THE FED'S LIQUIDITY CONUNDRUM AND SHORT-TERM RATES DILEMMA

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In March 2020, as a response to the pandemic, the Fed initiated quantitative easing at a massive scale. Currently, the Fed is still creating $120 billion through QE every month that supplies significant liquidity to the financial system. But has QE run its course, causing unwanted side effects?

As the economy recovered from the pandemic and as inflation expectations rose, long-term yields started climbing slowly in August last year. Then in February this year, yields started accelerating higher. But short-term yields moved lower. That was the first sign something isn't right. Then in April, long rates rolled over and confirmed the down trend in yields.

Source: FRED, Omnia Family Wealth

On June 18, investors were waiting to hear the Fed's remarks after the FOMC meeting. The consensus was that yields will rise, but while the Fed was more hawkish than the market expected, Treasury yields actually continued lower. My guess is that just like in 2018, the bond market is telling the Fed that under all this massive, ongoing stimulus, the economy is not as strong as it appears.

THE OVERNIGHT REVERSE REPO PROGRAM

A repo or "Repurchase Agreement" is a form of short-term borrowing in government securities, usually overnight but can be extended, where financial institutions holding securities can borrow cheaply from the Fed using the securities as collateral. A reverse repo is exactly the opposite where the Fed sells securities and raises cash in return. The Fed uses reverse repos to keep the federal funds rate in the target range. You can learn more about repo and reverse repo here.

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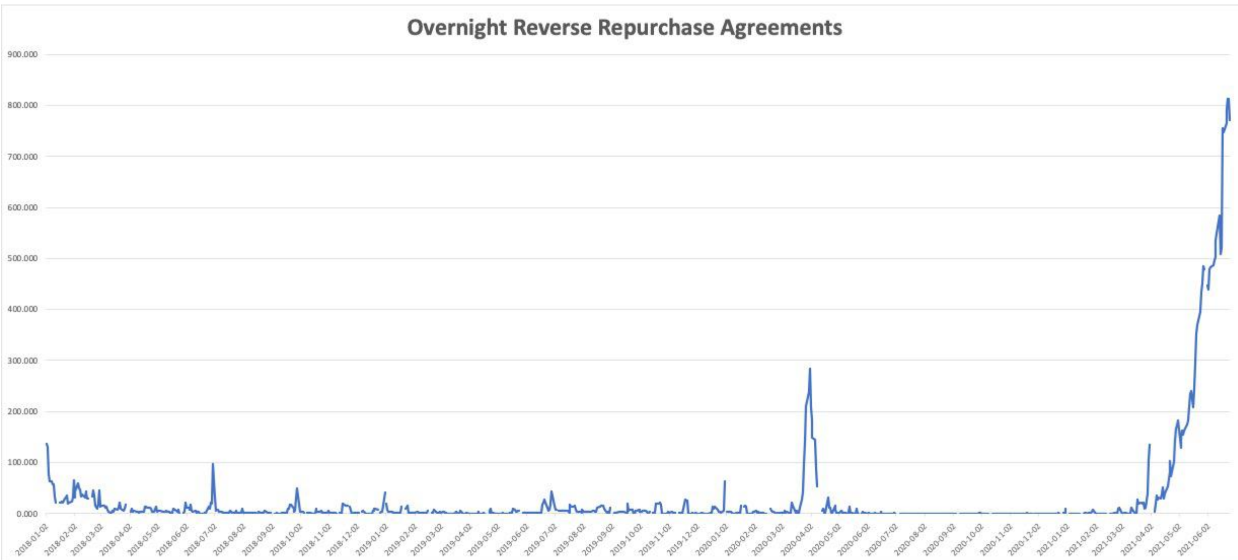
From May this year, we saw an increase in the Fed's reverse repos operations (May 9 H.4.1. Report). On May 6, it was at $166 billion, on June 9 it stood at $487 billion, on June 16, $548 billion, and on June 24, it jumped to $766 billion. Looking into this, we found that many money market funds flooded with dollars needed a place to park some of the cash (which they receive 0% on) and turned to the Fed.

It seems the banking system can't handle the massive liquidity the Fed is injecting into the financial system (which we wrote about here) and has reached an inflection point, which is why we see the Fed "sucking" money out of the system using reverse repos. There's just too much liquidity. **My interpretation is the Fed is mostly using this facility to prevent short-term interest rates from becoming negative, which would have significant unwanted implications.**



Source: FRED, Omnia Family Wealth

H.4.1 REPORT- FACTORS AFFECTING RESERVE BALANCES

1. Factors Affecting Reserve Balances of Depository Institutions (continued)
Millions of dollars

Reserve Bank credit, related items, and reserve balances of depository institutions at Federal Reserve Banks	Averages of daily figures: Week ended Jun 23, 2021	Change from week ended Jun 16, 2021	Change from week ended Jun 24, 2020	Wednesday Jun 23, 2021
Currency in circulation (11)	2,178,457	- 150	+ 217,299	2,179,557
Reverse repurchase agreements (12)	1,012,189	+ 250,908	+ 788,424	1,055,931
Foreign official and international accounts	245,395	+ 25,937	+ 21,634	242,281
Others	766,794	+ 224,971	+ 766,790	813,650
Treasury cash holdings	43	0	- 37	42
Deposits with F.R. Banks, other than reserve balances	1,040,050	- 28,601	- 791,115	1,051,325
Term deposits held by depository institutions	0	0	0	0
U.S. Treasury, General Account	734,689	+ 80,800	- 889,253	733,877
Foreign official	5,701	- 21,459	- 10,526	6,769
Other (13)	299,661	- 87,941	+ 108,664	310,679
Treasury contributions to credit facilities (14)	50,278	0	- 63,722	50,278
Other liabilities and capital (15)	50,214	- 4,131	+ 2,064	48,342
Total factors, other than reserve balances, absorbing reserve funds	4,331,231	+ 218,026	+ 152,913	4,385,475
Reserve balances with Federal Reserve Banks	3,808,042	- 131,996	+ 889,286	3,765,713

Note: Components may not sum to totals because of rounding.

Source: https://www.federalreserve.gov/releases/h41/current/

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THE SUPPLEMENTARY LIQUIDITY RATIO OR "SLR"

On March 31, the Fed terminated the supplementary leverage ratio (SLR) exemption for bank holding companies it announced last year in response to the Covid-19 crisis. The exemption allowed banks to exclude treasuries and other papers issued by the Fed from its SLR calculation. The SLR rule was designed to encourage banks to reduce their risky lending habits and to encourage them to instead purchase government debt. The SLR is the amount of liquid assets other than cash a bank has to hold in reserves before it can offer credit to customers. It is another tool to reduce systematic risk in the financial system. SLR = (tier 1 capital)/(total leverage exposure). The Fed also used SLR to:

1. Control the expansion of bank credit
2. Ensure the solvency of the bank
3. "Incentivize" commercial banks to invest in government bonds
4. Control or adjust liquidity in the market

By excluding these treasuries, banks had more flexibility to lend money, accept deposits, and participate in the treasury market. But what the Fed didn't take into consideration, by not renewing the exemption, is that as banks look to do something with the amount of reserves, they will reject and reduce new deposits which will send investors into money market funds that invest in T-bills, **depressing short term yields even further.**

THE RISK FOR MONEY MARKET FUNDS

The additional flow of money and the potential for negative short-term rates poses high risk to money market funds and to the financial system. These funds currently hold about $4 trillion.

Money market funds play an important role. They are a significant provider of overnight funding for corporations by purchasing commercial paper and for banks with acceptances and CDs. They are also large purchasers of treasury bills and repo agreements.

If short-term rates become negative, money market funds will struggle to generate positive returns, and investors would withdraw capital. This will then disrupt the overnight funding market and disrupt the smooth functioning of the financial system. **That is the main reason for the increase in reverse repos operations.**

The Fed is in a tough spot. Liquidity is a double edge sword. On one hand, falling long-term yields are telling the Fed the economy is not as strong without stimulus despite inflation fears, and talking about raising rates and tapering is premature. On the other hand, massive liquidity from ongoing QE has created some serious unwanted side effects like the risk of short-term yields turning negative. For many investors, these are background noises, and yes, the monetary system is very complicated to understand, but as we saw over and over again, it is critically important for understanding the potential implications of the Fed actions on liquidity and asset prices.

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