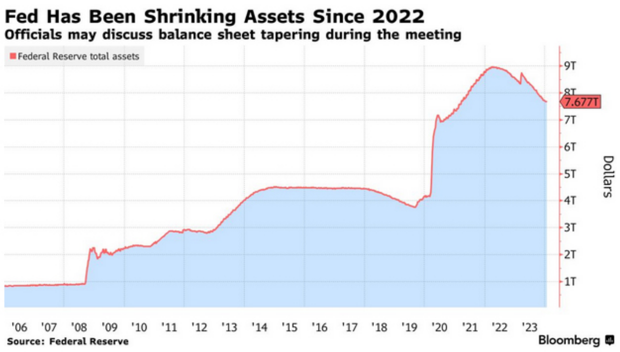
The Reflationary Effect Of Muted Quantitative Tightening (QT)

Evidencing The Stimulation Of Residual Printed Money



With more money printed over the past four years (4 years next month) than printed over all of human history before it, the premature cessation of its unwinding – posited to be either by this November or early 2025 – is consequential for the global economy and markets *secutus sum*. Muted Quantitative Tightening, or QT, has a substantial reflationary effect on Risk Assets across developed markets and remains stimulatory for some time to come.

According to Modern Monetary Theory, or MMT, the global economy is led by the US Dollar or Greenback, anchored in large part to the issuance of US debt products globally and thus, US liquidity matters to the continuance of *Risk On* momentum strategies.

Cite:- What The Fed's QE4 Means For Australian Investors, 22 October 2019
Cite:- Modern Monetary Theory or MMT, 1 April 2019
Cite:- The Inexorable Effect Of Unconventional Monetary Experiments On Equity And Bond Prices, 5 July 2020
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
Cite:- Taper Tantrum 2.0: Quantitative Tightening (QT), China's Nocebo Effect & Why To Avoid Emerging Markets (EM), 7 February 2022

At the onset of the pandemic in March 2020, the US's bellwether Federal Reserve, began increasing its balance sheet by buying large quantities of US Treasury debt and Mortgage-linked Securities, known as Quantitative Easing, or QE, similar to what it had done post the seismic shocks of the Great Recession.

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

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

Cite:- Bidenomics, Slavery Reparations & The Global Reflation Supercycle: Atoning For America's Original Sin Recompensed Via Even More Money Printing (US$7-9 trillion), 23 March 2021

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:- 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

Subsequently, it began reducing its balance sheet gradually – quantitative tightening in practice – in June of 2022 by not reinvesting all the proceeds of maturing securities. As of early January 2024, the US's FOMC had reduced its assets from a peak of nearly US$9 trillion to US$7.7 trillion. FOMC Chairman, Jerome Powell, said at his 31 January 2024 press conference that FOMC officials will discuss "*balance sheet issues*" at their upcoming 19-20 March meeting, which has been interpreted by pundits as meaning at some point, likely in late 2024 or early 2025, the US central bank will stop shrinking its balance sheet, shift to an *"ample reserves"* framework and normalise their Overnight Reverse Repurchases, or ON RRP, programme for the remainder of the *Roaring Twenties*.

In January 2022, the FOMC listed several principles for reducing its balance sheet; among them was this: "*Over time, the Committee intends to maintain securities holdings in amounts needed to implement monetary policy efficiently and effectively in its ample reserves regime*". At his December 2023 press conference, Fed Chair Jerome Powell said the plan is to "*slow and then stop the decline in the size of the balance sheet when reserve balances are somewhat above the level judged to be consistent with ample reserves*".

Cite:- Understanding The Financial Markets Tumult of 2022: Maintaining Portfolio Quality In The Era Of Quantitative Cheating, 19 June 2022

Why this is all material to the evidencing of the stimulatory effect of muted QT is quite straight forward: regardless of the fractional quantum unwound, the vast majority of printed money since March 2020 remains in the system, circulating and crowding out lower substacks of the capital stack and across asset classes to boot.

In central banking parlance, Reserves are funds that banks deposit at the central bank {plus the cash in bank vaults}; no other asset is as safe or as liquid. Banks use them during the day to settle payments between banks or between customers of different banks. Banks hold reserves so they always have liquid assets that can be tapped if they confront a large outflow of deposits and to satisfy liquidity regulations and supervisory guidance.

Cite:- Investors Be Warned MIFID II & MIFIR Could Be The Work Of The Devil Himself, 29 November 2017

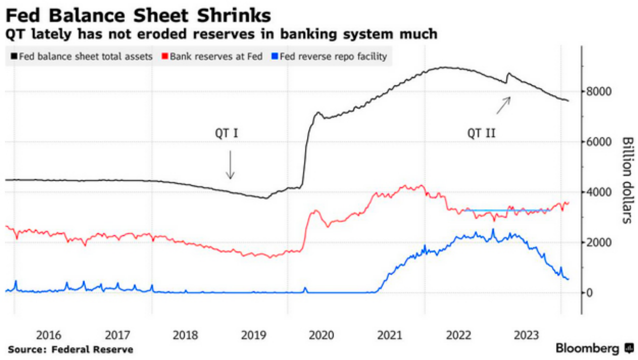
The FOMC's main lever for steering the US economy is adjusting short-term interest rates— particularly the federal funds rate. That's the rate banks charge each other for overnight loans and it's also a benchmark for other short-term rates. Before the Global Financial Crisis, or GFC, the FOMC used changes in the supply of reserves to influence the federal funds rate in what is known as a scarce reserves regime. In that era, banks held as few reserves as possible, in part because back then the US central bank did not pay interest on those deposits and thus the FOMC actively managed the quantity of reserves in the financial system by buying and selling short-term US Treasuries and on a daily basis.

Cite:- Central Banks Are Now Market Makers: Reshaping The Global Economy From A Torus Revolution Towards A Torus Knot, 22 July 2022

When the FOMC buys Treasuries or other securities, it pays the sellers of those securities with cheques drawn on itself >> when the sellers deposit those cheques at their banks, those claims on the US Federal Reserve become new reserves in the banking system. In short, the central bank's buying of securities creates bank reserves. When the FOMC sells Treasuries, the process works in reverse and bank reserves decline. Increases in the supply of reserves tend to push down the fed funds rate (the price of reserves) and other interest rates, while decreases in the supply of reserves raise interest rates. In the days before the GFC, the Federal Reserve Bank of New York, which manages the FOMC's money market operations, carefully monitored banks' fluctuating demand for reserves and adjusted the Federal Reserve's daily purchases and sales of securities (known as open market operations) to keep the US federal funds rate close to the target level set by the FOMC.

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

All that changed during the Global Financial Crisis in 2008. The crisis was followed by the Great Recession, which the US central bank tried to fight by pushing short-term interest rates down almost



to zero (Zero Interest Rate Policy, or ZIRP) or in technical vernacular, the Zero Lower Bound, or ZLB. That proved insufficient to shore up the struggling US and consequentially, global economy. Accordingly, the FOMC began purchasing large quantities of long-term government bonds and mortgage-backed securities via QE programmes, with the goal of pushing down long-term interest rates, which had remained above zero. Long-term rates are important because they influence mortgage rates and the rates that businesses pay to borrow. When the US central bank bought the longer-term bonds, it created bank reserves: from an accounting perspective, bonds that the Federal Reserve hold, sit on the asset side of its balance sheet. Increasing assets (QE) must be matched by increasing liabilities, mainly reserves and currency. Shrinking assets (QT) must be matched by reducing liabilities.

In conjunction with its adoption of QE in 2008 and 2009, the Fed moved to an ample reserves regime in which banks hold substantial quantities of reserves. Banks were willing to do so because the FOMC started paying interest on those reserves. The switch to ample reserves and the Federal Reserve's payment of interest changed how the central bank controls short-term interest rates. Today, the FOMC no longer influences the fed funds rate by injecting or withdrawing reserves every day but instead administratively puts a floor on short-term rates by the interest rate it pays banks on their reserve deposits (commonly known as the Interest on Excess Reserves Rate, or IOER) and the interest rate it pays other money market funds and other financial institutions on their deposits with the US Federal Reserve (the Overnight Reverse Repo Facility, or ONRRP rate). Most central banks outside North America use a similar approach to control short-term rates.

Cite:- Australia Begins Quantitative Easing, 17 March 2020
Cite:- Australian REPO Operations, March 2020, 22 March 2020

A regime in which banks hold far more reserves than necessary to meet legal requirements and banks' demand for liquidity buffers is known as abundant reserves regime. The US is effectively in an abundant reserves situation now, but the FOMC's stated policy is to move to an ample reserves regime.

As long as the US central bank was keeping short-term interest rates at zero, a financial system flush with reserves didn't pose any challenges to its ability to steer the economy. However, in 2015, the FOMC wanted to begin raising interest rates. Buying and selling modest amounts of reserves—traditional open market operations—would have little influence when reserves are so plentiful. The FOMC, accordingly, relied on raising the IOER and the ON RRP to lift short-term rates, triggering what has come to be known as the first *Taper Tantrum* [cite:- Rates Riot Behind The Market Correction, 29 August 2015].

In an ample reserves regime, the FOMC supplies enough reserves so that the fed funds rate (where demand for reserves equals supply) changes very slightly when the quantity of reserves in the banking system changes. To help determine when reserves are sufficient—that is, when reserves aren't scarce—the Federal Reserve monitors short-term interest rates in money markets, such as rates in the repo market, an important market in which one institution lends another money for a very short-term period collateralised by US Treasury securities. The FOMC anticipates that banks with lots of reserves will use them to lend in the repo market when rates there rise, which smooths out sharp movements. If banks are reluctant to use their reserves to lend into the repo market even when repo rates are unusually high, that's a sign that banks feel they don't have reserves to spare—that is, reserves are not ample.

A 2019 episode shows the challenge the Fed faces in figuring out how ample reserves are. As the FOMC shrank its balance sheet from October 2014 to September 2019, the level of bank reserves fell to around US$1.5 trillion. The FOMC believed that would leave the banking system with sufficiently ample reserves. That proved wrong, as the central bank learned when short-term rates in money markets shot up in September 2019 and banks held onto reserves instead of using them to lend at attractive interest rates; in response, the Fed again began increasing reserves and the size of its balance sheet.

Cite:- 'End The Fed', 24 September 2019
Cite:- Bull Rally And Not A Recession, 11 September 2019
Cite:- Market Microstructure Theory and the Australian Dollar, 14 August 2019
Cite:- How The Inverted Yield Curve Affects Australia, 20 June 2019
Cite:- Inversion Reversion Subversion, The Inverted Yield Curve, 1 June 2019
Cite:- US Equities Still Place To Be For Growth, 17 April 2019
Cite:- Cross Asset Inflation, 13 March 2019
Cite:- Seismic Shifts In 2019, 16 January 2019

Over the past couple of decades, the quantity of reserves that banks consider ample has risen because of more stringent liquidity regulation and because banks want larger cash buffers in the wake of the GFC. In an email report, Goldman Sachs economists say they expect the Fed to stop shrinking its balance sheet when "*reserves go from 'abundant' to 'ample' in aggregate—that is, when changes in the supply of reserves have a real but modest effect on short-term rates. So far, key short-term rates are still well below the interest on reserve balances rate on most days and the fed funds rate remains insensitive to changes in reserves, suggesting that reserves remain abundant*". Goldman Sachs and Morgan Stanley predict the Fed will stop QT in the first quarter of 2025. J.P. Morgan economists see an earlier stop in November 2024.

Some US central bank officials view the total size of ON RRPs as a gauge of the amount of liquidity in financial markets and thus one guide to when the FOMC should stop reducing its balance sheet. In short, when the Federal Reserve reduces its balance sheet to the point where reserves are deemed ample (as opposed to abundant), there will be no need for the ON RRP. Between the beginning of May 2023 and the beginning of January 2024, ON RRP balances fell from about US$2.2 trillion to around US$700 billion (largely because money market mutual funds turned away from ON RRPs to get slightly higher rates on short-term U.S. Treasury securities). In other words, much of the FOMC's QT has been reflected on the liability side of its balance sheet as a decline in holdings in the ON RPP facility as opposed to a reduction in bank reserves. When ON RRP balances become very low, further QT will result in lower reserve balances & a decline in ON RRP balances to very low levels may therefore signal that the end of QT is in sight.

The FOMC has seen the difficulty of assessing when bank reserves are ample and the volatility that can result in money markets if reserves prove less than ample. So in July 2021, the Fed formally created a new backstop – the Standing Repo Facility – to which banks can turn at moments of stress if they are in urgent need of cash "*to support the effective implementation of monetary policy and smooth market functioning*"; the facility offers the banks and primary dealers' cash (think of them as substitutes for reserves) in overnight loans collateralised by US Treasury or agency debt or government-backed mortgage securities.

In totum, the residual of unprecedented money printing campaigns has left a significant reflationary tailwind ratcheting listed bourses higher and will continue to do so, evidently, for some time to come.

Australian Standfirst takes the responsibility of managing our client's investments seriously and welcomes all feedback.

Stirling Larkin, CIO,
Australian Standfirst Asset Management

Legal Disclaimer

Published by
Australian Standfirst Asset Management Pty Ltd
GPO Box 4808, Melbourne VIC 3001 Australia

Australian Standfirst

australianstandfirst.com

S&P Dow Jones Indices
A Division of S&P Global

Dow Jones Sustainability Indices 20th Anniversary
In collaboration with SAM