US Macroeconomics

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Joseph Lavorgna, Chief US Economist | 212.893.1528 | joseph.lavorgna@smbcnikko-si.com

# The Drying Up of Liquidity Does Not Bode Well for Stocks

**Liquidity drives financial markets**. In the chart below, we show the six-month annualized change in the S&P 500 compared to the six-month change in Fed-provided liquidity. The correlation coefficient is nearly 0.95. Liquidity is defined as the change in the Fed's security holdings, the change in the Treasury's general account balance and the change in the Fed's reverse repo facility.

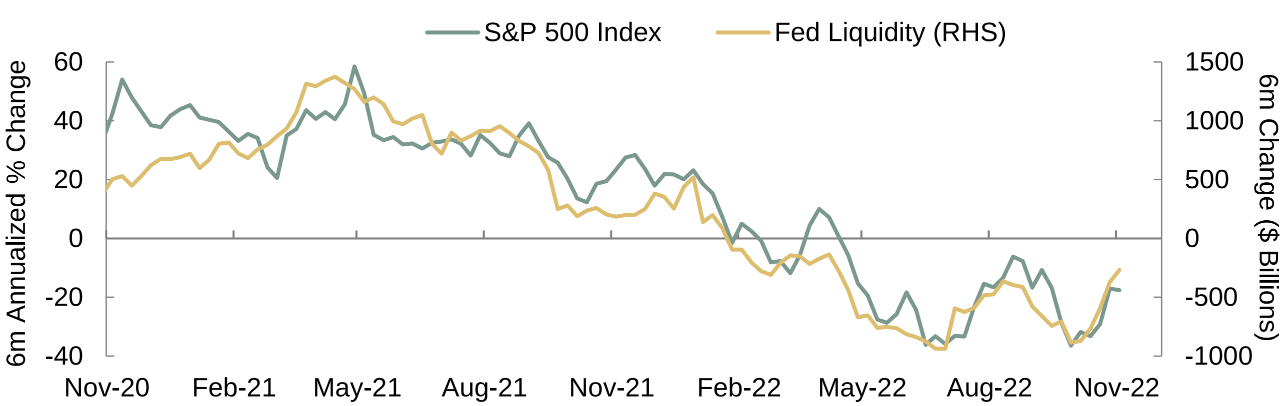
**The roll-off of the Fed's securities holdings is accelerating**. Over the last six months, the Fed's combined holdings of treasuries and mortgage-backed securities is down $42 billion. Soon it will approach $80 billion, which is less than the Fed's $95 billion cap because of few MBS prepayments, but more than twice the $27 billion monthly run-off from October 2017 to June 2019.

The decline in securities holdings has been mostly offset by a decline in the Treasury's general account balance which is down $35 billion to around $600 billion. However, the **Treasury Department announced last week that it intends to raise its cash balance to $700 billion by yearend**. This will drain reserves in the coming weeks in addition to balance sheet maturation which is happening in the background.

Primary dealers, money market funds and government sponsored enterprises are the main users of the reverse repurchase facility RRP. **Over the last six months, the RRP has increased $406 billion, effectively acting as the single biggest drain of liquidity in the system**. RRP balances are likely to remain high, if not increase, because of the Fed's commitment to further raise interest rates. In turn, this will absorb money that would otherwise go into the broader economy or financial markets.

The shrinkage of the Fed's securities holdings along with a higher Treasury balance and an elevated RRP will act as drag on liquidity creation. If the recent past is prologue, this will be negative for risk assets, in particular equities. The market needs a Fed pivot. Stay tuned.

**S&P Returns Have Followed the Change in Fed Liquidity**




*Sources: Federal Reserve, Haver, SMBC*

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