US Macroeconomics

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Excess Liquidity Can Paper Over Problems

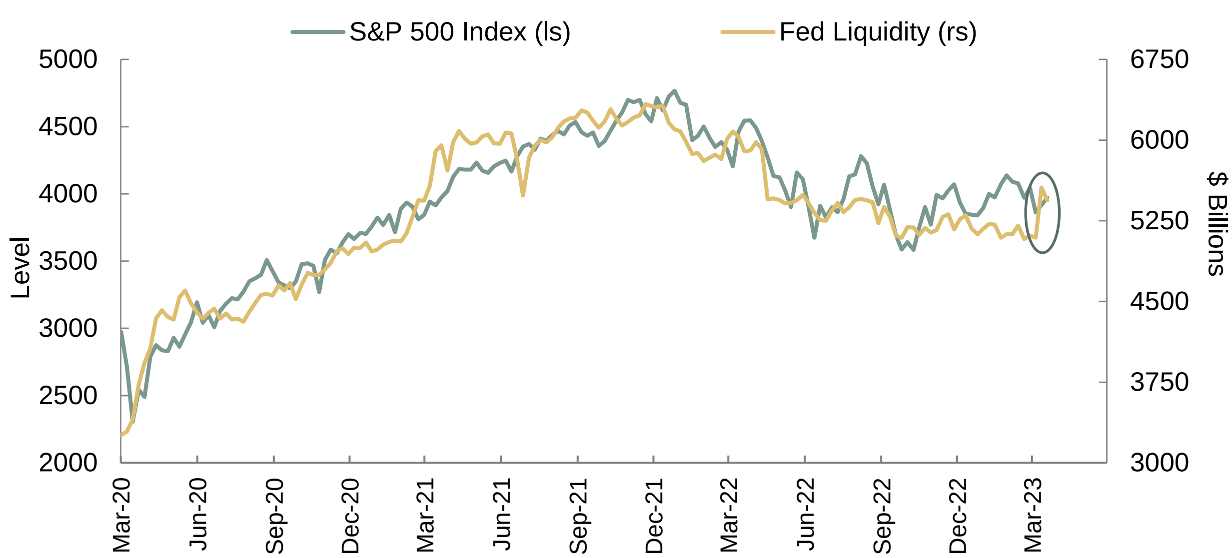
We have defined liquidity as the Fed's securities holdings (treasuries and mortgages) less the Treasury General Account (TGA) less the reverse repo facility (RRP). Securities holdings are assets on the Fed's balance sheet while the Treasury balance and the RRP are liabilities on the Fed's balance sheet. **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. Recent 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 reinstituted QT last year, stock prices went sharply lower. But **over the last three weeks the Fed has lent out a massive $382 billion to commercial banks, which offset almost 70% of the QT that had been done**. What the Fed does next will dictate how financial markets perform for the remainder of the year.

Since Treasury securities will continue to mature, if the Fed does not continue to make new loans, the negative effects of QT on liquidity will reemerge. Ironically, this will put further pressure on commercial banks because (again) QT drains bank reserves from the financial system. Furthermore, **if the Fed imprudently raises rates again as some recent Fed-speak has warned, this will also aggravate deposit flight**. Investors will continue to seek higher yields outside of the banking sector. What a bind!

For now, the Fed's latest actions have soothed the financial markets. Risk assets (stocks) have gone higher, and measures of volatility have gone lower. There is relative calm. However, we are not sure this is sustainable unless the Fed pivots toward an easier monetary stance. Stay tuned.



Sources: Federal Reserve, Haver, SMBC Nikko

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