unstated, Chair Powell may view the balance sheet as the last piece of unfinished business from the pandemic crisis, to be resolved before his term ends next May. Leaving the balance sheet in a steady state will make it more difficult for any successor to change its use, until another crisis opens this path again.

In an upcoming meeting, we expect the Federal Open Market Committee to announce a new strategy that will set a steady state for the balance sheet. And with that, the years-long case of the missing trillions will close.

Credit Canary?

People of my generation were expected to have a basic familiarity with automobile maintenance. At my peak, I was able to change spark plugs, filters, headlights, hoses and batteries.

Many of those components came from the Autolight line, which later became part of the First Brands Group. First Brands filed for bankruptcy late last month, training investor headlights on the credit markets.

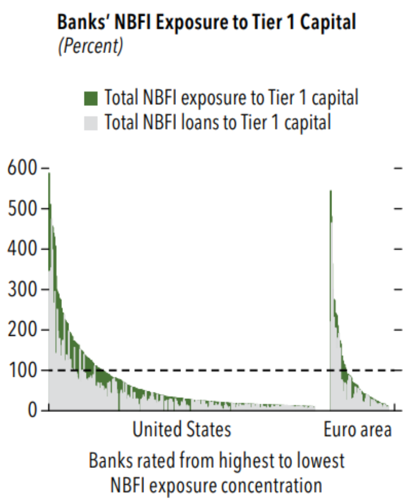
Rumors surrounding the company had been swirling for months. As a private firm, First Brands was not subject to the same kind of reporting standards that public firms are. An auditor had certified its financial statements last spring, but apparently had not understood the layers of debt the company had taken on. At the end, there was a $2 billion hole in the firm's balance sheet.

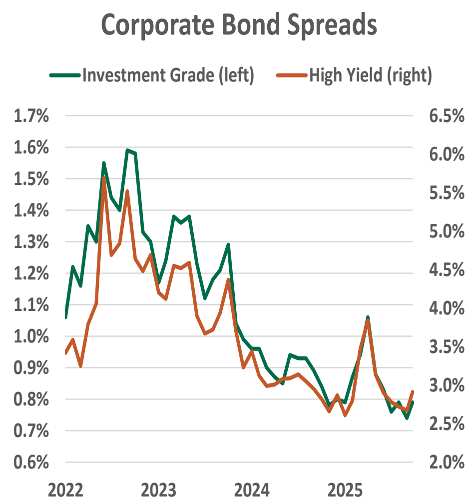
First Brands had tapped a wide range of financing sources. Its long-term borrowing has been packaged into securities that were sold to investors in the form of collateralized loan obligations (CLOs). It made liberal use of leveraged loans, secured by cash flows. The company used its accounts receivable as security for short-term cash needs. In the spring, it received a loan from a private credit fund.

This diversity of debt is not at all unusual for private firms, but sustaining it relies on investors' confidence in a company's finances. While analysts have highlighted the idiosyncratic nature of the fall of First Brands, some investors have interpreted the event more broadly. Redemptions from funds containing the instruments employed by the company have accelerated in recent weeks.

We highlighted the issues surrounding private credit last year. The sector has grown rapidly over the past decade, thanks to attractive returns. Concerns center on light levels of regulation and reporting, which make it difficult to fully appreciate the risks involved. As often happens, questions are muted until adversity strikes. When it does, it provokes a powerful behavioral reaction, and contagion can ensue.

Credit extended directly by investors to corporations typically comes from funds or pools which are very well capitalized, and reasonably remote from the banking system. But in its October Financial Stability Report, the International Monetary Fund found that some banks have substantial exposure to non-bank financial institutions (NBFIs). It was these linkages that proved especially pernicious during the 2008 financial crisis, and which have been a focus of systemic concern ever since.





Sources: IMF, Bloomberg

Concerns about private credit have resurfaced.

Global equity markets have surged this year, in spite of moderate economic growth and an accumulating series of risks. This has led some to worry that valuations have been stretched a little too far. The same can be said of credit markets, which have seen spreads fall to levels last seen in 2007. Credit spreads provide compensation for underlying risks; the First Brands debacle suggests that these may be underappreciated.

Losses related to First Brands have been widely felt. For now, contagion appears to be limited. But the system could certainly be tested again. JP Morgan Chase recently took a $170 million charge when a privately-held auto lender failed; the bank's Chairman, Jamie Dimon, suggested that other problems might lie ahead. "When you see one cockroach there are probably more," he observed. Bank earnings and call reports are under elevated scrutiny; at this time, loan defaults remain limited, not a hidden infestation.

Today, attempts to perform car maintenance are deterred by a cover that is fitted over the engine of many vehicles. The opacity of the lining makes it difficult to know what is going on under the hood. A similar sort of uncertainty is spreading through credit markets, and fixes may be difficult to apply.

Trading On Uncertainty

Last week, the International Monetary Fund (IMF) issued an updated World Economic Outlook. In it, the IMF edged up its global growth forecast for 2025, suggesting that U.S. tariffs haven't turned out to be as damaging as the Fund anticipated in April. Yet the IMF was unequivocal in its warning: trade policy uncertainty and fragmentation have become the defining risks to the global economic landscape.

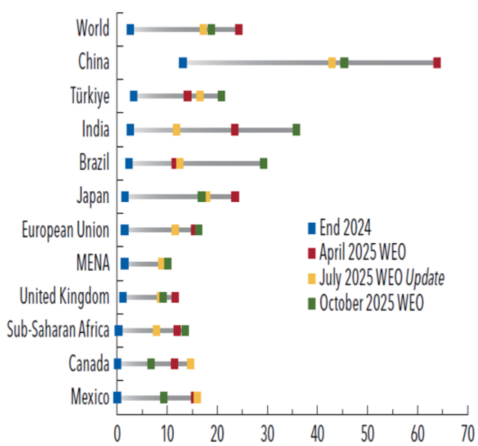
What distinguishes the current episode from previous rounds of protectionism is its breadth and unpredictability. While 2018-19 trade policy measures were focused on China, this year's shift has seen broader-based tariff hikes affecting a much wider array of America's commercial partners.

This has been accompanied by a notable escalation in policy uncertainty, marking a fundamental shift from a truly global trading system to one that is a patchwork of bilateral deals and ad hoc arrangements.

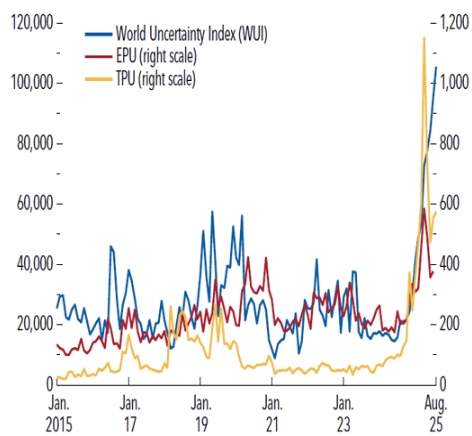
These developments are not only weighing on investment and consumption, but are also casting a shadow over longer term growth prospects. Fragmented supply chains and slower sharing of technology will make it harder for economies to become more productive. The net result will be a drag on global growth that is both immediate and cumulative. Even as some tariffs have moderated, the IMF's projections are for global growth to remain below pre-policy-shift forecasts.

Trade is the overarching theme shaping global growth prospects.

U.S. Effective Tariff Rate By Country (%)



Overall, Economic Policy, and Trade Policy Uncertainty Index



Source: IMF WEO October 2025

While the IMF acknowledged the progress emerging markets have made in strengthening their policy frameworks and bolstering resilience to external shocks, trade fragmentation is seen as a significant threat for these nations. For economies that rely on global integration as a pathway to prosperity, the breakdown of open trade is a structural roadblock. Without a reversal of this trend, the prospect of income convergence with advanced economies risks slipping further out of reach.

Without bold steps to reduce trade policy uncertainty and push back against growing disintegration, the global economy could find itself stuck in a rut marked by sluggish growth, frequent bouts of volatility and fewer opportunities for shared prosperity. The world cannot afford to let uncertainty become the status quo.

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