US Macroeconomics

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So Goes Liquidity, So Goes The Stock Market

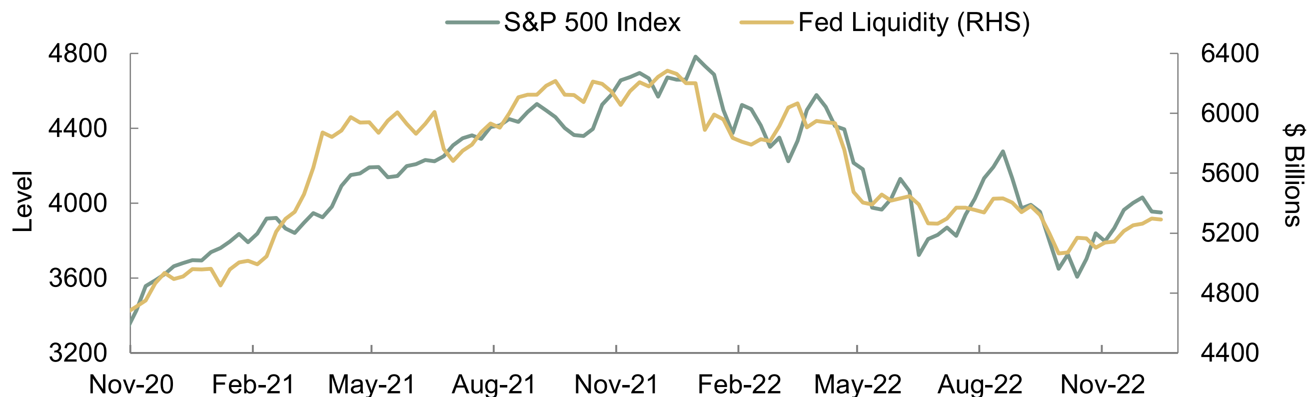
The Fed has aggressively raised rates this year, and the stock market is down sharply. But **it may be the underlying amount of liquidity sloshing around in the financial system that matters most**. Indeed, we believe that liquidity will be the key determinant to the economic and financial outlook. With effects of quantitative tightening (QT) likely to be meaningfully felt next year, we are negative on the economy and risk assets. It must be noted that Fed actions are the dominant driver of market liquidity.

Monetary policymakers have raised rates 425 basis points in the past nine months, the fastest pace in four decades. During this time, the broad stock market has fallen about 20%. But as we can see in the chart below, **the movement in liquidity has tracked the movement in stock prices nearly one for one**. Indeed, the weekly correlation coefficient is a remarkably high 0.93.

Liquidity is defined as the level of the Fed's securities holdings (governments and mortgages) less the Treasury General Account balance (TGA) less the amount of assets in the Fed's reverse repo facility (RRP). While all three subcomponents can move in different directions, it is the aggregate amount of liquidity that counts. Individually, when the Fed's securities holdings rise, it adds liquidity by increasing bank reserves. The same dynamic occurs when either the RRP or the TGA go down. The opposite is true when securities holding fall and/or the RRP and TGA increase.

Since peaking at $6.3 trillion for the week ending December 8, 2021, the level of overall liquidity has declined to $5.3 trillion as of the week ending December 14, 2022. Interestingly, the decline in liquidity over the past 52 weeks has not been due to QT because the Fed was adding to its balance as recently as April. And there has been relatively little roll-off since then. Rather, it has been the RRP that has drained most of the liquidity from the system. Over the past year, the RRP is up $0.8 trillion while the TGA has increased $0.2 trillion. Unless the Treasury issues more bills, the RRP will remain elevated. Additionally, the Treasury announced its intention to lift its general account balance. Liquidity will fall further. But it is QT that is most concerning.

As the pace of treasury runoff is set to continue through 2023, **more liquidity will be drained from the financial system**. Recent history suggests this is negative for stock prices. Thus, investors hoping for a pivot in interest rates should also hope for pivot in QT. Stay tuned.



Sources: FRB, Haver, SMBC

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