

US Macroeconomics

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Excess Liquidity Continues to Paper Over Problems

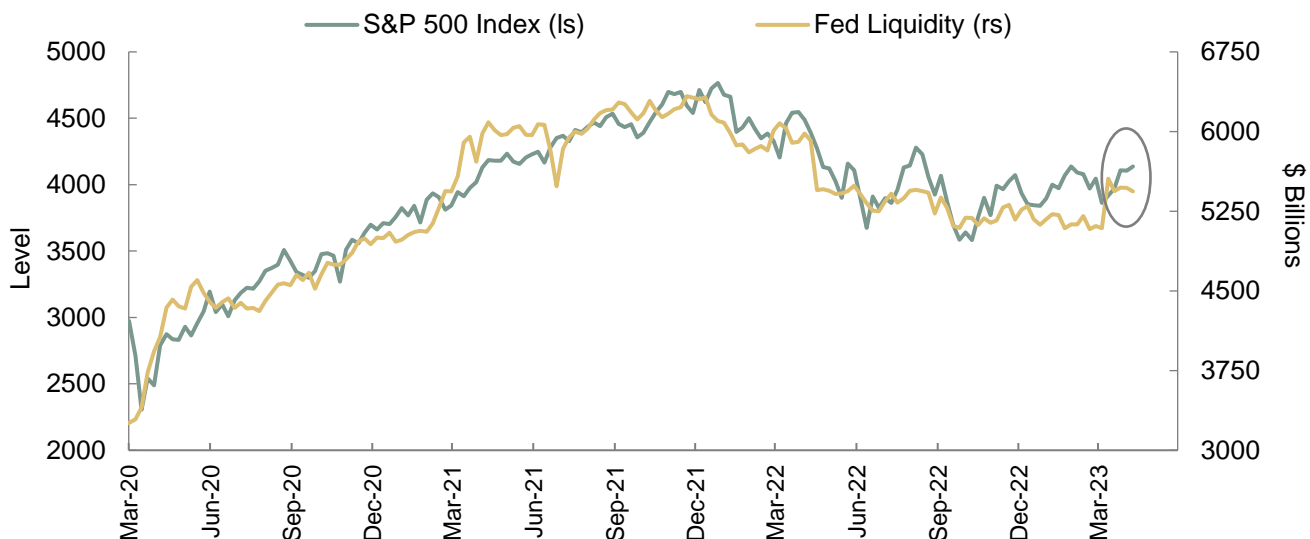
We have defined liquidity as the Fed's securities holdings (treasuries and mortgages) less the Treasury General Account (TGA) less the reverse repo facility (RRP). Securities holdings are assets on the Fed's balance sheet while the Treasury balance and the RRP are liabilities on the Fed's balance sheet. **When the Fed's assets rise relative to its liabilities, bank reserves (liquidity) are created.** This tends to have a powerful effect on financial asset prices, in particular stocks, which trend with the growth in the Fed's balance sheet. Ongoing developments in the commercial banking system have added a new twist to the provisioning of liquidity.

To stem deposit flight which has been exacerbated by quantitative tightening (QT), the Fed has extended copious amount of liquidity to the financial system via its discount window. While this liquidity has not necessarily gone directly into the stock market, it has alleviated concerns about systemic financial risks. In the process, this has given a huge lift to financial assets especially stocks.

Fed liquidity and stock prices have moved nearly one-for-one since March 2020. When the Fed began raising rates and reinstated QT last year, stock prices went sharply lower. But **over the last six weeks the Fed has lent out a massive \$356 billion to commercial banks, which offset almost 70% of the QT that had been done.** Monetary policy actions rather than macro data per se will dictate how financial markets perform for foreseeable future.

Since Treasury securities will continue to mature, if the Fed does not maintain this newly created liquidity, the negative effects of QT on the financial markets will reemerge. Interestingly, this would reassert pressure on commercial banks because (again) QT drains bank reserves from the financial system. Furthermore, **if the Fed keeps rates "higher for longer" this will also aggravate deposit flight** all else being equal because investors will continue to seek higher yields outside of the banking sector.

For now, Fed liquidity provisioning has soothed the financial markets. Risk assets (stocks) have gone higher, and measures of volatility (MOVE, VIX) have gone lower. There is relative calm. However, this is not a long-term sustainable situation.



Sources: Federal Reserve, Haver, SMBC Nikko

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