# The massive unintended stimulus from rate hikes and QT - 02/16/2023

During this past week, while seeing clients in Europe, I had a revelation. It was one of those "lightbulb above the head" moments where I thought to myself, "How could I have not seen this before??" It kept me up quite late for a couple of nights as I worked through all the details. And then I realized just how significant it was for the global economic, policy, and market outlooks. Please stay with me here for a few more paragraphs while I explain; I think it will be well worth your time.

The revelation began as I was wondering why things were not a lot worse. Or more specifically, why there have not been more serious global economic and financial stresses. After all, over the last 11 months the Fed Funds rate has risen 450 bps and the Fed balance sheet has contracted by over $500b from its peaks. At the same time, monetary policy has tightened markedly across the entire G20. And while there have been extremely large total return losses throughout the fixed income markets, and plenty of ugliness in the growthy equity space, overall market functioning has generally been orderly. Further, the economic fallout, particularly when looking at labor markets and corporate earnings, has been largely nonexistent.

I guess I just thought there would have been some more spectacular blowups. I found myself harking back to the tightening cycle of 1994. I know I'm dating myself when I go back to my market experiences of nearly 30 years ago, but hear me out. That particular tightening cycle had just 300bps of Fed rate rises, with no change in the balance sheet, over about the same amount of time as our recent tightening cycle – 11 months. Other major central banks were also tightening at that time, albeit by smaller amounts. But back then, fixed-income markets largely stopped functioning. Orange County went bankrupt by choking on MBS derivatives. A guy by the name of David Askin almost singlehandedly destroyed the entire agency MBS market. Mexico broke its peg and plunged into the Tequila Crisis. Prop desks inside of both the commercial and investment banking worlds lost records sums of money. And it was nearly impossible to trade in parts of the Japanese or European sovereign debt markets. A lot of stuff broke, and a lot of folks, particularly in the interest-rate-focused portions of the financial markets, lost a lot of money.



So why are there not more David Askins blowing up the MBS market? Why are there not more Jon Corzines blowing up bank prop desks? Why are there no Orange Counties or Mexicos? Where are all the massive losses after 450 bps of rate hikes and over $500b of QT?? Then it hit me – it was so obvious I couldn't believe I'd missed it: A massive chunk of the losses that would usually occur during a rate-hiking cycle were being socialized on the balance sheets of global central banks.

Back in 1994 the Fed balance sheet was tiny – just a few percentage points of GDP, and it only held T-bills. Today it's ~40% of GDP and it holds a ton of those same interest-rate exposures that blew up so many folks in 1994. And in Europe and Japan, the central bank balance sheets are much larger as a percentage of GDP than in the US, with even larger holdings of spicy rate-sensitive risk assets.

Just for some perspective on size here, the Fed + ECB + BoJ balance sheets total around $22 trillion. For argument's sake, let's say they are all down by about 10% on a mark-to-market basis. (I would say that's conservative since there are many MBS bonds that the Fed holds with high 70s to low 80s dollar prices). So we are talking about $2.2 trillion of losses that have been WITHHELD from the private sector during this tightening. In the old world, aka pre-unconventional monetary policy, those losses would have been distributed to the market – often in concentrated/leveraged hands. Today, though, those losses are socialized and hidden inside the creature from Jekyll Island and its Basel buddies. Had this $2.2 trillion been set loose into the global financial markets over the last 11 months, my guess is there would have been some epic blowups and a much more serious drag on economic activity. That's the big revelation!!!

The bottom line here is that in the old pre-QE world, an individual, a company, or a municipality that locked in a loan with term funding would win, while the holder of that loan would lose. For example, every US household that gained from locking in a low mortgage rate for 30 years had those gains offset by losses at a bank portfolio, a pension fund, a hedge fund, or any other holder of the loan in the private sector. In the old days like 1994, the gains and losses in the fixed-rate term lending markets offset one another in the private sector – it was a zero-sum game for the economy as a whole.

But today, in the post-QE world, the loss side of this zero-sum game is not being realized in full. The central banks have become a socialized buffer for large portions of the losses, thereby creating a one-sided private sector stimulus effect from the rate hikes. That's why both financial markets and the economy have held up so well after this tightening. Trillions in stimulus have gone to fixed-rate borrowers across the globe, while trillions in unrealized mark-to-market losses have hit the central banks, with no immediate negative economic or financial-market consequences. There are no shareholder revolts or forced sellers after central bank losses. No CEOs get fired; no valuations collapse.

This is a huge, and highly unpleasant, unintended consequence from QE. It implies that monetary policy tightenings are now much less potent than in the past. Before, a central bank could blow things up and slow down the economy with just the flick of a 300bps switch. But now, QE has become a monkey on the back of the inflation-fighting process, hampering the process of "getting the job done." Of course, the obvious implications are that that policy will have to remain tighter for longer, and possibly go higher than previously thought. Or – another way to think about it – central banks just haven't tightened as much as you think.

Now, to the extent that my views on the supply side vs. the demand side play out as I have outlined in past notes, this revelation shouldn't require a huge bearish market pivot for my credit trade. It's an additional headwind for growth equities, for sure, and it's a repricing higher of the short-term path for real rates. But to the extent that we just enter a supply-side Goldilocks-style outcome with better growth prospects and longer-term disinflation, credit should be just fine while equities struggle to break out of their recent ranges. Also on the brighter side, one now needs to worry far less about the hard-landing effects on riskier credit. And this whole storyline does create a nice dollar-bullish backdrop.

In any case, I still want to keep working through all the implications of this revelation. I think there may be even more to this. With that in mind, I do think one could easily make the case that QE may have been even more powerful than we had initially surmised. There are all the positive effects that come from QE through raising inflation expectations and lowering real rates, as well as driving term premiums and risk premiums lower. Those are clear and well known. But when you look at the accrual gains in the Fed portfolio, which were cumulatively over a trillion dollars since the start of QE1, those created a continuous fiscal tailwind as the proceeds were remitted back to the Treasury. Looking at QT in the same way, there is a modest headwind as Fed remittances to Treasury cease; but now the Fed defers all accrual losses. This deferral during QT vs. the immediate recognition of the gains during QE creates a huge asymmetry. The fiscal tailwind from QE is much larger than the fiscal drag from QT. All that said, while some pundits and academics have highlighted the fiscal effects of QE/QT, I don't think there has been anything written on the tailwinds that come from socializing mark-to-market losses on central bank balance sheets after rate rises. That is the most important point from all this analysis.

Here is the bottom line: This is not your father's or your grandfather's tightening. QE has watered down the effectiveness of this tightening by creating trillions in non-offset private sector gains. A pure and simple story. With that idea in place, I'm going to leave you to ponder this revelation and what it means for the big picture. As I said above, I do not believe there has been any academic work, Fed papers, or street research that has highlighted this before. Maybe I missed it. Or maybe the whole argument has some flaws. Either way, I'll be curious to hear everyone's thoughts. I know it shook me initially once I processed the idea fully. And remember, the $2 trillion plus in "net private sector stimulus" from this tightening does not include any additional net stimulus from the losses on other G20 central bank balance sheets. There is plenty more out there!!

Summing it all up, the power of traditional rate-based tightening could have been returned to something more normal if central banks considered selling assets BEFORE raising rates. Sadly, though, the big bad bank holding companies of the world lobbied hard against it for their own self-interest. And they won. As a result, they got tons more NIM, and they got to avoid losses on fixed-rate assets (which they instead shoved onto central bank balance sheets). The central banks on the other hand have been left with mounting portfolio losses and a much less powerful inflation-fighting toolkit. All very sad indeed. Good luck trading.