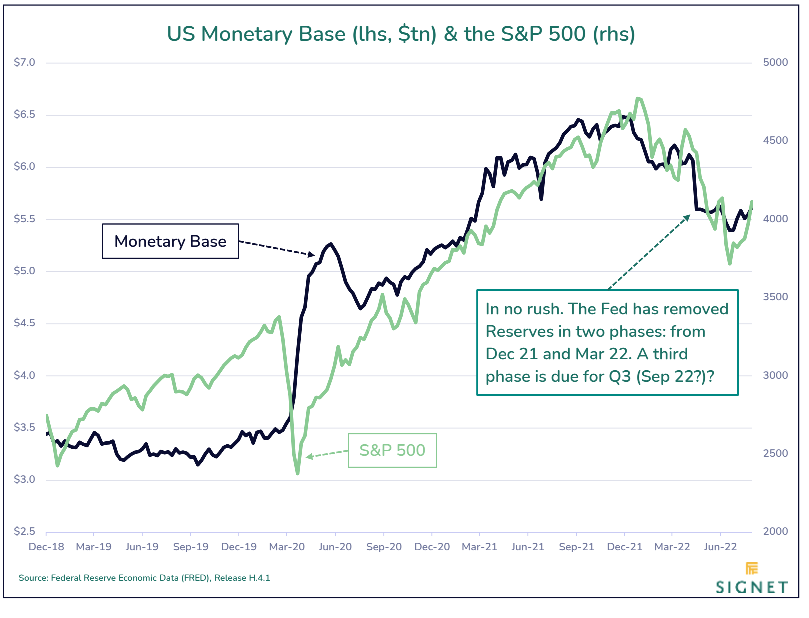
Beneath the Surface

Snap Comment – 15 August 2022

SIGNET

Buy the Dip or Bear Market Rally? The Fed's Liquidity Channel

- Central bankers and the Federal Reserve (Fed) are under pressure to bring inflation down, in accordance with their formal mandates. This is driving the expectations for interest rates, growth (recession), liquidity and asset prices. While the spotlight is firmly on the Fed's interest rate policy and the size of its balance sheet, it is also important to monitor the detail that exists beneath the surface, on the 'liability' side of the Fed's balance sheet. It is the *composition* of their liabilities that matter, not the absolute dollar amount on the balance sheet.
- Our primary concern remains further downside pressure on risky asset prices - this pressure is being driven by the draining of USD liquidity. US monetary policy has evolved over the last 14 years and the changes have repercussions for the global economy: the Eurodollar system, collateral and liquidity. US monetary policy is currently focused on the interplay between interest rates, fiscal policy and – critically – the liquidity channel. The liquidity channel is the key mechanism through which Reserve Balances are effective.
- The chart below identifies the US Monetary Base against the S&P 500. The Monetary Base comprises currency in circulation (largely predictable) and Reserve Balances. Reserve Balances are down by $700bn YTD. This is base liquidity – the commercial banks use these balances to collateralise / multiply their deposits. This $700bn has been largely absorbed by the Reverse Repo facility and the Treasury General Account, which reduces collateral from the system. It represents the draining of liquidity and aggregate demand.
- The Fed seems to be engineering this in phases. The first phase was initiated from Dec 21 and the second phase from Mar 22. The Fed relaxed the tightening process in Feb 22 and Jun 22 – and risky assets rallied shortly thereafter. Reserve Balances have increased by $224bn over the last six weeks and the S&P 500 has rallied. The chart captures this process quite well. More overtly, the Fed indicated it would urgently undertake up to $47.5bn per month of quantitative tightening (QT) from June, although we have only seen an average of $20bn per month so far.



- So what? If this liquidity is a fundamental factor driving asset prices, then we need to remain cautious. The recent speculative rally does not support the Fed's mission of bringing inflation expectations back down. The Fed is due, and likely, to continue its phased draining of Reserve Balances. We might expect to see more in Q3 – before the end of September. To compound this, the QT programme will be accelerated up to $95bn a month from 01 Sep 22 (doubling the ceiling).
- Bear market rallies are testing events and the equity market has front-run a Fed pivot. This rally in risky assets may roll over with any further draining of liquidity. To exacerbate this, economic and corporate fundamentals have deteriorated recently, and we are entering the seasonally volatile period.

Therefore:

- Remain defensively positioned. The rally may tempt investors – but there may be more weakness ahead.
- The Risk-Return trade off looks unattractive here – but opportunities may appear in the Autumn.
- Investments: Prioritise liquidity and quality. For corporate securities, target resilient growth and profit margins.
- Treasuries and other high quality liquid assets will continue to signal that inflation expectations are turning down.