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Liquid Insight

Liquidity drain isn't as bad as it looks

06 July 2023

Rates and Currencies Research
Global

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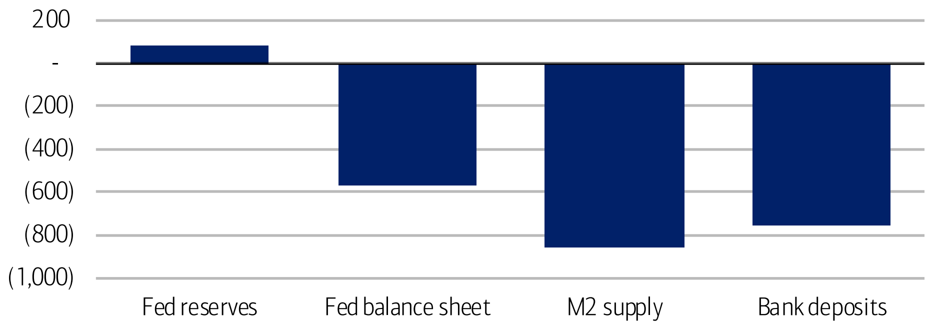
Key takeaways

- We disagree with consensus that the ongoing liquidity drain is uniformly negative for the macro outlook.
- The Fed balance sheet contraction moves households out of low yielding bank deposits and into higher yielding USTs and MBS.
- This generates more interest income, preserves net wealth, and implies the Fed may need to rely more on rate policy to slow.

By Ralph Axel

Chart of the day: Traditional measures of liquidity have declined over the past year ($bn)
The ongoing liquidity drain we think may offer more positives than negatives



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Resilience is the new buzzword

The big surprise this year is the ongoing strength of the economy and equity markets despite the most aggressive Fed tightening cycle since 1980 and the fastest pace of liquidity drain ever seen in the US. Resilience is the new buzzword, including resilience to higher interest rates and resilience to quantitative tightening (QT) and liquidity drain more generally. In Liquid Insight: Higher rates aren't all bad March 2023, we argued that higher interest rates do not hurt everyone, and in fact help many. Higher interest rates hurt borrowers, but they help savers, and the net impact depends on the offsetting impacts to each group. Today's savers in money market funds or T-bills earn about 5% per year, the highest rate in more than two decades and well above the 3-month annualized inflation rate. As rates rise on the $17tn of bank deposits outstanding, households will be getting more income from their banks – a cost borne by equity holders. But what about the liquidity drain, are there any benefits there, or is it all negative? Surprisingly, we would argue there are benefits to liquidity drain, and in this note we discuss how it can help households and why the decline in M2 money supply may not be as bad as it looks.

Liquid Insight
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What is liquidity?

To clarify some terminology, we define core liquidity as the level of bank reserves, which is a cash asset held in the banking system and a Fed liability. Reserves are one of several government liabilities that can generally be considered as "government money". We can also define broad Fed liquidity as the total size of the Fed balance sheet including its other main liabilities (Fed money types): overnight Fed repo (RRP) which is money held by money market funds, currency in circulation which is money held in pockets, and deposits held at the Fed by Treasury, government-sponsored entities and international organizations (money held by Treasury and other officials).

Another important measure of liquidity is the M2 money supply which includes currency, checking accounts at banks, small-denomination savings accounts at banks, and retail money market funds. The Chart of the Day shows most liquidity metrics have declined. Reserves have remained relatively stable due to increased Fed lending this year, decreased Treasury cash holdings, and decreased RRP usage.

A simple way to think of these various liquidity metrics is 1) Fed balance sheet and 2) bank deposits. The reason why investors focus on these liquidity metrics is that they are associated with the supply of spendable money, and therefore associated with overall spending power in the economy. But we think this thinking is flawed and results in unjustified fear around the ongoing liquidity drain – both in the Fed balance sheet and M2.

How is liquidity draining?

Quantitative tightening – the planned and orderly decline in the size of the Fed's balance sheet – is achieved by the Fed letting its Treasury and Agency security holdings mature without replacement from its asset holdings. The Fed holds $7.7tn in securities today versus $8.5tn a year ago. As the securities roll off, the stock of Treasuries and Agencies once held by the Fed becomes publicly held securities, and the Fed's reserve liabilities decline in lockstep. This mechanically reduces bank deposits because the household sector must use some form of money to buy the securities which the Fed effectively sells. If households use their deposits to buy Treasuries, then deposits and reserves will fall. If they instead spend their RRP holdings, then RRP holdings will fall. If the public uses paper currency to buy the securities, then currency would fall.

Liquidity drain is not actually draining household assets

The key observation here is that the public spends one form of government liability to buy another. It is an asset swap. As a result, the liquidity drain does not actually reduce financial assets of the public, it only changes the composition of financial assets held by the public. As the Fed contracts its balance sheet, reserves and RRP holdings go down and Treasury and Agency liability holdings go up.

Liquidity drain boosts household interest income

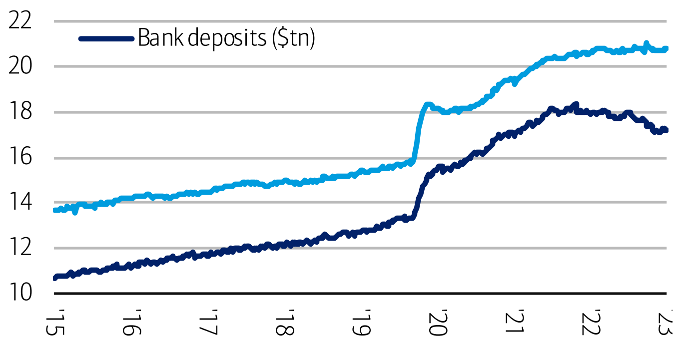
What is the impact of this? Because bank deposit rates are so much lower than security yields, it means that the public's financial wealth generates more income via the higher interest rates on securities. RRP is an exception here: to the extent the public spends RRP, the impact is a wash because RRP rates are similar to Treasuries. But either way, the stock of financial wealth is not changed. One downside to the public, however, is that they take on duration risk which was previously held by the Fed. While an argument could be made that this duration risk creates increased volatility of household wealth, we expect that the duration risk is distributed amongst the public in a way that minimizes this issue: risk-averse households hold T-bills and those who want or need the duration hold longer securities. In addition, it is plausible to expect interest rates to offer a natural hedge to equities held by the public over the long run.

Is there less money when M2 is lower?

The simple answer is no. The decline in M2 does not mean that households have less financial assets or spending power. Money more broadly consists of liabilities of the government plus liabilities of the banking system. M2 is mainly bank deposits, which go down with 1) the Fed's balance sheet decline, and 2) bank usage of FHLB funding (Federal Home Loan Bank) which replaces bank deposits with bank "borrowings". FHLB usage was heavy last year and then accelerated in March (Exhibit 2). This helped drain bank deposits, but did not drain total bank liabilities, which is more relevant for money supply (Exhibit 1).

If we consider Treasury securities – and arguably also securities of Agencies such as FHLB and Fannie/Freddie (government money market funds buy Agency liabilities) - as part of the money supply, we would find the supply of money is actually increasing, especially with ongoing large federal deficits. A Treasury is just an obligation of the Fed to pay reserves at the maturity date. Treasuries are therefore equivalent to time deposits at the Fed, while Fed reserves and RRP are like checking accounts at the Fed.

Exhibit 1: Bank deposits are down, but not total bank liabilities ($tn)
Bank liabilities plus govt liabilities are a better measure of total money supply



Source: BofA Global Research

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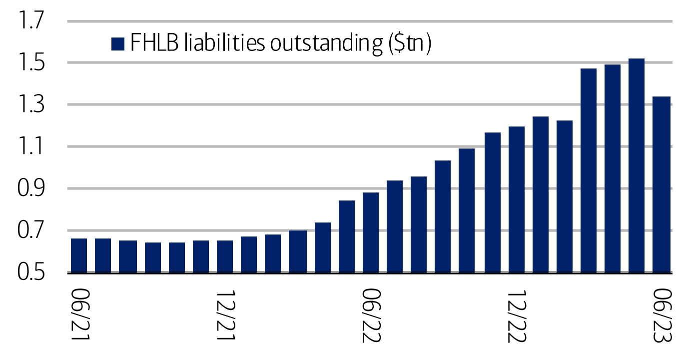
Exhibit 2: FHLB liabilities increased rapidly since 2022
Bank deposits shifted into FHLB borrowings



Source: BofA Global Research

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Some reasons for concern around liquidity drain

Funding markets experienced a spike in repo rates (SOFR) back in Sept 2019 which was clearly linked to the Fed's reserve drain. The SOFR spike was a result of not just QT but reaching a state of reserve scarcity, where banks could not freely lend in the repo markets. The Fed's solution was the standing repo facility, which we believe will give early signs of reserve scarcity to avoid a repeat of 2019.

Another justification for fear around QT is that it arguably puts upward pressure on Treasury interest rates. But as we have argued, higher Treasury payments is a net benefit for the private sector unless the Treasury raises taxes or cuts discretionary spending to offset these higher government payments.

Another problem with QT, particularly after the banking events of March 2023, is that by draining deposits the banking sector has to manage deposit levels more vigilantly. Because deposits have become scarcer for some banks, some banks may face more rapid increases in their funding costs because of QT. This comes at a time when financial stability is more vulnerable.

What's the takeaway for macro investors?

The Fed balance sheet and M2 are only part of the picture. Households are not losing wealth in the liquidity drain but are swapping into higher yielding government liabilities. For the Fed, this means that QT is probably less potent in slowing demand, which implies greater risks of a higher, and higher-for-longer, Fed rate path than markets currently price. While the market-priced Fed path now peaks at 5.42% and prices cuts beginning in Dec 2023, our base case is that the Fed peaks at 5.58% and holds there until May 2024 (see US Economic Weekly: Good news for the time being 30 June 2023). This implies 2y rates could be at risk of rising further with more Treasury curve inversion to come.

Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023 –** Year Ahead 2023: Pivot ≠ Peak, 20 Nov 2022
- When carry rules **Global FX Weekly**, 30 June 2023
- In data denial **Global Rates Weekly**, 30 June 2023
- Change of heart, **Liquid Cross Border Flows**, 26 June 2023

Rates, FX & EM trades for 2023

For a complete list of our open trade recommendations, as well as our trade recommendations closed over the past 12 months, see the reports below:

Global FX weekly: When carry rules 30 June 2023

Global Rates Weekly: In data denial 30 June 2023

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