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Understanding Reflation & Central Bank Liquidity During A Taper Tantrum

Portfolio Attribution

14 April 2022 | HFI #842

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Following the immediate aftermath of the LTCM-bank recapitalisation and 2002 *Dot-Com* crises, heralded *market microstructure theorist* Maureen O'Hara published a seminal article in *Economic Policy Review* illustrating the unglamorous yet pivotal role regulated banks play in the liquidity dynamics that govern economies and financial markets alike.

Whilst central bankers continued to work on daily bases with their regulated bank counterparts, elected officials and quasi-autonomous regulators distanced themselves, especially after the ***Global Financial Crisis***, or ***GFC***, when sweeping reforms curtailed the elasticity of these bank-intermediaries balance sheets following the *Dodd-Frank Act (2010)* in the US, *Financial Instruments Exchange Act (FIEA, 2006)* in Japan and a plethora of legislative handcuffs imposed on Eurozone public banks, much of which remain to this day.

Cite:- German-American Interest Rate Differentials: The Bundesbank's, ESG & A Federalised Europe, 8 August 2020

These curtailments, were not causing issues until the event-driven shock of March 2020's ***Global Corona Crisis***, or ***GCC***, when in response to the SARS-CoV-2 pandemic – and to solve the problem of expanding economic output after such an acute shock – the US followed closely by the Eurozone, Canada and Japan implemented Reflationary programmes, stoking aggregate demand within economies by artificially increasing total spending across four key pillars.

Cite:- Evidencing The Continuation Of The Global Reflation Supercycle: Outlining Australians Proximity To The Money Multiplier And What Happens Next In The Pursuit Of Exceptional Investment Returns, 29 July 2021

Cite:- Bidenomics, Slavery Reparations & The Global Reflation Supercycle: Atoning For America's Original Sin Recompensed Via Even More Money Printing, 23 March 2021

Cite:- The Unprecedented Reflation Supercycle: Big, Bold, Strategic Moves, Surreptitious Inflation & The Incandescence of "Swarm Trading", 22 February 2021

Cite:- More Money Will Be Made In Financial Markets In The Next Two Years Than The Past Twenty Combined: Reflation, Cost Of Capital & Pricing Systematic Risks, 23 November 2020

The allure of Reflation to policy makers, business owners and risk-asset investors is that unlike unconventional monetary policies or big spending alone, Reflation combines several tenets of stimulus and in this cycle, the shift towards the "*Whatever-it-takes*" monetary support and fiscal expansion – a kind of practical application of **modern monetary theory** – coupled with a very strong synchronised economic rebound (from a record deep recession) leaves little doubt that Reflation has triggered *1970's-esque* inflation.

Whilst Reflationary policies have always led to rises in equity markets and "*Risk Assets*" as a whole, they run contrariwise to inelastic intermediary-bank balance sheets, explaining the frenetic REPO operations required in Australia, Canada and the US and more importantly, the unprecedented **Taper Tantrum 2.0** still plaguing global bourses.

'Treasury Switches', FIMA Repo Facility & Other Market Microstructural Reforms Are Bullish For Eurozone, Japanese & US Blocs

Cite:- Taper Tantrum 2.0: Quantitative Tightening (QT), China's Nocebo Effect & Why To Avoid Emerging Markets (EM), 7 February 2022

Cite:- Rates Riot Behind The Market Correction, 29 August 2015

Cite:- Truth Stranger Than Fiction As Yellen Sounds Death Knell For Economy, 19 September 2015

The simplest explanation for this is because of the expansive US Treasury issuances seen within Reflationary programmes, the growth in treasuries collateral requirements has far exceeded that of dealer-bank balance sheets, constraining dealers' ability to intermediate, especially during bouts of heightened market volatility when order-flow sees newer gigantean quantum.

This in part reflects the post-GFC regulatory overhaul, which has made it more costly for the largest banks in particular to grow their balance sheets and in response potential regulatory changes have been floated to help increase the elasticity of intermediary-bank balance sheets.

US treasuries liquidity remains paramount to a global recovery, with the US Federal Reserve's FOMC's balance sheet ostensibly anchoring the global economy and international equities collectively underperforming US equities by a cumulative 270% since October 2007.

Currency played a role in this underperformance, representing as twenty-five percent of this boon, as foreign currencies steadily weakened against the greenback during this time.

Cite:- Market Microstructure Theory and the Australian Dollar, 14 August 2019

In response to the ***GCC*** shock, in April 2020 the FOMC provided Dollar liquidity to foreign official holders of Treasury securities via the ***FIMA Repo Facility***.

This facility alone has abated a deeper correction after four consecutive months of *Risk Asset* retracements and heightened volatility.

Many foreign central banks hold Treasury securities (bonds) in custody at the Federal Reserve Bank of New York ("*FRBNY*"), which count toward their official foreign exchange reserve assets [about US$2.9 trillion or approximately one-quarter of all global foreign exchange reserves].

Operationally, the FIMA Repo Facility works like the traditional reserve-supplying actions the FRBNY conducts on a regular basis prior to ***Quantitative Easing***, or ***QE***, with the central bank buying treasuries on a temporary basis through a repurchase agreement and supplying US Dollar reserves; the employment of this facility expands the central banks' balance sheet, providing a natural cushion against the US$9 trillion balance sheet runoff beginning later this year (the size of the FOMC's balance sheet represents a staggering ~38% of nominal US GDP today versus ~6% in 2008).

Cite:- Quantitative Easing & Why Financial Markets Appear Complex: Corroboration 'QE' Is The Only Game In Town, 29 October 2020

Across Europe and the United States, several additional market microstructural reforms are being explored, all of which alleviate elasticity restraints imposed on bank-intermediaries, including changes to the ***Supplementary Leverage Ratio***, or ***SLR***, "*Treasury Switches*" and centralised clearing, which are meant to address market fragilities and safeguard against future liquidity shocks.

One approach that does not entail regulatory changes is for the US Treasury to conduct periodic buybacks, where it would purchase select less liquid, *off-the-run* bonds from bank-dealers, as was done in 2000-2002, when the US Treasury repurchased government securities as the US budget balance was in surplus, in order to keep issuance sizes from dropping even as financing needs witnessed a sharp decline (**until 9/11 changed everything**).

An alternative to buybacks is bond exchange operations, or "*Treasury Switches*", which sees a Governments Treasury buy back *off-the-run* bonds while simultaneously auctioning off new securities on a duration neutral basis.

Switches, like buybacks, are a tool other issuers, such as the Canadian government more recently, employ; the ***Bank of Canada*** offering to purchase *off-the-run* bonds in a stated maturity sector, and then replaces them with a benchmark bond of comparable maturity in an amount that matches the duration of the aged security.

Either buybacks or switches would allow Treasury to relieve market pressure at specific points and improve market liquidity, however, switches rely less on the broader deficit outlook and are largely neutral in their impact on the maturity structure of outstanding debt, which becomes material when the bellwether yield curve inverts or nears inversion.

Cite:- Inversion, Reversion, Subversion, 1 June 2019

Cite:- How The Inverted Yield Curve Affects Australia, 20 June 2019

It is delusional to think that ***Financial Repression*** will end in our lifetimes or that *this era of cheating on cheating on cheating* will abate but what O'Hara concluded in 2003 should not be forgotten, "*As financial institutions become more complex and less centralized organizations, although regulators clearly have an important monitoring and oversight role, the concomitant role and responsibility of regulated banks cannot be ignored.*" ■

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