

# US Macroeconomics

August 1, 2023

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## How Long Will This Last?

Over the past several years, **the trend in Fed liquidity has been highly correlated with the trend in stock prices.** This is illustrated in the chart below. Recently, though, the two series have diverged. Stocks are moving higher while liquidity is trending downward. How this divergence is resolved could have important implications for the economy and broader financial markets.

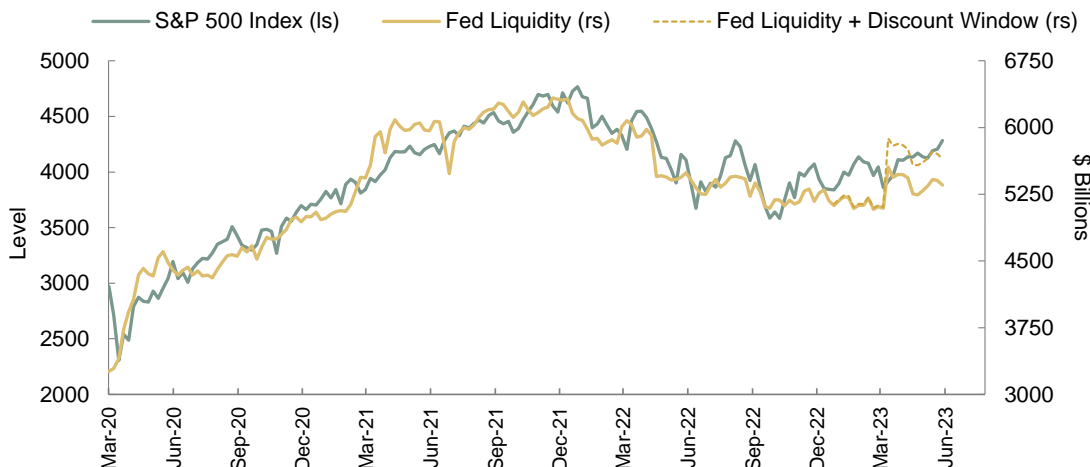
Central bank liquidity is defined as the level of the Fed’s securities holdings (treasuries and mortgages) less the Treasury General Account (TGA) less the reverse repo facility (RRP). Securities are assets on the Fed’s balance sheet while the TGA and RRP are liabilities on the Fed’s balance sheet. **When assets rise and/or liabilities fall, bank reserves are created, and liquidity is added to the financial system.** The opposite is also the case when asset fall and/or liabilities rise, bank reserves are destroyed, and liquidity is drained from the financial system.

When the Fed began raising rates in March 2022, policymakers also instituted quantitative tightening (QT). The Fed announced that it would allow a prescribed amount of treasury and agency-backed securities to mature each month. In reducing its assets, bank reserves would decline, and liquidity would be drained from the financial markets all else being equal. However, **last fall when stocks were making new lows, a portion of QT was offset by a lower TGA.** The net effect was to stabilize liquidity. Stocks eventually bottomed.

When the regional bank crisis struck this past March, **the Fed flooded the financial system with nearly \$400 billion in discount window lending.** This massively boosted liquidity which in turn stabilized financial markets. The S&P 500 zoomed even higher.

At present, liquidity is going down while the stock market is going up. History suggests this will not last. Either stock prices will decline, Fed liquidity will increase, or the two series will meet in the middle. Our best guess is that stocks do most of the adjustment because of a near record amount of US government borrowing.

**Further, the Treasury announced its intention to borrow nearly \$2 trillion in the second half of this year,** which will lift the TGA by \$200 billion and drain the same number of reserves from the system. While this is less than the near \$3 trillion of Q3 2020 debt issuance seen during the height of the pandemic, the Fed is no longer a buyer but instead a marginal seller. Hence, a spike in interest rates could also weigh on stock prices. Stay tuned.



Sources: Federal Reserve, S&P, Haver, SMBC Nikko

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