MI2 Presentation for Macro Voices

January 2020

Debate does liquidity inflate assets?

- There are two distinct camps in the Fed

- One group believes that QE/Liquidity doesn't directly flow into risks assets and especially stocks. Instead, it works via expectations, lowering the price of the risk free asset. So it's just another form of rate cut

  "I want to emphasize that growth of our balance sheet for reserve management purposes should in no way be confused with the large-scale asset purchase programs that we deployed after the financial crisis," Powell

  "QE conspiracists can say this is all about the balance sheet growth. But someone explain how swapping one short- term risk-free instrument (reserves) for another short-term risk-free instrument (bills) leads to equity repricing. I don't see it" Kashkari

- The other utterly disagree. They believe that players are able to leverage liquidity and that the former don't want to confess to the link, because they don't want to admit to creating an asset bubble.

  "My own view is it's having some effect on risk assets," Kaplan said. "It's a derivative of QE when we buy bills and we inject more liquidity; it affects risk assets. This is why I say growth in the balance sheet is not free. There is a cost to it." Kaplan

  "I think you have to be careful and frank on what drove the markets. Look at all the interviews you've had since we've started the QE program and it was the Fed, the Fed, the Fed. All driven by quantitively easing. That's not how markets should be working. We frontloaded and enormous rally to achieve a wealth effect" Richard Fisher

To see who is right lets go back to the beginning

Prior to 2000 the correlation between policy and financial conditions was positive
But then it flipped!

Central banks target broad financial conditions. Prior to 2000, the correlation between financial conditions and rates was positive (green) i.e. rates fell and FC eased. That changed in 2000 when the correlation became negative (purple)

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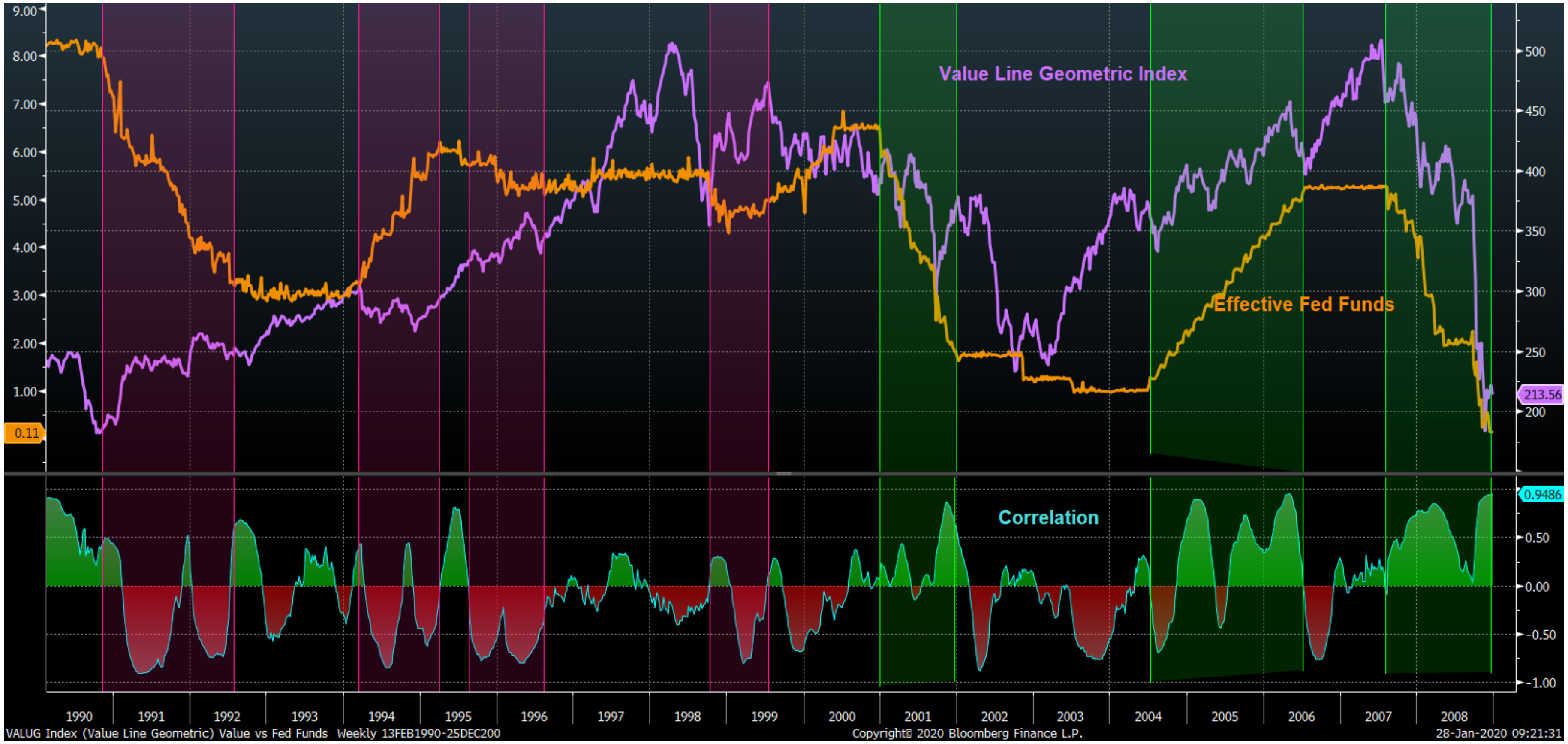
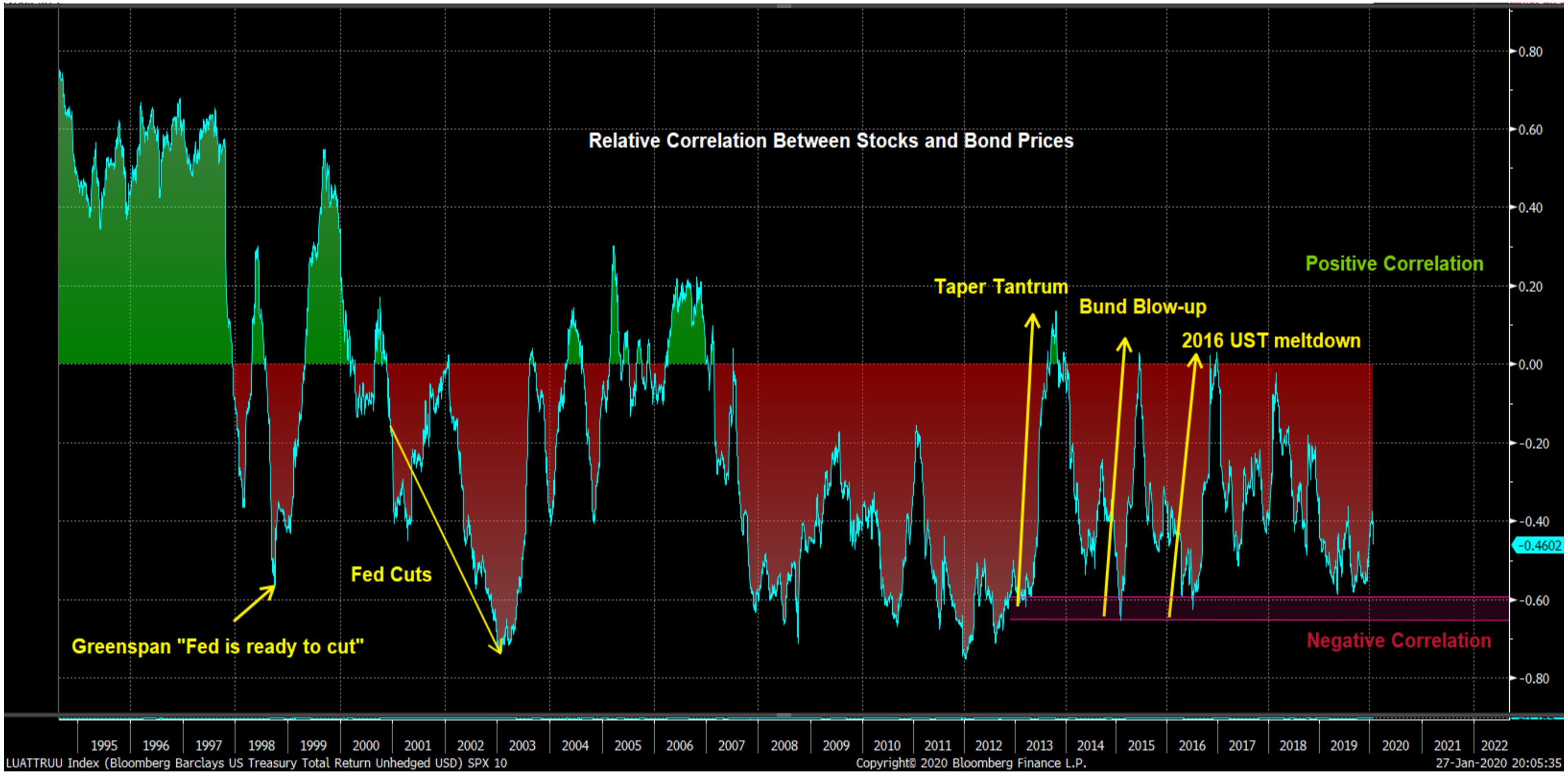
We think the reason is that post the dot.com bubble the ability of conventional monetary policy to direct stocks broke down

Prior to 2000, the correlation between Fed Funds and stocks was negative (purple) i.e. as the Fed eased stocks rose and vice versa
But after 2000, rates alone seems insufficient to control stocks and the correlation became positive (green)



For the Fed this was a big problem because in 1998 they'd reoriented policy from fight inflation to deflation

Prior 1998, the Fed's objective was to supressing inflation. Rates were hiked (bond prices fell) and stock fell i.e. positive correlation. Post Greenspan's "put" the objective of policy was deflation. That mean that stocks prices became a more important policy objective and rates were cut (bond prices rose) to support stocks i.e. negative correlation



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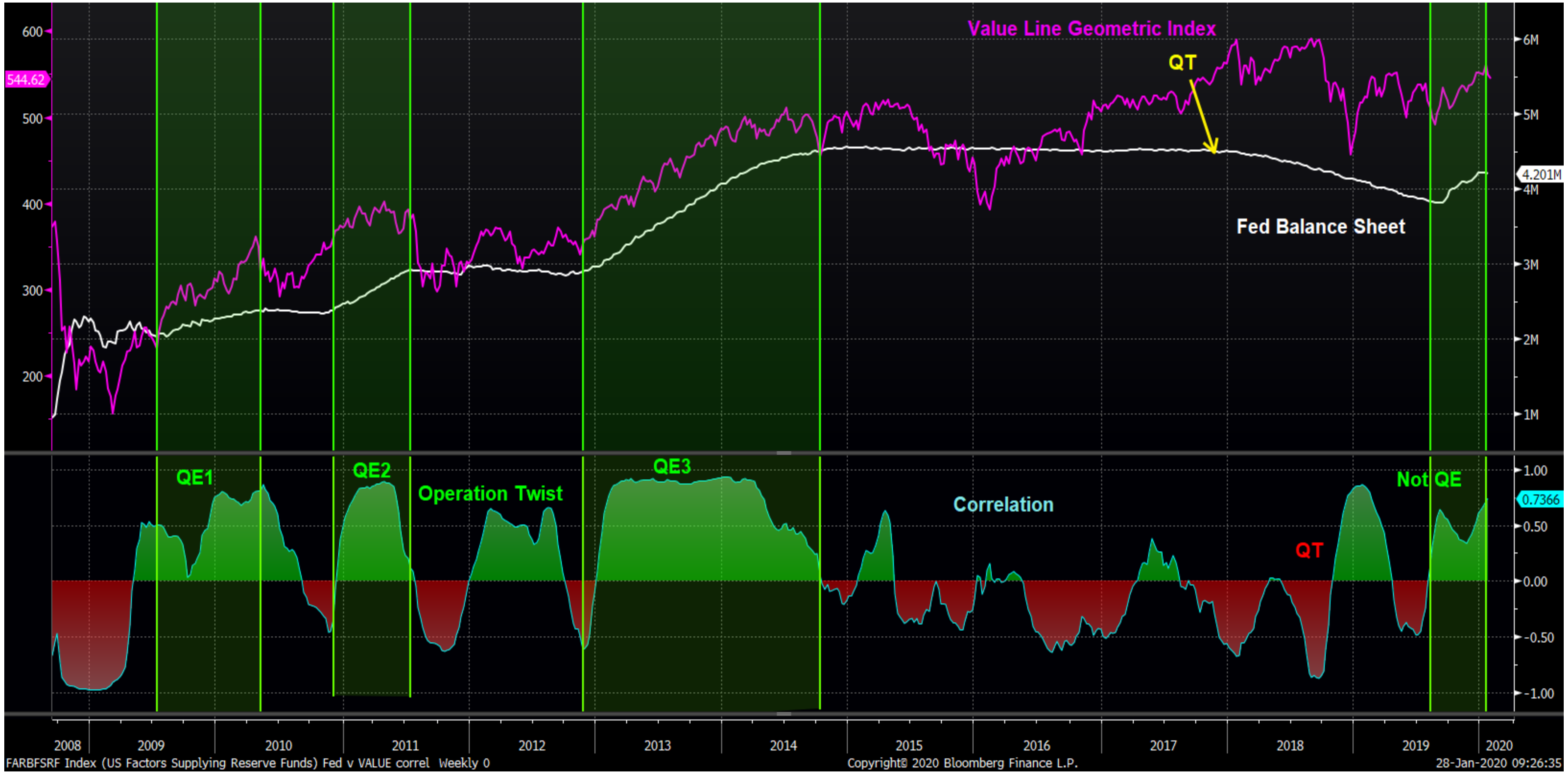
This issue persisted until the GFC when the emergence of the zero bound forced then to create a new tool. For stocks it was highly effective!

Note how during QE and QT the correlation between stocks and the balance sheet approached 90%



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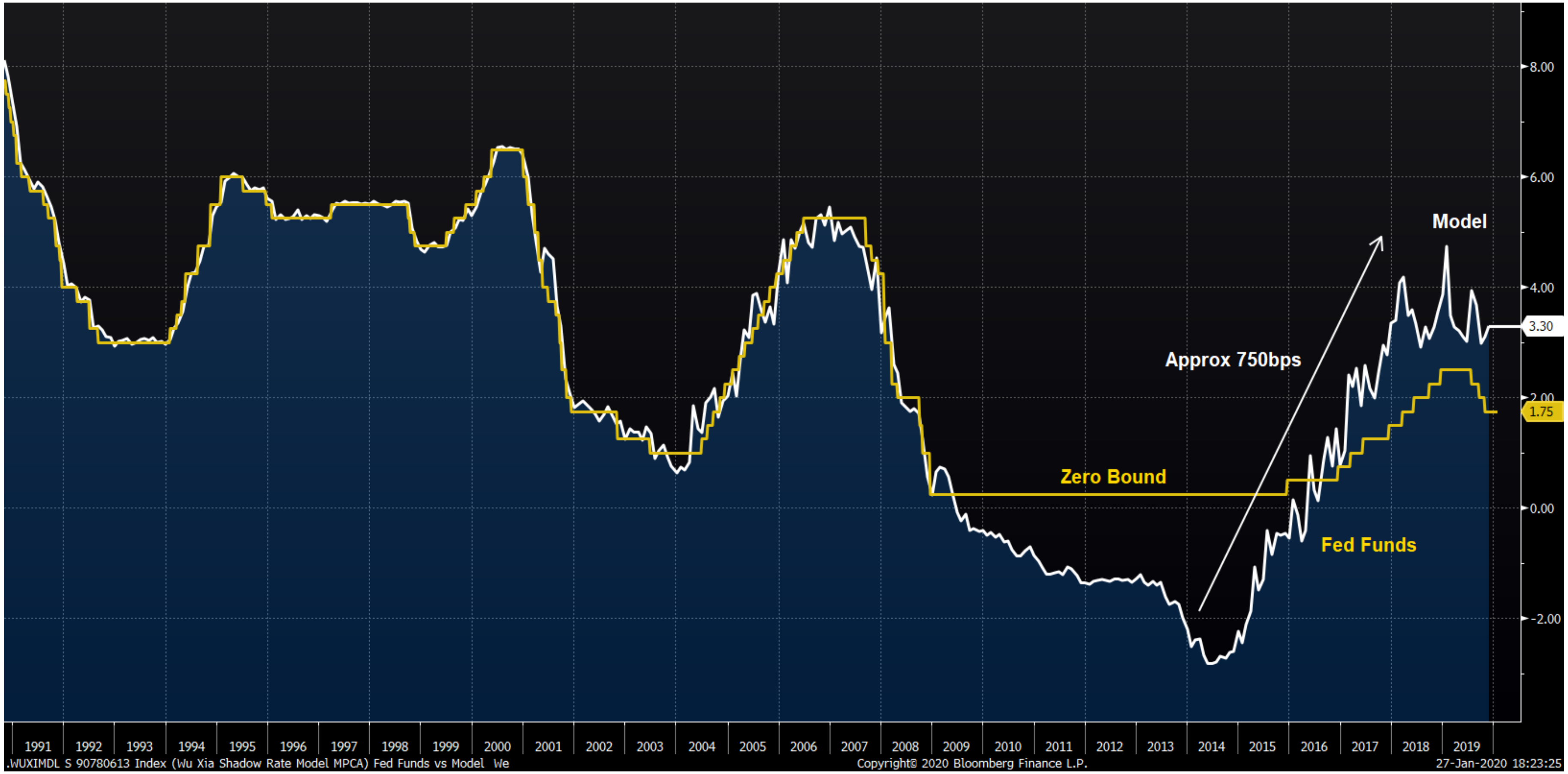
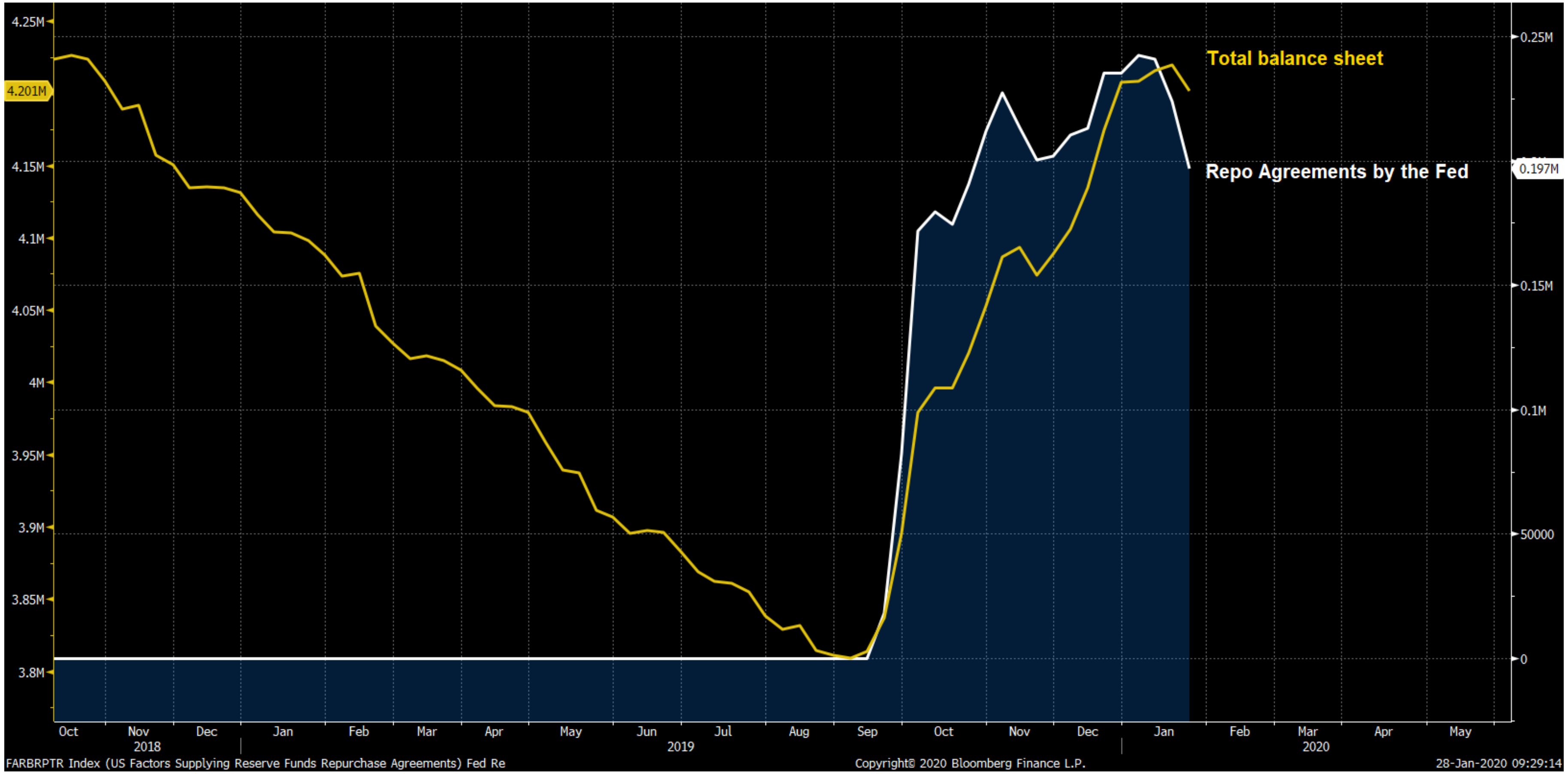
Indeed it was so powerful that when they started to raise rates they miscalculated how much QT would add to their tightening cycle

This model was designed by the Fed to measure the efficacy of QE, which in 2014 effective drove rates to almost -3%
But it also suggests that QT added massively to the 225bps of Fed Fund hikes



The result was a massive overtightening and thanks to plumbing problems in money markets, once again the Fed was forced to resort to liquidity

The explosion in repo operations resulted in a substantial expansion of the balance sheet



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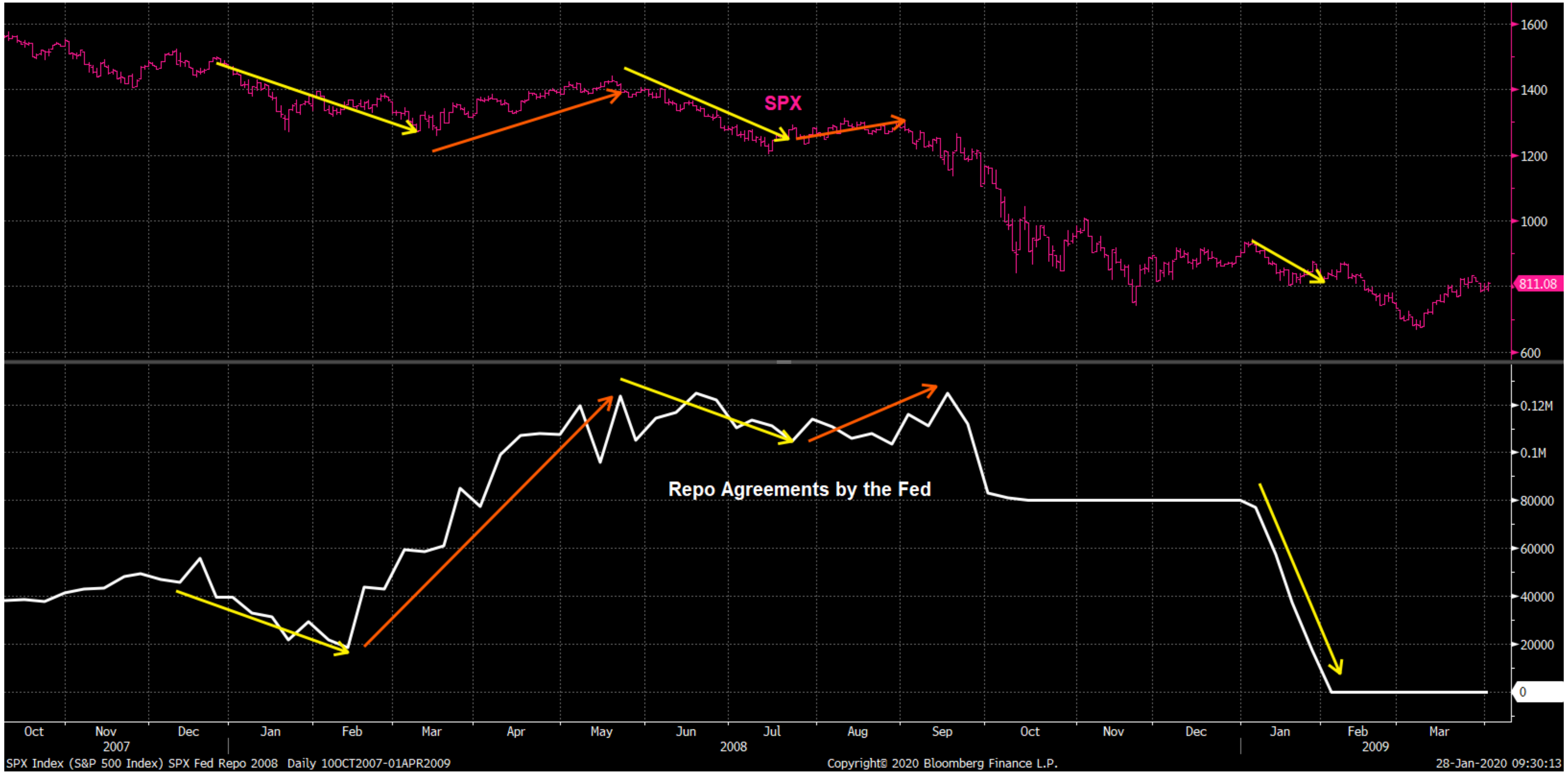
But according to Powell Repo is not QE
However, history suggests he might not be right!

In early 2008 the Fed used increased repo operations to address problems at AIG

Ultimately this wasn't enough and when Lehman failed QE was launched but at the start the two operations were viewed as fungible



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Don't forget in 2000 the Fed used short term liquidity to address a problem and the impact was profound

In preparation to Y2K the Fed opened a number of special financing facilities. At that point the Nasdaq which was already up 100% YoY rose 80% in 5 months until 2 weeks before they expired and it collapsed.

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As in 2000, once again the money has flowed to momentum

Apple a $1tln company was up almost 50% YTD but courtesy of the Fed's "Not QE" it jumped another 50%

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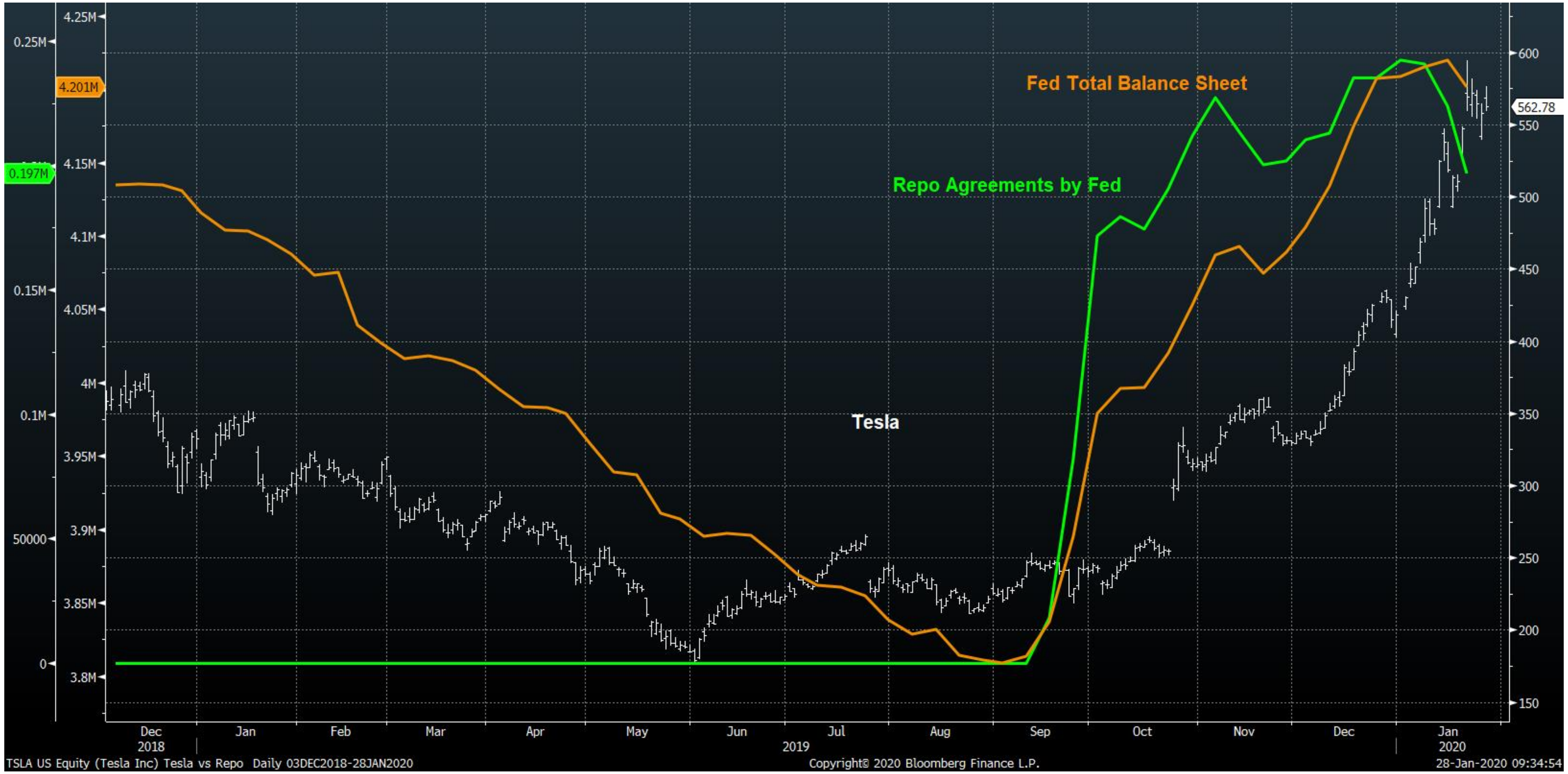
A heavily shorted stock like Tesla exploded

Having be range bound for 3 years between $180 and $390 the Fed's largess decided that the bulls were the winner



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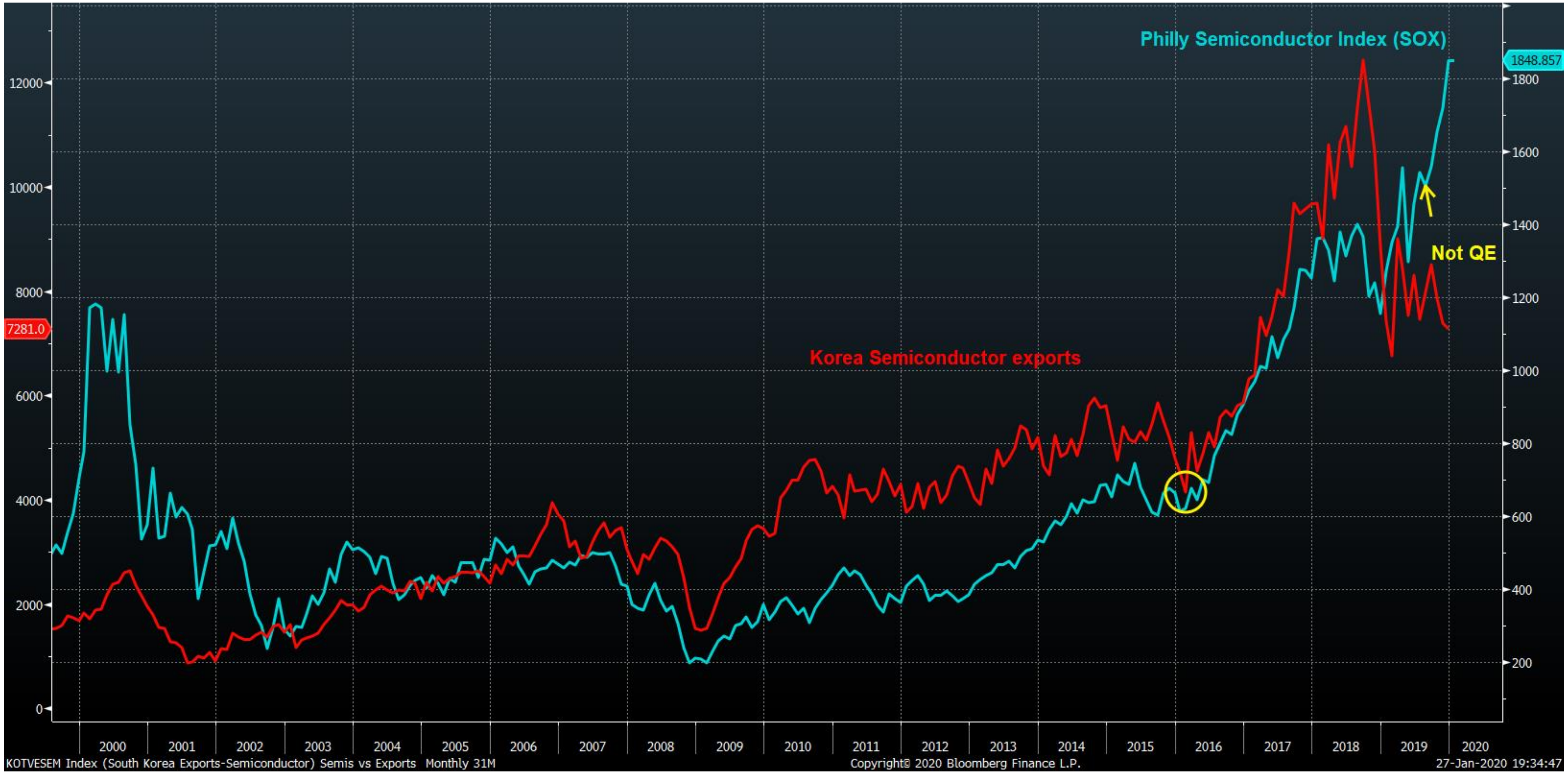
And sectors like semi's that have already diverging from their fundamental have been pushed to extremes

The last time that the SOX diverged this far from underlying fundamentals was during the dot.com bubble



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The problem is that moves like this just aren't sustainable

There's an inherent vulnerability to parabolic moves

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Indeed we are reminded what we wrote in September 2018

That brings us to the big daddy Amazon, where given that 90% plus of analysts have a buy recommendation, it is sacrilegious to suggest that we might have a top in place. However, we aren't interested in fundamentals, just chart patterns. In that context, the doubling of the stock since the end of last October, which in the process has added a mind-blowing $500bln in market cap certainly counts as a parabolic move, i.e. the blow-off final move of the "Mania" phase. As we've discussed, while these moves always look like they can go to the moon, the reality is that just like a jet fighter that "goes vertical" at some point, it runs out of oxygen or, in the case of Amazon, marginal buyers to suck in. <u>That's a tipping point, because it doesn't fly off to the side but loses momentum and drops sharply.</u>

And as in the past the Fed has opened up that vulnerability by slowing the recent balance sheet expansion!

Starting in September the Fed's balance sheet expanded $100bln per month
But this month its down $30bln and going forward unless they have a change of plan at best its likely to be flat to slightly down
In the past turning off the liquidity tap resulted in 10-20% corrections in stocks

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So to sum up

- Post the dot.com bubble, conventional monetary policies ability to influence financial conditions via stock prices broke down just as the Fed started to target deflation
- This ineffectiveness was tested to breaking point by the GFC and the Fed was forced to resort to QE, to offset a massive contraction in the global $ balance sheet
- Thank goodness this proved a highly effective tool at supporting risk assets but …
- Unfortunately, it appears to have created a dependence between asset prices and QE. The $ banking system and $ markets are reliant on the Fed's balance sheet at the margin. Even curtailing the flow of liquidity let alone cutting it seems to create instability and fragility
- One group think QE works via the expectations mechanism, its "psychosomatic" and only works because markets believe it works. But even if that's the case, they are trapped unless they are willing to call the markets bluff
- But we think naysayers in the Fed who dismiss the link are using the wrong banking model
- If we think of the total public/private dollar balance sheet in aggregate then swapping one asset (bills/bonds) for reserves would in theory be a wash
- But the Fed actually increases its balance sheet. So the total grows. If this was a game of musical chairs the Fed is actually adds more chairs
- Furthermore the private sector gets reserves for bills/bonds it wanted to hold and is displaced into other assets. A move exacerbated by leverage. There is almost certainly some portfolio balance effect
- The question is can they ever stop? (If they knew how this all worked, why did they lose control of repo?)