Australian Standfirst

Pseudo-QE Whilst Lifting Interest Rates, Separating Financial Stability *Tête-à-tête* Monetary Policy

Central Banking

04 April 2023 | HFI#849

Stirling Larkin, CIO

Statistics are no substitute for judgment, especially in early 2023 where what was once considered *unconventional* has become über-unorthodox and now heading towards the bizarre. Twentieth century monetary policies were, for all intents and purposes, initiated to smooth out the excesses of the *Smithosian* classical business cycle – when an economy ran too hot, baseline interest rates were lifted with the thought doing so would maximise healthy growth without the vex of hyperinflation and in kind, lowering these rates during harder times would restore the proper functioning of what Smith dubbed, *the invisible hand*. This convention started to become, unconventional, when in 1961, ***Operation Twist*** (named after the popular dance move of that era) redefined monetary policy in the name of offsetting the then unusual combinations of economic stagnation, uncomfortably high inflation whilst also peculiarities in domestic employment at the tail end of the Korean War (with Australia, in particular succumbing to the ***Poseidon Bubble*** which decimated the Australian economy until the ***Roaring Tigers***, namely Japan re-invested in the Australian export-machine). Ever since, the conventional has become more unorthodox leading us to 2007, when during the nadir of the ***Great Recession***, the US central banking propellor-head introduced the concept of, ***Quantitative Easing, or QE***. In its most organic form, QE was designed and executed to complement baseline interest rate policies in the pursuit of '*smoothing out the excesses of the business cycle*' or inversely, cooling down **hot money. And it did.**

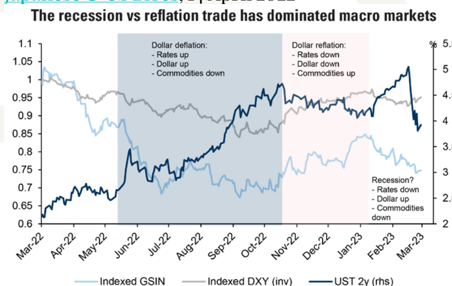
When ***Zero Interest Rate Policies, or ZIRP*** scraped the lower bound ***(Zero Lower Bound, or ZLB)*** and QE ran its course, the newer novel concept of ***Quantitative Tightening, or QT*** was explored, first in 2013 which sparked ***Taper Tantrums*** and then most recently in 2022 with the worst statistically quoted markets year since 1929.

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

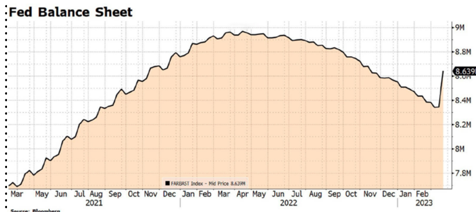
Cite:- Understanding Reflation & Central Bank Liquidity During A Taper Tantrum: 'Treasury Switches', FIMA Repo Facility & Other Market Microstructural Reforms Are Bullish For Eurozone, Japanese & US Blocs, 14 April 2022

The recession vs reflation trade has dominated macro markets

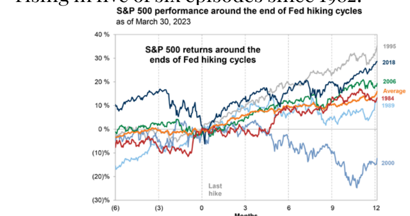


Fast forward to today, financial contagion over the past three weeks has seen the largest bank collapse since 2008, the largest two-year bellwether US Treasury yield drop since 1987 and two of the largest European banks pushed into a merger for the sake of broader systemic stability; such turmoil has very different financial and physical implications: financially, this was a VaR shock that started in rates as Silicon Valley Bank's ("SVB") collapse forced a rethink on the path of the leading US Federal Funds Rate, which ostensibly is that baseline interest rate level introduced post Smith. While oil and commodities were initially resilient, financial contagion bled into the commodities asset class because of high leverage and a poor start to the year, creating the initial sell-off across cyclical commodities like oil and base metals that were long, creating a phenomenon known as, "*negative gamma*" and the overall question of unrealised bond market losses (we can include loans and private debt in the "bond market" for these purposes) in the financial system hasn't gone away, however, many are wondering if it is already priced in. One of the biggest enigmas in the recent market reaction to banking system stress is the resilience in US equities alongside sharp declines in market pricing of the policy rate path and in oil prices, reflecting a view that a significant credit crunch is likely, with large impacts on growth, but that its impact will be heavily concentrated on smaller businesses with the larger firms that dominate the US equity market likely to lose less on the growth side and gain more from the policy easing that targets the economy on aggregate.

Fed Balance Sheet



One question that comes up is whether it makes sense for the US Central Bank to continue QT while offering loans through the discount window and its new facility – although it is true that the two pull the Fed's balance sheet in opposite directions; the former affects the aggregate system-wide liquidity levels, which we think remain ample, whereas the latter addresses the uneven distribution of this liquidity and this is not easy for the FOMC to communicate, as at prima facie, **this is QE in play, not QT**. Two accounts on the US central bank balance sheet that are unrelated to QT or QE, but are all about whether or not the banks are in trouble: "***Primary Credit***" ("Discount Window") for banks in the US, and ***Central Bank Liquidity Swaps*** for banks in other countries for Greenback liquidity. On today's balance sheet, there are two new accounts, the ***Bank Term Funding Program*** (BTFP) and "*Other credit extensions*" that were announced last month as part of the liquidity support for banks and the depositor bailout with the US's FDIC. The Discount Window of US$153 billion, or Primary Credit, as it's dubbed, allows banks to borrow at 4.75% currently, against collateral, seeing a spike by US$148 billion, from US$5 billion in February to US$153 billion today, the biggest jump in the data, ever (pseudo-QE in all but name). This is expensive money for banks and it requires collateral, ergo, banks won't borrow long at this rate if they can avoid it and they tend to pay back those loans quickly, nonetheless, it has reversed the US Central Banks balance sheet tightening (QT) by a two standard deviation leap. US banks borrowed this way because they needed to have the funds immediately when depositors ran on banks post the SVB Financial collapse and subsequent panic. Put into context of the Great Recession and the number of overall deposits, the US$153 billion is much smaller than during 2007-2008 when US$111 billion was backstopped: In 2008, total deposits amounted to US$6.7 trillion; at the beginning of March 2023, total deposits were US$17.6 trillion, over 2.6-fold the level in 2008. Today's macro market pricing suggests an imminent end to the US Central Bank hiking cycle, which is likely incorrect and won't be witnessed until atleast 2024. Notwithstanding, US equities have generally rallied in the months following the end of past US hiking cycles, with the S&P500 posting an average three month return of +8% and rising in five of six episodes since 1982.



In step, on March 9-10, the Bank of Japan, or BOJ held its Monetary Policy Meeting (MPM) and in a unanimous vote decided to maintain the status quo across all monetary policy parameters, including ***Yield Curve Control, or YCC*** and asset purchase programs and the recent banking tensions have raised the uncertainty around the European Central Banks, or ECB's tightening cycle, as lower bank lending could weigh notably on the economic outlook despite recent steps to undertake their own continental QT. Lastly, for the Swiss, Americans and Asian ***Hot Currencies*** (especially the Australian Dollar), fresh in investors' memories is the recent long cycle of Greenback strength (2012-2022), during which the dollar strengthened thirty eight percent *vis-à-vis* its trading partners (in real terms). What is often forgotten is that the Greenback moves in long cycles of alternating strength and weakness, lasting each on average nine years (since 1978). From September 2022 to January, the US Dollar weakened over six percent, leaving investors wondering whether we are now on the other side of the mountain: a cycle of Dollar weakness. There are reasons to believe so; elevated valuations versus long-term fundamentals combined with a turn in short-term catalysts like growth differentials, interest rate differentials, flows and sentiment and it is important to remember, periods of Greenback depreciation have been associated with international equity outperformance albeit against a backdrop of less global macro financial stability. **Acta, non verba** [*Deeds, not words*].

australianstandfirst.com

This information contained herein has been prepared and issued Australian Standfirst Asset Management Pty Ltd ACN 612 265 219 as an AFS Representative 1276948 of Australian Standfirst Funds Management Ltd ACN 618 083 079 AFSL 510315 and is provided for educational purposes only and should not be taken as advice. This is not an offer to buy/sell financial products. We do not provide personal advice nor do we consider the needs, objectives or circumstances of any individual. Financial products are complex and all entail risk of loss. The price and value of investments referred to in this research and the income from them may fluctuate. Past performance is not indicative of future performance, future returns are not guaranteed and a loss of original capital may occur. Fluctuations in exchange rates could have adverse effects on the value or price of, or income derived from, certain investments. Certain transactions, including those involving futures, options, and over-the-counter derivatives, give rise to substantial risk as they are highly leveraged, and are not suitable for all investors. Please ensure you obtain professional advice (including tax advice) to ensure trading or investing in any financial products is suitable for your circumstances, and ensure you obtain, read and understand any applicable offer document.

All intellectual property relating to the information provided vests with Australian Standfirst unless otherwise noted and the research is provided on an as is basis, without warranty (express or implied). All views shared are Australian Standfirst views and do not represent any other organisation or individual (unless cited accordingly). The information, opinions, estimates and forecasts contained herein are as of the date hereof and are subject to change without prior notification. We seek to update our research as appropriate and where possible. Whilst the research has been prepared with all reasonable care from sources, we believe to be reliable, no responsibility or liability shall be accepted by Australian Standfirst for any errors or omissions or misstatements howsoever caused. No guarantees or warranties regarding accuracy, completeness or fitness for purpose are provided by Australian Standfirst, and under no circumstances will any of Australian Standfirst, its officers, representatives, associates or agents be liable for any loss or damage, whether direct, incidental or consequential, caused by reliance on or use of the research.