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SPECIAL REPORT

November 4, 2024

Is QT A Threat To Markets?

A Word From Chen Zhao

While I am traveling, this week's *Global Strategy* features a *Special Report* titled ***"Is QT A Threat To Markets"***, prepared by my colleague and our Chief Quantitative Strategist, Henry Wu. Henry explains why the Federal Reserve's unprecedented quantitative tightening will not cause a replay of the chaotic unwinding of the Fed's balance sheet in 2019. He also points out that credit creation is accelerating, which will generate a soft landing for the economy and support asset prices.

I will report my findings from my recent trip to Europe and Asia next week.

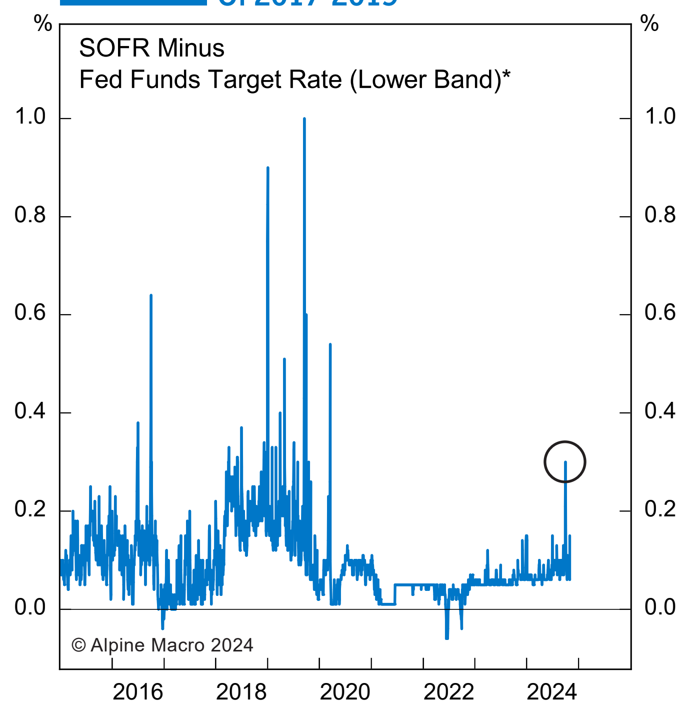
Best Regards,
Chen Zhao

In This Report

Money market rates experienced a sharp spike at the end of the third quarter as the Federal Reserve continues Quantitative Tightening (QT) (**Chart 1**). The Fed's balance sheet has shrunk by a historic $2 trillion since June 2022. This combination has reignited memories of the 2019 chaotic unwinding of the Fed's balance sheet.

In 2019, the Fed's aggressive balance sheet reduction triggered months of heightened volatility in money markets, culminating in a severe liquidity crunch that forced the Fed to abruptly halt QT and inject liquidity. Investors now question whether the current Fed balance sheet unwinding could lead to similar disruptions, threatening financial markets and the broader economy.

Chart 1 Repo Rate Spikes Reminiscent Of 2017-2019



*Truncated at 1

A repeat of the 2019 liquidity crunch is highly unlikely, in our view. QT will not be a constraint on bank lending. In fact, we see budding signs of accelerating credit growth.

A Few Key Differences

Since the start of this year, we have argued that the current balance sheet unwinding would unfold differently from the 2017-2019 episode.[1] We expected limited disruptions to financial markets due to three key differences.

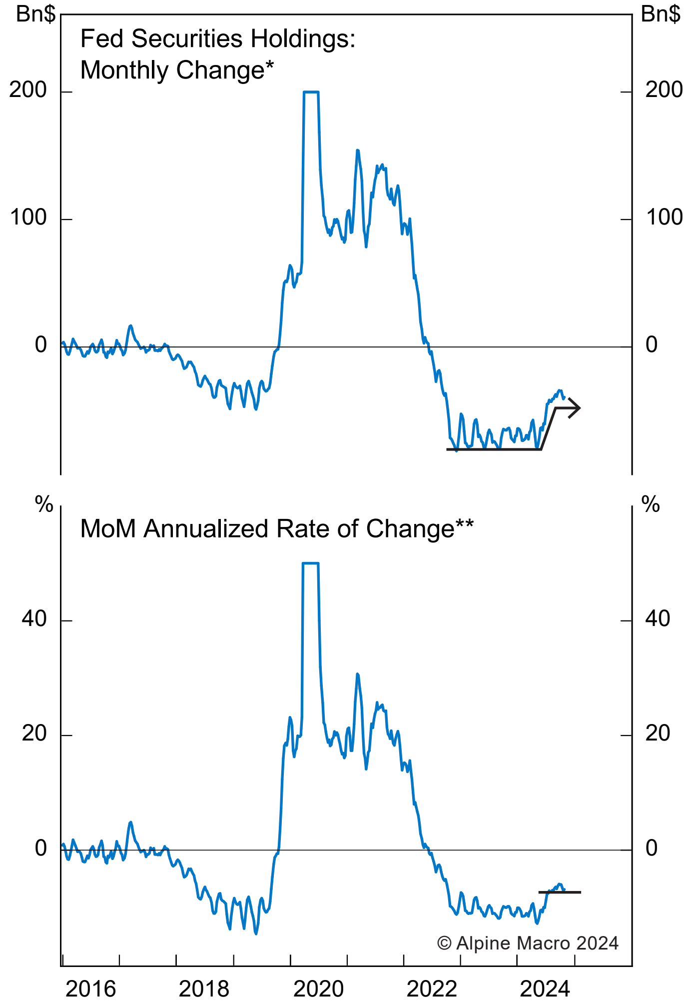
First, the Fed is taking a more proactive approach to monitoring QT in this cycle. In the previous cycle, the Fed had little clarity on the terminal size of its balance sheet, or which markets would be affected. Fed Chair Jay Powell famously likened QT to "watching paint dry", a passive stance that ultimately led to some hard lessons.

This time around, several Fed officials have publicly emphasized that they are closely monitoring liquidity to ensure it remains ample throughout QT. The Fed slowed the pace of QT this summer, despite no signs of pressure (Chart 2). A more gradual reduction could result in a smaller terminal balance sheet by giving market participants more time to adjust.

Additionally, the Fed has established a $500 billion standing repo facility (SRF) to provide liquidity if shortages arise. Unlike in 2019, when the Fed had to intervene on an ad-hoc basis, the SRF operates automatically without requiring explicit Fed action. Its current capacity exceeds the liquidity interventions made during the 2019 episode.

1 Alpine Macro *U.S. Bond Strategy Special Report* "Rate Cuts + QT: A New Policy Experiment" (January 4, 2024).

Chart 2 QT Has Already Slowed Significantly



*Truncated at 200
**Truncated at 50
Note: Both series are shown as 4-week moving average

With the Fed committed to backstopping funding needs, participants are less likely to hoard liquidity, a behavior that typically exacerbates liquidity crunches. In 2019, frequent repo market spikes led institutions to withhold lending excess liquidity, aiming to profit from rising repo rates during periods of stress.

Second, liquidity remains abundant relative to the previous QT cycle. Several metrics illustrate this:

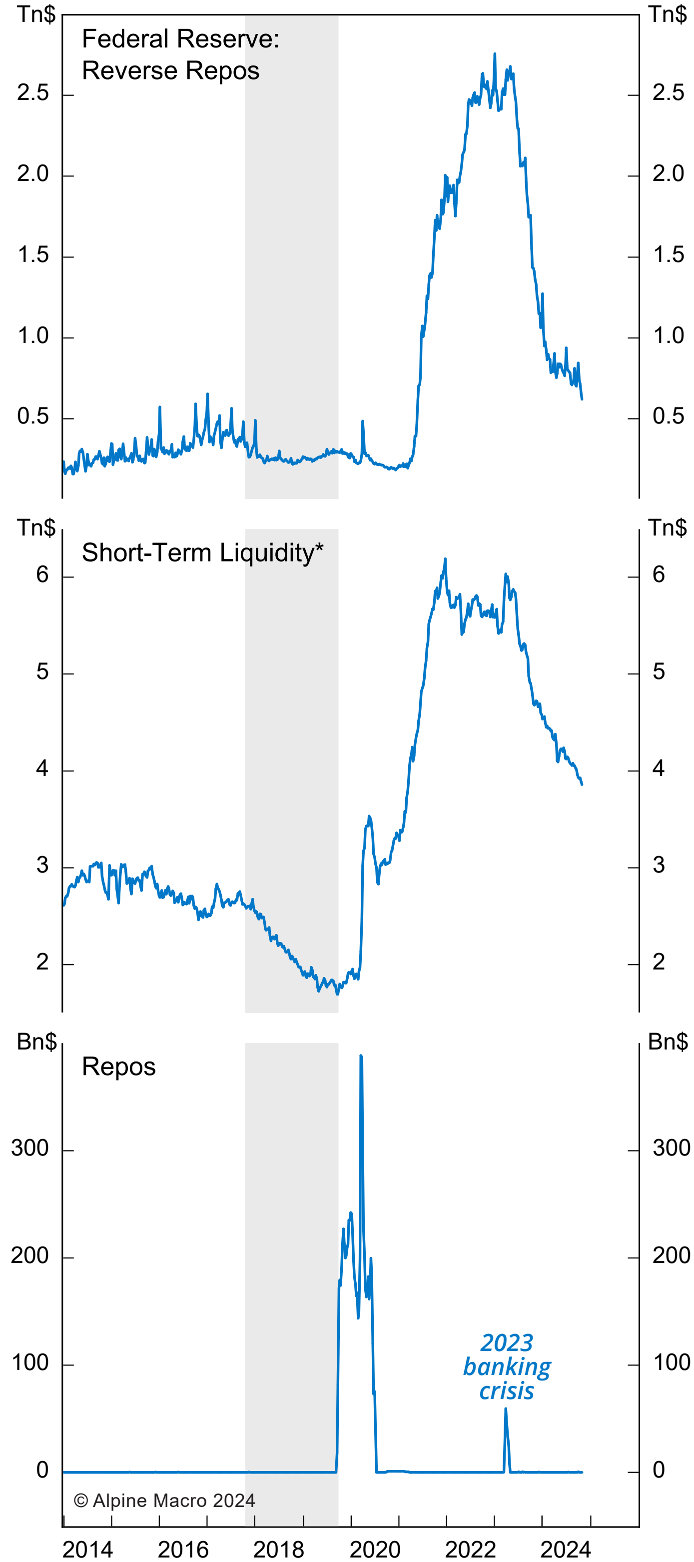
- Money market rates began spiking in early 2018, yet the Fed continued shrinking its balance sheet for another 18 months before reaching a breaking point. Currently, money market volatility has just begun and is limited to quarter-end bank window-dressing periods. While we do not anticipate liquidity to tighten to 2019 levels, we remain some months away from needing to halt QT.

- The Fed has already slowed the pace of balance sheet reduction to 8% per year, compared to the 11-12% annual shrinkage seen in 2018-2019.
- There are still $627 billion in reverse repos – liquidity that the private sector lends back to the Fed at the lowest possible rate. In contrast, this excess liquidity fell to under $250 billion during the previous QT episode (**Chart 3**).
- The total amount of short-term liquidity, calculated as reserves and reverse repos, remains large relative to the economy and banking system compared to the 2017-2019 period.
- The Fed's repo facilities currently show zero usage. The abrupt end of the previous QT cycle triggered a surge in demand for these facilities.

Third, foreign dollar funding needs are weaker this time. The dollar appreciated during the 2017-2019 cycle, underscoring a shortage of dollar liquidity for foreign demand. The cost of dollar funding for foreign borrowers rose sharply. This dynamic is best reflected in cross-currency basis swap spreads, which spiked alongside repo rates during 2017-2019 but have remained stable so far (**Chart 4**).

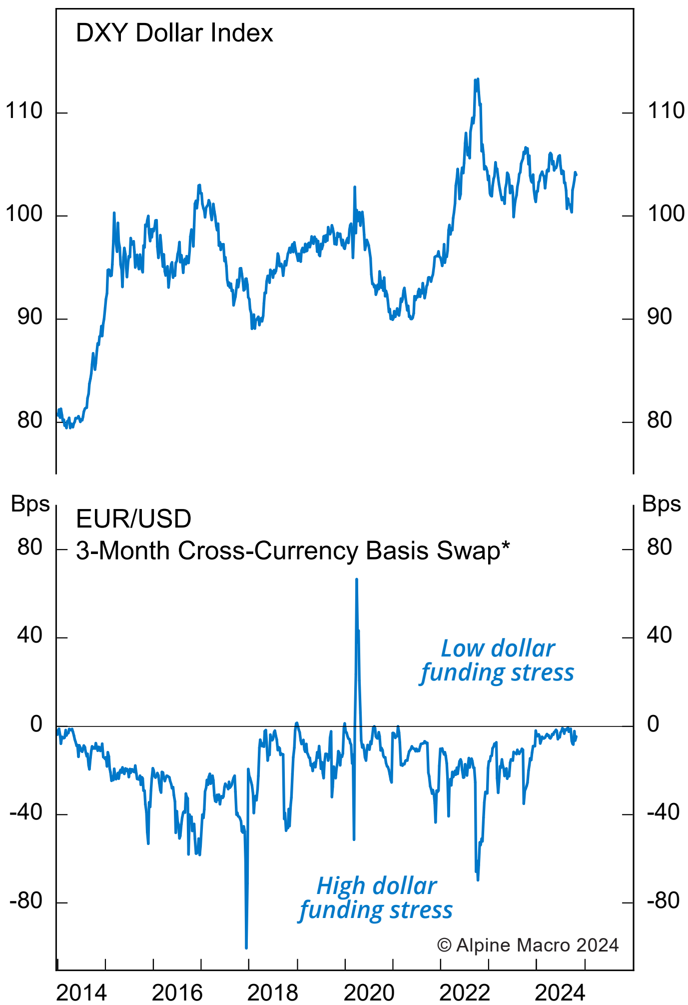
In this cycle, the dollar peaked in October 2022 and has been range-bound the past few quarters. The recent stimulus announced by Beijing could help boost the Chinese economy and further weaken

Chart 3 Short-Term Liquidity Remains Ample



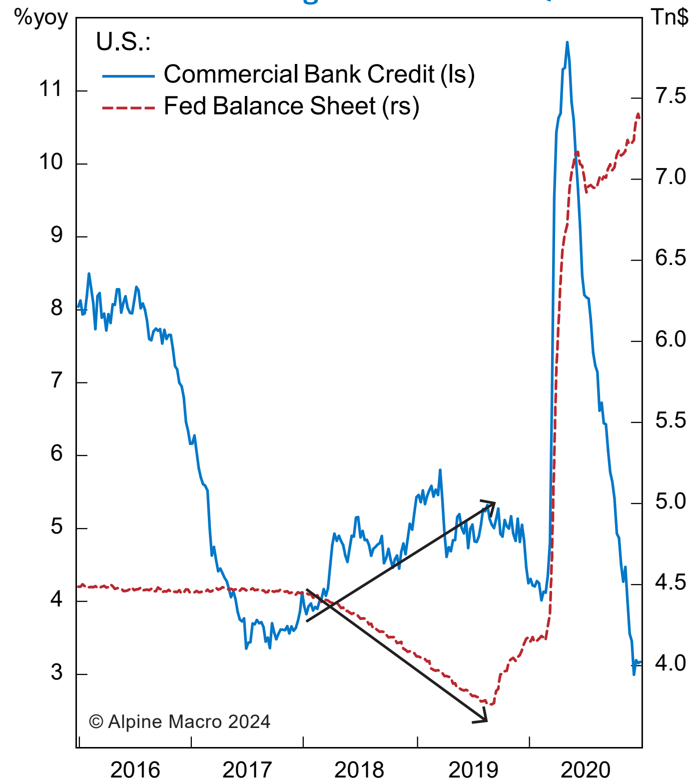
*Includes reserves and reverse repos
Note: Shading denotes the previous QT period

Chart 4 Cross-Currency Basis Swaps Do Not Signal Stress



*Source: Bloomberg Finance L.P.

Chart 5 Bank Lending Grew During The 2017-2019 QT



the dollar against higher-beta currencies. A weaker dollar would ease liquidity demand from offshore markets.

QT Will Not Hinder Credit Creation

The size of the Fed's balance sheet remains large and will not limit bank credit creation in the foreseeable future. Even at the height of the 2019 liquidity crunch, loan creation was unaffected (Chart 5). The key factor determining loan creation is credit demand, not liquidity supply.

Before the Global Financial Crisis (GFC), banks operated under a fractional reserve system, where the Fed supplied minimal reserves and required banks to hold a percentage of their deposits as reserves. Bank reserves limited total credit creation *via* this reserve requirement ratio. The GFC ended this system, as the Fed flooded banks with liquidity through various QE programs, causing reserves to surge relative to deposits. By 2020, the Fed dropped the reserve requirement ratio to zero, fully acknowledging the permanent regime shift.

The post-GFC environment was characterized by an excessive liquidity supply and anemic credit demand which resulted in a liquidity trap. Chart 6 shows that following the GFC, credit growth lagged behind liquidity supply growth until the

Chart 6 **Liquidity Supply Outpaced Loan Demand Post-GFC**

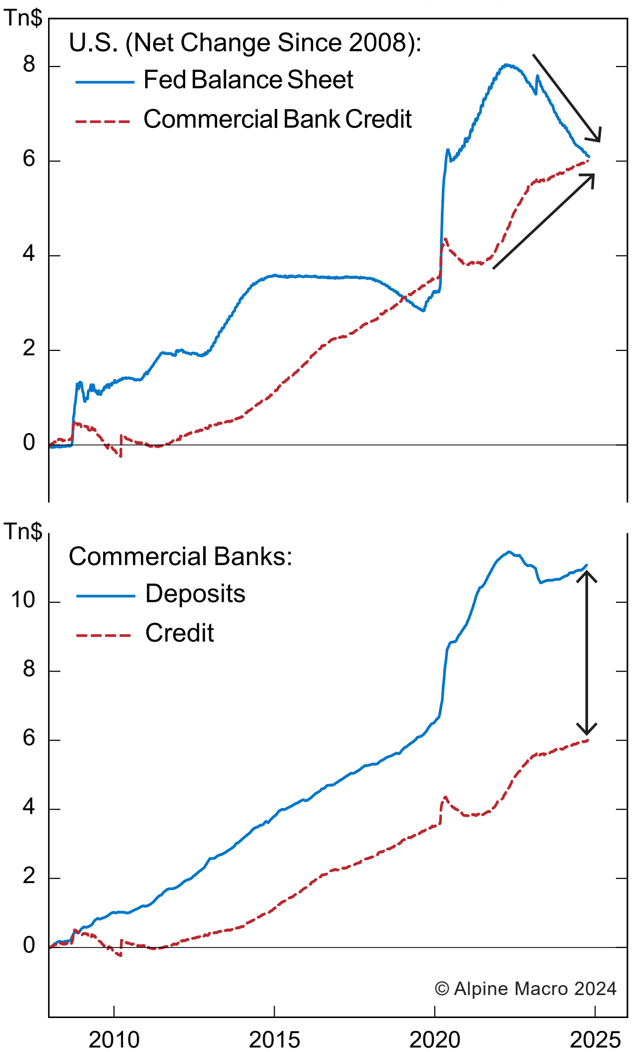
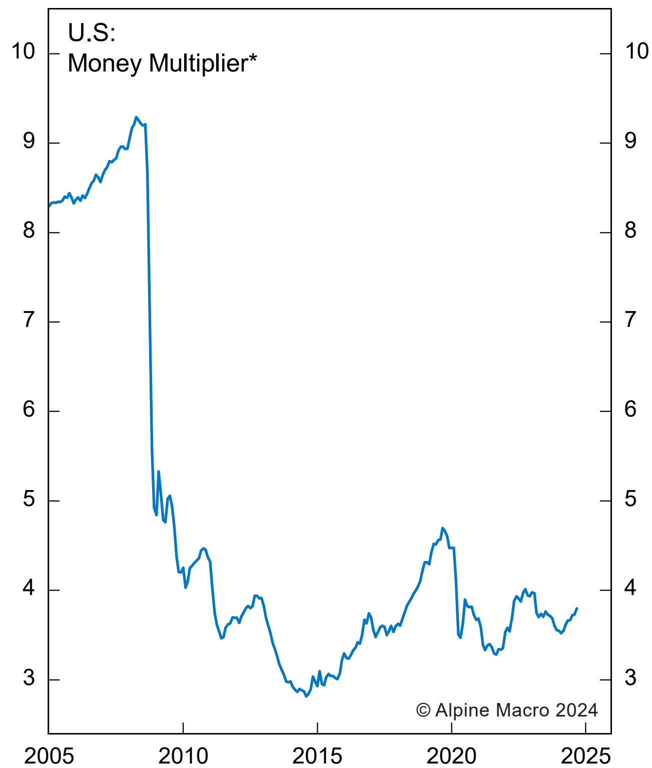


Chart 7 **The Money Multiplier Has Room To Expand**



*M2 divided by monetary base

post-pandemic recovery. Bank credit grew much more slowly than deposits.

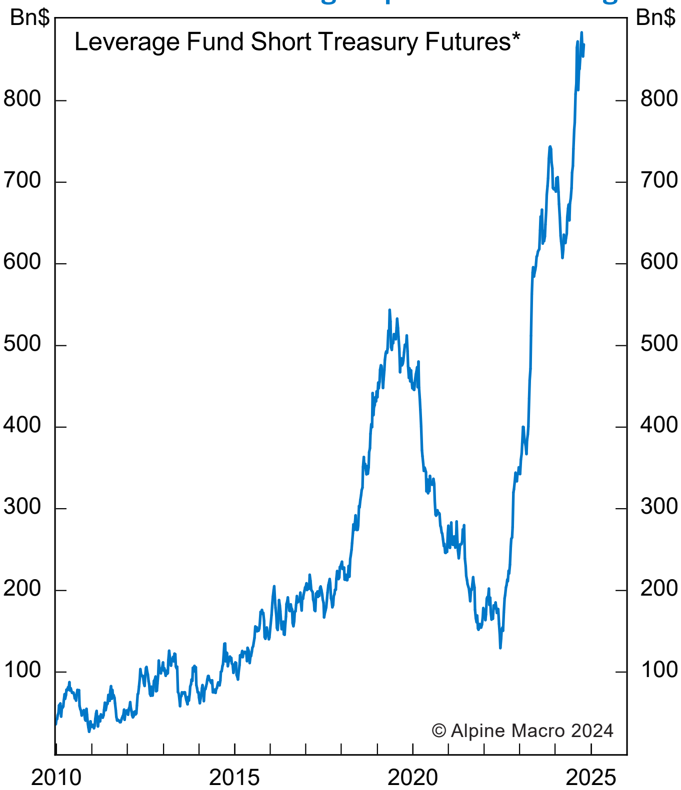
Currently, the supply of liquidity remains well in excess of what is needed for credit creation. The Federal Open Market Committee will halt QT long before a liquidity shortage constrains bank credit creation, a point that remains distant.

In the meantime, new credit demand can be met without banks having to make trade-offs in liquidity allocation. This is evident from the money multiplier, which still has substantial room to expand (**Chart 7**). Broad money supply can continue to grow despite QT.

A potential early warning signal of liquidity tightness would be banks scaling back high-volume, low-margin lending activities, such as unused lines of credit, Treasury basis trades, and currency swaps — areas they expanded to maximize abundant liquidity. Banks are likely to unwind these operations first before cutting lending to the real economy, which typically yields higher margins. These activities, especially Treasury basis trades, remain robust, as indicated by record volumes of speculative futures (**Chart 8**).[2]

2 Alpine Macro *U.S. Bond Strategy Special Report* "The Treasury Basis Trade: When Leverage Meets Size" (January 25, 2024).

Chart 8 A Lot Of Liquidity Supporting Low Margin Speculative Trading



*Sum of 2-, 5- and 10-year contracts

Accelerating Credit With A Shrinking Fed Balance Sheet

Lately, there are signs that credit demand is reviving. Bank credit growth remains positive despite the highest interest rate in decades. Several structural changes are supporting credit demand, including stimulative fiscal policy, the end of household deleveraging, and investments in cutting-edge technology catalyzed by industrial policies.

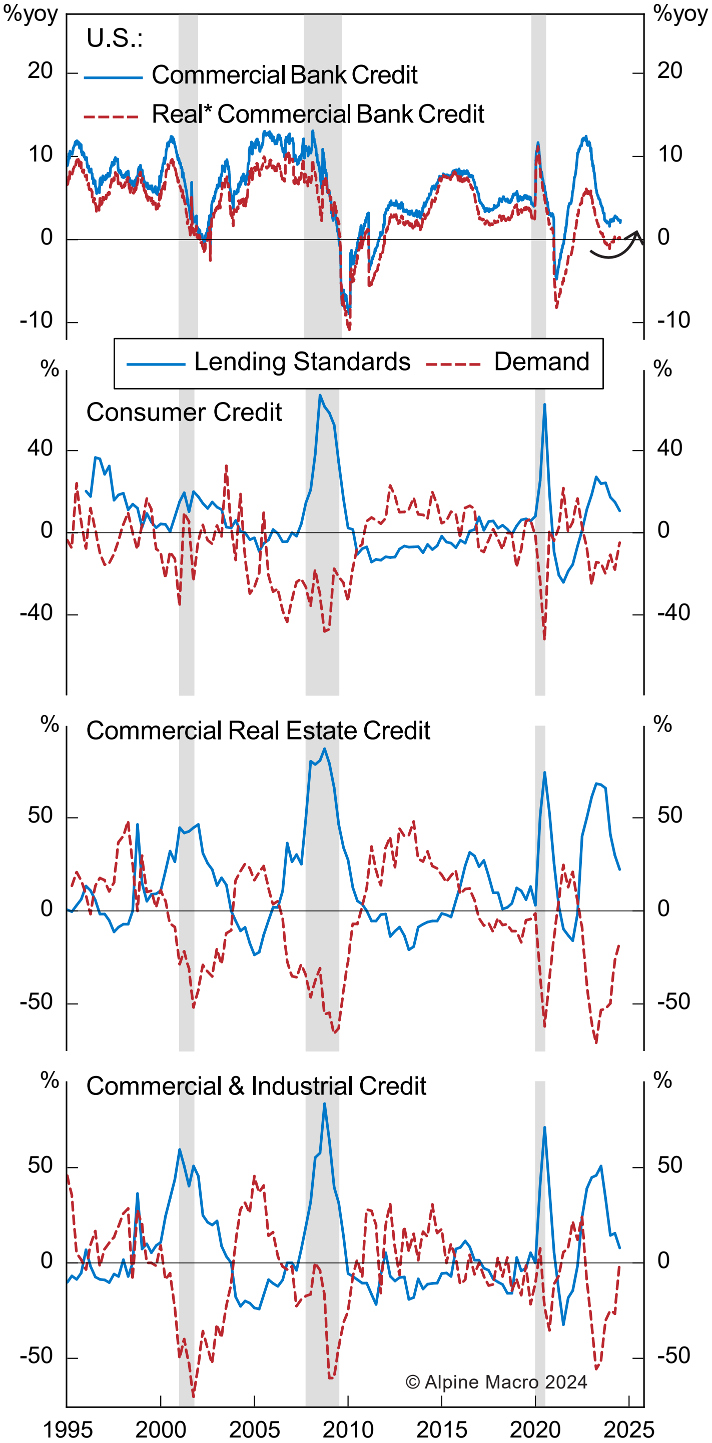
Cyclically, credit demand could pick up due to ongoing Fed rate cuts. Higher rates in recent quarters had prevented many companies from making major investments. This headwind is now fading as highlighted by the September S&P Global PMI report: *"A boost from lower interest rates was mentioned by companies that saw new orders increase in September as clients became more willing to commit to new projects."*

Bank loan growth appears to be bottoming out in both real and nominal terms (Chart 9). Lending standards have stopped tightening, and credit demand has stopped weakening across all three major bank lending categories – a trend typically seen after recessions and slowdowns, not before (Chart 10):

- Consumer loan growth, which slowed significantly from 2022-2023, is stabilizing. The average consumer remains in good shape, with near-record-high FICO scores, low total debt-to-income ratios, and falling interest burdens. This should limit how far delinquencies can rise.
- Lending to the commercial real estate (CRE) sector is set to improve. We turned constructive on CRE in early 2024[3], and various indicators have shown CRE prices recovering in recent quarters. Higher CRE prices increase the collateral value of CRE loans, boosting banks' confidence to lend in this sector. Fears of office CRE contagion have proven exaggerated, as regional bank stock prices have fully recovered from the drawdown of the March 2023 crisis.
- Residential real estate loan production should also grow, albeit with a longer lag. There is pent-up housing demand. Housing construction permits have slowed significantly, and completions will likely decline in the coming months despite elevated home prices. However, lower rates should lead to increased construction activity down the road.

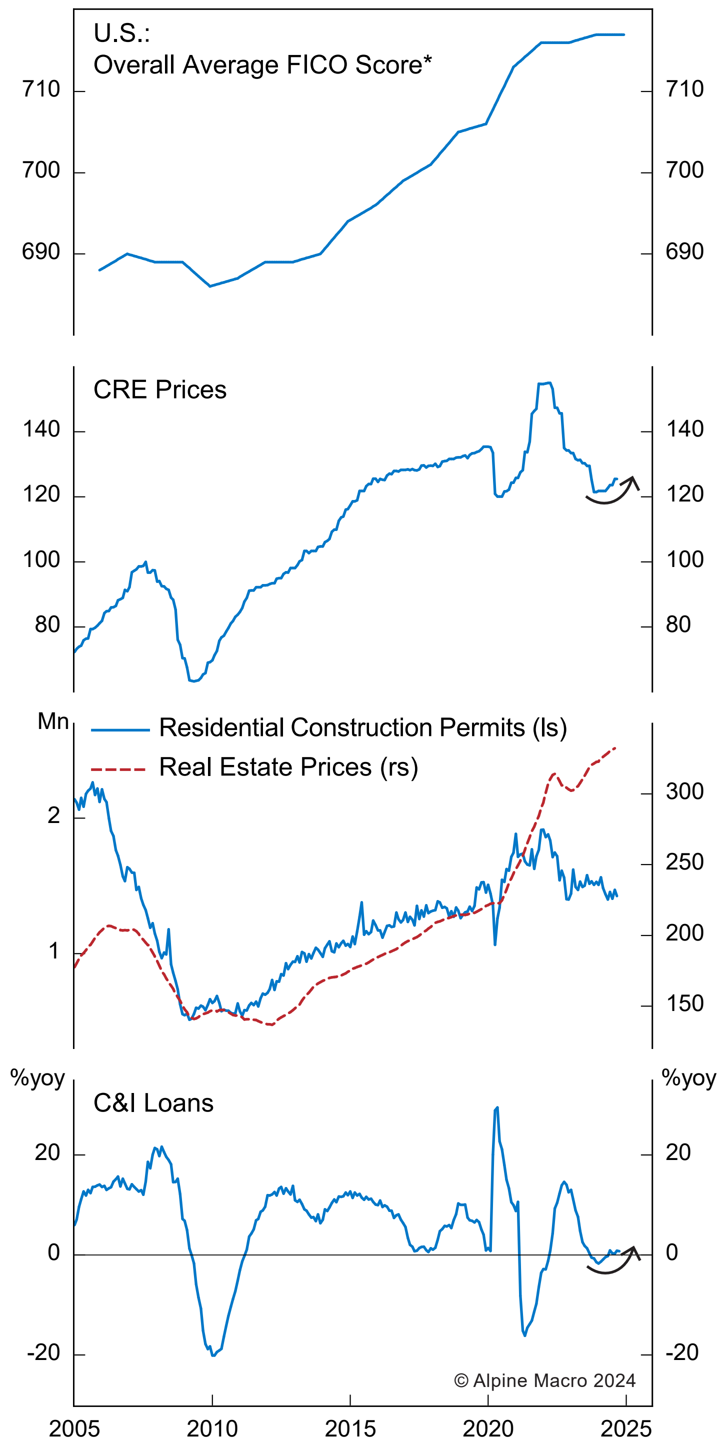
3 Alpine Macro *Global Strategy Special Report* "How Risky Is Commercial Real Estate?" (February 12, 2024).

Chart 9 Bank Loan Growth Is Troughing



*Deflated by headline PCE
Note: Bottom three panel series constructed using averages; shading denotes U.S. recessions; source: Federal Reserve Senior Loan Officer Opinion Survey

Chart 10 All Three Categories Of Bank Loans Could Accelerate



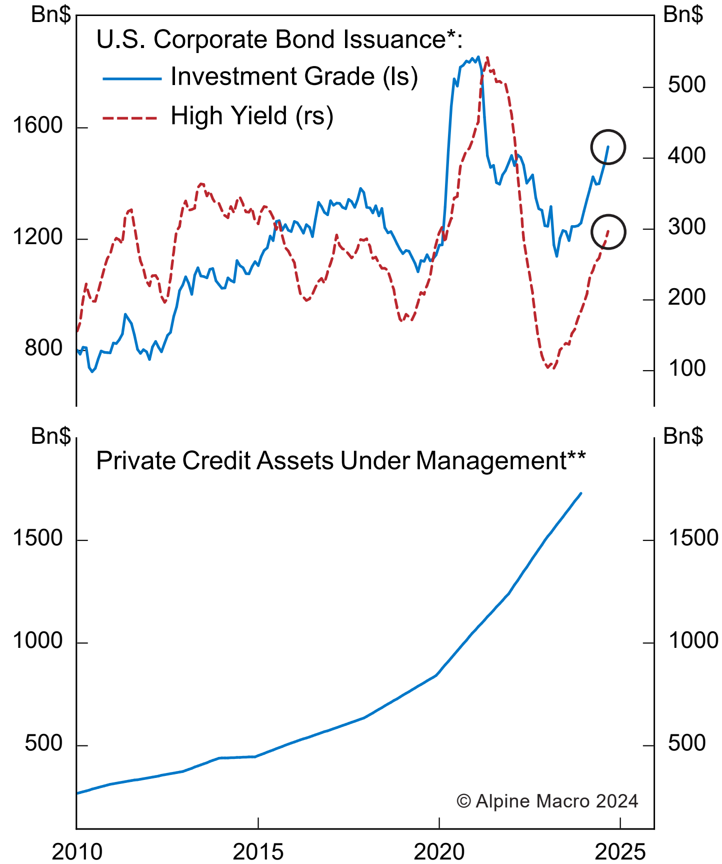
*Source: myFICO

- C&I loans contracted earlier this year but have since resumed growth. The drop in long-term yields lowered borrowing costs ahead of rate cuts, spurring loan expansion.

There is also positive news on the regulatory front for bank lending. The initially feared Basel III "end game" capital rules have been revised to be much more lenient than expected. The Fed eased its originally stringent regulation proposal after facing strong opposition from banks.

We also expect non-bank lending to remain robust (**Chart 11**). Corporate bond issuance, both investment-grade and speculative, has rebounded sharply this year, indicating that corporate borrowers can manage higher interest rates. CLOs and private credit have also grown significantly, reflecting a strong risk appetite for credit. While defaults have increased, many stem from voluntary restructuring rather than bankruptcies, allowing businesses to remain operational after these credit events.

Chart 11 Non-Bank Lending Has Been Solid



*Shown as 12-month moving sum; source: SIFMA
**Source: Northern Trust

Conclusions

Quantitative tightening in this cycle will differ from the 2017-2019 episode. We are confident the Fed can avoid a repeat of the previous chaotic process. Neither funding markets nor lending to the broader economy will be significantly impacted. Consumer, real estate and C&I loans may all accelerate as interest rates fall. Endogenous credit growth will limit recession risks, help a soft landing and support asset prices.

Henry Wu
Chief Quantitative Strategist

Housekeeping

Our recommendations to go long ASHR and EEM on October 7 were badly timed. To control risk, we are cutting losses and closing both positions. We will reassess the conditions and decide what to do next.

Investment Recommendations						
Tactical Investment Positions (3 - 6 months)						
Recommendations	Open Date	Open Levels	Stop	Closing Date	Closing Levels	P&L Since Inception
Long U.S. Regional Banks (ETF: KRE)[1]	12/04/2023	48.12	Rolling -8%	-	-	25.7%
Long Gold (ETF: GLD)	04/01/2024	207.82	Rolling -5%	-	-	21.5%
Long U.S. Financials (ETF: IYF)	08/19/2024	101.30	-	-	-	5.6%
Long Russell 2000 (ETF: IWM)	08/19/2024	215.20	-	-	-	2.1%
Long Copper[2]	09/30/2024	4.55	-5%	-	-	-4.5%
Long 10-Year German Bunds/ Short 10-Year JGBs	10/07/2024	2.3%/0.93%	-	-	-	-1.1%
Long Emerging Market Equities (ETF: EEM)[3]	10/07/2024	47.36	-	11/01/2024	44.53	-6.0%
Long China A-Shares (ETF: ASHR)[4]	10/09/2024	30.00	-10%	11/01/2024	27.34	-8.9%
Short Brent Oil	10/22/2024	76.00	-	-	-	3.8%

Note: P&L is calculated using daily closing prices.
[1] We are tightening the stop for our Long U.S. Regional Banks (ETF: KRE) trade from 53 to a rolling -8%.
[2] We are adding a stop to our Long Copper trade at -5%.
[3] We are closing our Long Emerging Market Equities (ETF: EEM) trade at a loss of -6.0%.
[4] We are closing our Long China A-Shares (ETF: ASHR) trade at a loss of -8.9%.

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