

# DIVIDENDCAFE | PODCAST TRANSCRIPTION

FRIDAY, AUGUST 21, 2025

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Hello and welcome to this week's Dividend Cafe. I'm your host, David Bahnsen. I'm the Chief Investment Officer at The Bahnsen Group, which means. I often get to be the one to talk about the really fun things in life with our clients, with our listeners, readers, followers, by fun things. Of course, I'm referring to the subject of today's Dividend Cafe, which is gonna be the balance sheet of The Fed Reserve, the Central Bank of the United States.

I'm gonna refer to the activities around their balance sheet, known as quantitative easing and quantitative tightening. And if it sounds like it's gonna be a lot of fun, it's 'cause it is. Now, this is being recorded before J Powell has spoken in Jackson Hole, Wyoming I don't know exactly what time you're listening to this, but on Friday morning, August the 22nd, J Powell's talking in Jackson Hole and there is a very good possibility that some of the things he'll address will impact expectations for what The Fed is gonna be doing.

As I'm sitting here right now the fact of the matter is that expectations are still pretty strong that The Fed will cut rates a quarter point in September, but I should be clear that that expectation had been near a hundred percent just a little over a week ago. And as I'm sitting here right now, the actual Fed funds futures market is pricing in an implied 71% probability of a rate cut.

Which would mean a 29% probability of no move at all. Why is the, why have those odds come down so much? Largely from last late last week, the hot PPI number, the producer price index, that showed big price growth and certain market actors saying this may give. Chairman Powell, the cover to not have to cut rates yet.

And you say, why does he need cover to not cut rates? Well, you know, you could argue he needed cover before to cut rates because he didn't wanna look like he was capitulating the president. There are arguments people can make on all sides of it. I

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am happy to recap what I believe about it all but I think that the point being most market actors are gonna look to Jackson Hole.

For some hint as to what the Fed's gonna do with rates in September and what The Fed is gonna do with rates by the end of the year, and there still remains a extremely strong probability of half a point of rate cuts between on the end of the year and a decent probability of three quarters of a point.

This is not the topic of today's Dividend Cafe. It is the topic that I imagine will dominate media headlines for the weekend outta Jackson Hole, and it will dominate perhaps a lot of financial media in September as The Fed does meet, and very likely, but not certainly, although I think it's quite probable cut rates.

For the first time since December , January. And so all this discussion about rate cuts, has been the big Fed story, will stay the big Fed story yet. Today's Dividend Cafe, I want to talk. About this issue of the Fed's balance sheet. What I mean by that is The Fed has assets, liabilities on a balance sheet, primarily assets of things they have bought as a means of affecting monetary policy.

They decide that they want to stimulate with various tools and they've used their balance sheet to become a tool. Now, I say stimulate. They could also decide they want to un stimulate or de stimulate what we call Titan and go the other way. Use the balance sheet to demotivate credit growth or economic activity.

There's all kinds of reasons that they would want to do one or the other. And the history of this is very important, but we're gonna put a chart up right now that I think is very important to remember the olden days, and by olden days, I remained way back till like 2008, 2007, and for years and years before that, where up and down movement of The Fed Balance sheet was not a monetary policy tool.

That in fact what The Fed did was at the time of the financial crisis, lowered interest rates to 0%, decided more support to financial markets was needed, and then found this process of quantitative easing whereby they buy bonds onto their balance sheet from banks. The banks, of course, could be an intermediary from

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other pensions or insurance companies, private actors, or it could be off their own balance sheet.

But either way. They were creating liquidity in financial markets by becoming a buyer freeing up cash in the system. The Fed was crediting cash to banks and receiving these treasury bonds or mortgage bonds. A bit of history on this is, first of all fascinating and unless you're some kind of a nerd but for most of us cool kids, we find this stuff very interesting.

What we would, in hindsight have called QE one, it was not called that at the time, that began in November of 2008 with about \$600 billion of quantitative easing activity was mortgage backed securities. The Fed found total illiquidity for the mortgage market and the immediate aftermath of the financial crisis, so became a buyer.

What were essentially aaa credit, money, good quality debt instruments, but in the purpose of trying to create some financial stability and liquidity and affect smoother financial operations became a buyer. And we ended up calling it quantitative easing. They were doing this with money that didn't exist, so they were crediting money to banks.

And then receiving these bonds, and it was to help make a market for mortgage bonds, but then also affect basically excess bank reserves. The money was not circulating into the economy but it became a tool for The Fed, but at the time, not a stimulus tool as much as financial markets, liquidity and just general efficiency of operations in our financial system that were really quite broken.

Well, no one really thought of it as a stimulus tool, a monetary policy tool. They thought of it as housekeeping at a time where there was a lot of other housekeeping going on too. A lot of things happening with Citigroup, a lot of things happening in the aftermath of tarp. And we were still catching our bearings after the September of 2008 activity, but then in March of oh nine, they then announced one and a quarter trillion dollar bond buying.

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At this point, there was still a significant freeze in markets, financial markets. We were not out of the woods. We were not thawed, but they were now buying treasury bonds where there had not been any freeze up of liquidity. There was not some massive inefficiency of operation. It was clearly a bonus tool of monetary policy.

Again at the zero bound in interest rates, this became a way to try to additionally stimulate when you couldn't go any lower with the interest rate. So you can use any of these priority any of these kind of objectives you want as far as the order of importance? I debate what I think. I wasn't in the FOMC meeting and I don't know in their mind what was most important, but they were absolutely trying to impact rates at the long end of the curve with quantitative easing.

They were definitely trying to add to excess bank reserves to help re reliquify the banking system and trying to bring stability to mortgage markets by the use of purchasing mortgage backed securities as well. Now, this is all well and good people can agree with it or disagree with it. I'm not sure we would ever have talked about it again, if that was the end of quantitative easing.

It was aggressive. It was somewhat mini bazooka like with that, you know, additional batch of QE in March. But then all the way to the end of 2010, and as I'm talking it was 15 years ago today, right at this Jackson Hole, Wyoming moment, the Ben Bernanke came out to announce a QE two. Now, what was going on at the end of 2010, mortgage markets had unfrozen financial markets.

Liquidity was fine. The stock market had bottomed a year and a half earlier. The problem by August of 2010 that resulted in a second round, it was \$600 billion of QE two by the end of 2010. The problem was that the economy was bad. Unemployment had stayed above 10% and they were viewing at this point qe, not merely as a financial markets tool to provide liquidity and smoothness of operations.

They were doing it as a stimulative tool to a macro economy that was flawed. This now becomes Japan bazooka like whereby Japan had used bond buying as a

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monetary policy tool for a long time, and done so aggressively, not merely for financial market purposes, but to avoid recessionary deflation now.

You could argue that Bernanke was onto something in the fact that unemployment was still at 10% two years after the recession had begun. You could also argue that what he was doing was no way to go about treating that. But I would still maintain, and I by the way, am holding back on purpose. There's a lot of opinions that are reasonable about QE one and QE two, in my opinion.

The reason I'm not gonna get into that is because QE three made it all obsolete because really there is a large difference between the rationales for QE one and QE two, and then QE three. And QE three was the real bazooka announced another two years later into 2012 that would last another over two years going all the way into the end of 2014, six years after the financial crisis had ended.

At this point, why were they doing it? First of all, you have to understand they were not looking at Japanese monetary policy saying, boy, we gotta learn from those lessons, learn from their mistakes. They were looking at it saying, we should look at what they've done as a model. They believed that it proved.

The good idea here, not disproved it. And in fairness, inflation after QE one and QE two was very low. It was about 1.5%, and that gave The Fed a lot of latitude with its critics who had wrongly prophesied big hyperinflation coming out of QE. The economy was slowly growing. Double dip recession had been avoided.

But. There was not robust growth, and at this point Bernanke felt like it was risk-free monetary stimulus to embark on a hyper aggressive third round of QE that was open-ended. And used a mix of treasury bonds and mortgage backed securities to affect it at one point and I remember this quite well, he had stated, we're gonna keep the QE going till we see unemployment.

Get down to 6.5%. And then that became sort of a joke 'cause it was a moving target. They kept it going even after it got to six point half percent. But risk assets, loved it. The stock market was up 32% in 2013, and any talk of ending QE three would really cause stock and bond markets to revolt, but The Fed would keep it

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going for another two years, adding to the balance sheet all the way, as I said to the end of 2014.

So, I wanna be clear this, the Bank of Japan's level is not the same as ours. They were much more aggressive. The Bank of Japan owned well over half of their bond market. Our Fed never got anywhere near those levels, but the model being. That you are not gonna create inflation because there's not enough credit growth coming from it.

You're not trying to get the banks to take this cash and lend it all out. And in fact, you're paying them interest on the reserve so that they will have incentive to keep the reserves there. But what you're doing is facilitating financial market activity, leaving excess reserves in the system and allowing more fluidity into market and kind of a controlled.

Stimulative policy tool is the way they viewed it. Now, the question that was never answered was, well, how do we ever undo it? Now, someone did ask the question, someone actually said, and I wanna look at my notes the word for word quote from this individual. Lemme see if I have it here. I don't, I, the person, I'll just get to the chase here, cut to the chase.

It was Jerome Powell, who was a Fed governor at the time. Obviously not the chairman, who was worried about the quote, risks and costs of a third round of qe. The risk and costs being, what is gonna happen when we have to undo it. And this is an important. Conversation point for us even now. So all I would say is that 2015 and 2016 are sort of anomalies in post financial crisis era because they're the only two years since 2008 that there was nothing happening at The Fed Balance sheet in 2015 and 16.

They had stopped qe, but they did not go to qt quantitative tightening. They were not reducing the size of their balance sheet. They had just stopped increasing it. So there was neither tightening nor easing going on where basically every year since 2008, you've seen the fed's balance sheet either going down or going up.

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Except for those two years, they left it still. And then chairwoman Janet Yellen in 2017 began a very, very modest reduction of The Fed balance sheet, a kind of miniature quantitative tightening. And then when her term ended and President Trump appointed Jay Powell, the new chair of The Fed, he began a little bit more aggressive tightening.

Still not by selling bonds. Quantitative easing is buying bonds, but quantitative tightening is not selling bonds. It is merely letting bonds mature and not reinvesting all the proceeds. So the portion of the proceeds from bonds that mature, that you don't reinvest now that effectively is reducing their balance sheet.

It's removing a little bit of liquidity from the financial system and getting some of those assets off of the fed's balance sheet. So, all that to say in 2018, we had a little bit of our first reckoning. They had raised rates. They were trying to do quantitative tightening and it worked a little.

It worked a little as they turned the knobs up, then credit markets revolted and there was significant contraction of economic activity, but especially the ability to clear in credit markets rate spreads, blew. And famously or infamously in early 2019, J Powell called it off and reversed, and he took a lot of criticism for that, including from yours, truly.

But what he did though was reveal, no, we're not getting a free pass here of reducing this balance sheet or undoing the extreme policy tools of the financial crisis. We're still at this point now over a decade removed from crisis. We're kind of stuck with some of this, but then we went into COVID a year later.

And that's where everything changed in terms of this idea that, okay, we had done these emergency things in financial crisis and we'd like to figure out how we can undo 'em someday. But the patient doesn't seem quite ready. We had hoped to remove the training wheels from the bike.

It didn't go well. We're gonna keep that going a bit. And then all of a sudden they just flat out said, no, nevermind we're going to use quantitative easing for till Kingdom come. And they very quickly added about \$5 trillion to the balance sheet.



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And there was no controversy, there was no discussion, there was no pushback that the central bank viewed an expansion of the balance sheet as a really safe, fair policy tool.

Was without debate. And I think a lot of people might be critical that they continued it as long as they did. It started in March of 2020 and they were still doing quantitative easing till May of 2022, which is just bizarre. But regardless, that was the policy position that they felt that, hey.

QE one through three came without a lot of side effects. Now you could say, well, did it because in 2018 you weren't able to undo any of it. It doesn't seem like it came without cost and risks. Chairman Powell, but that was the decision they made, and then all of a sudden. In the spring of 2022, they began raising rates aggressively and did begin quantitative tightening.

And now there's another chart we'll put up that's the same chart as before, but in instead of just showing the flat period pre-crisis, so the balance sheet, now you see that The Fed did substantially reduce their balance sheet very close to about two and a half trillion dollars. And that's what's taken place over the last three years.

And they didn't do it. They did, by the way the first year or so of that was in concert with aggressive rate hikes, but nothing like 2018 happened. Credit markets did not freeze up. Levered loan defaults, high yield bond defaults did not skyrocket. Credit spreads did not blow out. So why did those things go better this last time than in 2018?

19? I think that there are a number of different theories out there. I'm open to, I don't have a firm answer myself or I should put it this way. Others may say they have a firm answer, but I recommend enough humility to say that there's a number of possible and plausible explanations. Quantitative tightening this time was very well telegraphed, so it didn't create the same shock and awe in the markets.

Expectations had been set very differently. Financial market liquidity was far stronger. A lot of borrowers had already taken advantage of very low rates in 2020 and 2021, so there was a very different liquidity profile impacting the tightening.



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This time there were a different liquidity profile that served as a backdrop for the tightening.

Corporate balance sheets were more liquified. And I also believe too, that markets, unlike in 2018, knew that if things did get hairy, The Fed was going to reverse. See, in 20 18, 20 19 hadn't happened yet, but in 20 23, 24, 20 19 had already happened, meaning in a weird, paradoxical way. I am open to the belief that some of the bad effects didn't happen.

Because markets already knew that if bad effects did happen, The Fed would undo it. Where before the uncertainty of what The Fed would do was creating some of that dynamic. I think all of these things make a bit of sense, but what I wanna do is just kind of now having walked through the post-crisis history of the Fed's balance sheet, what they've done and why and where we are, and what the challenges are is tell you what I think it means for the here and now.

Because I don't think quantitative e easing or quantitative tightening are gonna be discussed a lot outta Jackson Hole. Maybe I'm wrong, but I do believe they're gonna be discussed a lot for financial markets, for investors, and for kind of policy purposes into the remainder of the year, but most certainly into next year for a number of reasons.

First of all, and I'm not gonna get real into the weeds on it, but. The reverse repo facility for Fed open market operations had about two and a half trillion dollars at its peak in 2022, it's basically down to zero. Now, that's fine. We don't need a balance in the reverse repo facility, but what I mean by it is.

Quantitative tightening now really pulls money out of the financial system. It has far more of a tightening impact than when the reverse repo facility was on the other side. So in other words, there's more teeth in tightening now that impacts the liquidity dynamics substantially. Number two, I put two charts up so far.

It showed what the Fed's balance sheet has been and what it went to and showed you that the Fed's balance sheet, even with this two to two and a half trillion of reduction is still way higher than it was pre COVID. But if you look at the chart up

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now, the balance sheet as a percentage of GDP, I think that's the rationale that they're going to use.

It's, first of all. There is some prima facie acceptability to thinking of it in terms of balance sheet relative to GDP. It's not a totally pretextual concoction. There's some rationality to it. We were about 18% of GDP with the Fed's balance sheet. Pre COV. At the lowest level and then now it, it went up to 36% of GDP and it's now back down to 21.

So I, even though the nominal dollars have not reduced that much, they've more or less gotten it as a percentage of GDP very close to where it was pre COVID. And I think that provides them a lot of cover for the way we're gonna talk about the balance sheet going forward, having a perpetual balance sheet with trillions of dollars.

I also believe they have the ability to now continue tightening with mortgage backed securities, but easing with treasuries to get to a neutral spot. So the balance sheet is no longer going down, but also not going up, but they are doing easing with treasuries, providing more liquidity into funding treasuries and effectively aiding in the funding of government deficits while still tightening on the mortgage side where they don't believe they need any stimulus in the housing, and doing so at a net net neutral position. Now that may seem a little wonky what I just said, so reread the paragraph in Dividend Cafe dot com if you need.

But I think it's a very important observation that they have the ability to mix and match what they're doing and it not be totally incoherent from their policy objectives. Now, number four. I do not believe we can say, well, there was no hangover at all to quantitative tightening the last three years.

So that risk and cost concern of quantitative tightening and what we're doing with the balance sheet is off the table. There is still no historical precedent at all of any country on earth using a federal, excuse me, a central bank's balance sheet as a policy tool and then undoing it and saying, okay, look, it worked.

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It's not to say somebody won't, I don't think they will, but it's to say we don't know. The hyper experimental nature of this has still left us without clarity as to what it looks like to undo a balance sheet as monetary policy. Number five. Markets would respond more favorably, in my opinion, to some form of quasi QE or just stopping QT than another quarter point rate cut.

In other words, The Fed has the ability to add to monetary policy stimulus with the balance sheet side right now, in a way no one's talking about, and when they do do it, no one will understand even more so than rate cuts. So my own guess is if, if. Risk assets. We're trying to pick between the cessation of quantitative tightening and a half a point of eight cuts or continuing quantitative tightening and three quarters of point or eight cuts, or a whole point.

I don't think there's any question. Then this brings me to my final point that I think is most important is that the real dynamic in monetary policy right now, up and down the size of balance sheet, is not about the size of balance sheet that credit growth is not. Either contracted or stimulated with quantitative easing or tightening, but that the way in which The Fed has had to pay interest on reserves to banks has become the primary policy tool.

And until that rate is significantly lower, there's still a lot of incentive for banks to effectively hold money at The Fed on deposit as opposed to lending it out. And you would need at least a hundred basis points of cuts, if not 150 to 200 to change that dynamic. Now, I'm not predicting that's gonna happen anytime soon, but I am predicting that it's going to happen.

And the reason is that when things tighten, that policy tool will have more punch. Then the immediate Fed funds rate and the immediate use of quantitative easing. And central bankers have very good memories of what these types of stimulus effects do. I have a very good memory. How those things have played out.

And I think that when you go from one intervention, Fed funds rate, aggressive cuts to another intervention, quantitative easing, and these things start to get a diminishing return in your policy objectives, you have to move to a new policy

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tool. And I believe that trying to reduce the interest paid on bank reserves will be the tool that they want to use to try to really drive credit growth.

Will it work right now playing around the edges? Probably not. Because first of all, private credit's picking up a lot of the slack of what? Banks are not lending, and I'm not convinced that there is significant loan demand necessary to pick up that element. But merely increasing or decreasing size of balance sheet is far less, much less efficacious, is much less efficacious than it used to be.

And so what I do believe is not changed is the way central bankers think. What I suspect has changed is the tools by which they will use to affect their thinking. Thank you for listening to Dividend Cafe. Thank you for watching. Thank you for reading and please reach out with any questions you have.

Look forward to the end of summer wrapping up kids back in school, college football starting, but really welcome your questions. And I hope this has been interesting, informative, and yes, even mildly entertaining. Thanks again for being a part of the Dividend Cafe.