Economic Views Brief

Russell T. Price, CFA®, Chief Economist
November 15, 2019

Q&A ON RECENT FEDERAL RESERVE ACTIONS:

• **Liquidity problems and the return of Quantitative Easing (QE):** The Federal Reserve recently had to inject billions in new liquidity into overnight lending markets. Officials have also announced plans to continue large-scale Treasury Bill purchases in the near-term as a more permanent solution to the liquidity crunch in overnight lending markets (which includes the “repo” market). Is this a sign of trouble in the financial system?

• **Three quick cuts. Now a pause?:** After hiking interest rates four times in 2018 (for a cumulative increase of 1.0%), Federal Reserve officials recently reversed course and cut rates three times since July 31st (for a cumulative reduction of 0.75%). Is the Fed worried about a possible recession? And what might the rate cuts mean for the economy and markets?

**Liquidity problems and the return of QE:**

**Q:** In September, the banking system’s overnight lending market faced a dearth of liquidity, prompting the Federal Reserve to inject billions of new liquidity into the system to stabilize the market. Since then, the Fed has announced plans to inject billions more as to provide adequate liquidity. This all sounds uncomfortably similar to some of the problems that occurred just ahead of the Financial Crisis. Are we headed down that road again?

**A:** The financial system recently experienced liquidity problems in the overnight lending market (part of which is referred to as the “repo” market), but the factors responsible in this case are significantly different than those leading up to the Financial Crisis.

Broadly speaking, we believe the U.S. financial system is in good health and of little risk to underlying economic conditions.

Let’s look at the issue and put it in English: First a little background… Banks are required to hold a certain amount of their assets in reserve, sort of an emergency fund in case the car breaks down, or in their case, so they can stay afloat even if a relatively large percentage of the loans they’ve made go bad. The reserve requirements were increased materially after the 2008 Financial Crisis. At the end of each day some banks will have more than they need to meet their reserve requirements, while others may need to borrow from the excesses of peers to meet their requirements. Banks will also often borrow cash from each other to meet the expected needs of their customers.

During the Financial Crisis of 2008, this overnight lending system basically came to a halt. Financial institutions stopped making loans to each other because they were worried that they may not get their cash back, or they might require the liquidity to offset their own potential losses. There were serious, and justified, concerns over the financial health of their fellow financial institutions because bad loans were piling up and the system lacked the transparency that it needed. Although U.S. Treasury securities are often used as collateral on overnight bank-to-bank loans, banks with the reserves to lend were also worried that they would be left with less “liquidity” (i.e., cash) should they need it. Indeed, this was a sign of serious financial system problems.

Recent problems in the overnight lending market, however, have been attributed to much different circumstances. The Fed seems to have drained too much liquidity from the system as they reduced the size of their balance sheet over the past two years, while demand for liquidity jumped due to seasonal factors and the unprecedented borrowing needs of the U.S. Treasury. Heightened reserve requirements added to the shortfall in available liquidity.
To explain, large banks hold both cash and U.S. Treasury securities. U.S. Treasury securities are considered “risk free” and are a close substitute for cash given that they are usually very easily converted into cash. But when a customer comes in to cash a check you can’t very well hand them a Treasury bill – you need the cash, which is part of the liquidity we are referring to in this case.

Around mid-September, a lack of liquidity appeared in overnight lending markets. There were banks wanting to borrow cash but those that had excess cash didn’t want to part with it. The reasons appeared driven by a combination of reduced supply and increased demand.

Reduced Supply: The Fed may have drained too much liquidity from the system as it worked down its balance sheet over the last two years. To understand how this works, we refer to the chart at right. The blue line in the chart represents the dollar value of Treasuries owned by the Federal Reserve. From 2008 to 2015, the Fed purchased nearly $2.0 trillion of U.S. Treasury debt beyond what it already owned. Functionally, this meant that the Fed was buying Treasuries out of the banking system and replacing it with cash.

The blue line also shows us that from November 2017 until this past July, the Fed reduced its Treasury holdings. Over this period, its holdings fell by approximately $370 billion, according to the Federal Reserve. Functionally, this meant cash was coming out of the financial system.

This takes us to the red line in the chart, and the question of: what is the appropriate level of cash that the system needs? There is no exact formula or magic ratio of what amount of cash is appropriate, but we believe the line is instructive of the problem. Specifically, the red line represents the percentage of all U.S. Treasuries that are owned by the Federal Reserve. As shown, prior to the Financial Crisis, the Fed seemed happy owning Treasuries equal to about 16% of total U.S. government debt (issued, outstanding and held by the public). This ratio jumped in conjunction with the moves taken to stabilize the financial system and economy during and after the Financial Crisis, but more recently, the ratio has fallen below its pre-Crisis levels as the Fed sold-down its Treasury holdings. At the end of September, the ratio stood at 13%.

This is not a scientific or direct equation, but it does suggest that the Fed may have drained too much liquidity from the system, in our view.

Another way to look at it... When the Fed ended its balance sheet reduction program in July, excess reserves in the financial system stood at approximately $1.3 trillion (see chart at right). This indicates that officials thought that this level should be enough to provide for adequate bank to bank lending. As it turned out, the level was too low, and the recent ramp up of Treasury issuance quickly consumed those reserves (as discussed on next page).

The charts reflect how both the value and percentage of Fed Treasury holdings hit a near-term low around the same time that demand for liquidity began to surge.
Demand for Liquidity Surges: Soon after the supply of liquidity had hit its recent lows, bank demand for it surged in September. There were two fairly direct reasons for the surge. First, at the end of every quarter (September for Q3) corporations pay their quarterly taxes, amounting to billions and billions of dollars, to the U.S. Treasury. They do this by transferring cash (i.e., liquidity) from their bank accounts to the Treasury Department. This is a well-known seasonal factor and thus shouldn’t have been a problem. However, this time, there was a secondary issue that bolstered the demand for liquidity around the same time - a flood of new Treasury debt being sold.

The Federal government is currently running significant annual deficits ($984 billion in the fiscal year ended September 30th, according to the Treasury Department); deficits that need to be funded by the sale of Treasury securities. On top of this, the Treasury Department was unable to sell new, incremental debt after the government reached its debt ceiling limit in early March of this year.

In late July, Congress and the Administration finally reached an agreement to once again suspend the debt ceiling. As seen in the chart above, this resulted in a surge in new Treasury debt sales. Not only was the Treasury Department needing to fund the government’s heavy borrowing needs, but it was also playing “catch-up” in its funding requirements due to the prior limitation on new debt sales.

Why is this important? Because when the “Primary Dealer” banks (i.e., banks that are approved to bid-on and purchase new Treasury securities directly from the U.S. Treasury) pay for the Treasury security purchases, they do so with cash. Cash that in this case was in short supply because much of it was transferred to pay corporate tax bills or sucked out of the system by the Fed’s efforts to reduce its Treasury holdings.

Summary on liquidity problems: Federal Reserve officials have said they will continue to inject liquidity into the market. In early October, the Fed said it would purchase Treasury bills (short-term debt) at an initial monthly pace of $60 billion from mid-October through mid-November. Thereafter, the central bank has said it will adjust the amount and timing of its purchases “as to maintain an ample supply of reserve balances over time,” but that it expected its buying operations to continue through at least the second quarter of 2020.

There are always some sectors of the economy or individual companies where leverage is too high, but overall, we believe the financial system is currently on very sound footing. Consumer and corporate default rates are both below long-term averages, and leverage ratios, particularly for consumers, are quite low relative to historical standards. In fact, loan delinquency rates within the banking system (payments that are 30-days or more past due) for both corporate and consumer borrowers are currently low. According to the FDIC’s latest Quarterly Banking Profile report, just 0.93% of loans fell into this category as of the end of the second quarter, down from the Q1 rate of 0.99% and its year-ago level of 1.06%.

What is the “repo-market?” Stories related to the recent liquidity problems will often mention the “repo market.” The term is short for repurchase market. When institutions engage in short-term borrowing (often to meet reserve requirements) they often provide their counterparty (i.e., the lender) with collateral (usually Treasury Bills). The borrower agrees to repurchase the securities the next day (or some other short timeframe) at a higher price (which implies the interest rate on the loan). This is a heavily utilized component of the overnight lending system.
Q: The Federal Reserve just lowered interest rates three times in as many meetings. Is the Fed trying to stave off a recession? And what might the Fed rate cuts mean for the economy?

A: Fed decisions are driven by its mandate from Congress which is to promote the goals of maximum employment, a stable inflation environment, and moderate long-term interest rates. In this light, Fed officials stated that their recent cuts reflect that the U.S. economy has slowed, and we could see further slowing due to weaker global growth and potential repercussions from ongoing trade disputes.

Overall, we believe the recent cuts have been prudent. We don’t expect much economic stimulus to result from the actions, but they should be supportive of economic conditions, nonetheless. We also believe they were necessary as to realign the Fed’s interest rate targets with market-based rates (i.e., Treasury yields).

The chart at right helps explain why the Fed Funds rate may have needed to be realigned with market-based rates. Note that the yield on the 10-year U.S. Treasury security (the blue line in the chart) fell precipitously from early November 2018 thru the start of September 2019. In late May, the 10-year Treasury rate even dropped below that of the fed funds rate (the red line which is the Fed’s overnight lending target) – resulting in an inverted yield curve.

Inverted yield curves are outside of the logical norm for interest rates, and as such they can have negative implications for investor and economic sentiment when they occur. As such, it was proper, in our view, for Fed officials to adjust their overnight lending target to better align with market-based rates. This is somewhat of an overly simplistic description, but we believe it’s instructive of conditions at the time.

So why did the 10-year Treasury rate decline so much? There are a multitude of factors that affect Treasury security prices and yields at any given time. In this case, U.S. rates were pulled down by lower rates internationally. Over the prior year slowing economic growth had led many central banks outside the U.S. to institute new stimulus measures – lowering interest rates and in some cases, purchasing bonds. Since rates in certain key foreign markets were already very low, these actions pulled some government bond yields into negative territory. At the end of August, $16.8 trillion of global debt traded at a negative yield, according to Bloomberg; all of it outside the U.S. By comparison, U.S. interest rates looked quite attractive, enticing capital to their higher yields. Since bond yields decline as their prices rise, the 10-year Treasury rate dropped precipitously.

Summary on rate cuts: We do not expect the recent Federal Reserve rate cuts to have a material influence on economic activity. First, key borrowing costs, such as mortgage rates, had already followed the decline in the 10-year Treasury rate. As such, the potential boost from lower rates was already in-motion prior to the Fed action. Many corporate borrowing costs had also already declined with broader market rates. Businesses have taken advantage of the lower rates with via refinancing or adding leverage, but capital spending (the avenue of direct economic impact) is currently restrained by the uncertainty of trade disputes and political ambiguity.

Additionally, demand for borrowing has been more constrained in recent years than it has been in the past, particularly at the consumer level. Housing also remains in short-supply making for less demand for mortgages related to the purchase of a new home. However, consumers and businesses alike have shown a strong reaction to the recent decline in market-based rates as an opportunity to refinance current debt positions.

This space intentionally left blank.
“The content in this report is authored by American Enterprise Investment Services Inc. (“AEIS”) and distributed by Ameriprise Financial Services, Inc. (“AFSI”) to financial advisors and clients of AFSI. AEIS and AFSI are affiliates and subsidiaries of Ameriprise Financial, Inc. Both AEIS and AFSI are member firms registered with FINRA and are subject to the objectivity safeguards and disclosure requirements relating to research analysts and the publication and distribution of research reports. The “Important Disclosures” below relate to the AEIS research analyst(s) that prepared this publication. The “Disclosures of Possible Conflicts of Interest” section, where applicable, relates to the conflicts of interest of each of AEIS and AFSI, their affiliates and their research analysts, as applicable, with respect to the subject companies mentioned in the report.

Each of AEIS and AFSI have implemented policies and procedures reasonably designed to ensure that its employees involved in the preparation, content and distribution of research reports, including dually registered employees, do not influence the objectivity or timing of the publication of research report content. All research policies, coverage decisions, compensation, hiring and other personnel decisions with respect to research analysts are made by AEIS, which is operationally independent of AFSI.

**IMPORTANT DISCLOSURES**

*As of September 30, 2019*

The views expressed regarding the company(ies) and/or sector(s) featured in this publication reflect the personal views of the research analyst(s) authoring the publication. Further, no part of research analyst compensation is directly or indirectly related to the specific recommendations or views contained in this publication.

**INDEX DEFINITIONS**

An index is a statistical composite that is not managed. It is not possible to invest directly in an index.

Definitions of individual indices mentioned in this report are available on our website at [ameriprise.com/legal/disclosures/](http://ameriprise.com/legal/disclosures/) in the *Additional Ameriprise research disclosures* section, or through your Ameriprise financial advisor.

**DISCLAIMER SECTION**

Except for the historical information contained herein, certain matters in this report are forward-looking statements or projections that are dependent upon certain risks and uncertainties, including but not limited to, such factors and considerations as general market volatility, global economic and geopolitical impacts, fiscal and monetary policy, liquidity, the level of interest rates, historical sector performance relationships as they relate to the business and economic cycle, consumer preferences, foreign currency exchange rates, litigation risk, competitive positioning, the ability to successfully integrate acquisitions, the ability to develop and commercialize new products and services, legislative risks, the pricing environment for products and services, and compliance with various local, state, and federal health care laws. See latest third party research reports and updates for risks pertaining to a particular security.

This summary is based upon financial information and statistical data obtained from sources deemed reliable, but in no way is warranted by Ameriprise Financial, Inc. as to accuracy or completeness. This is not a solicitation by Ameriprise Financial Services, Inc. of any order to buy or sell securities. This summary is based exclusively on an analysis of general current market conditions, rather than the suitability of a specific proposed securities transaction. We will not advise you as to any change in figures or our views.

Past performance is not a guarantee of future results.

Investment products are not federally or FDIC-insured, are not deposits or obligations of, or guaranteed by any financial institution, and involve investment risks including possible loss of principal and fluctuation in value.

AFSI and its affiliates do not offer tax or legal advice. Consumers should consult with their tax advisor or attorney regarding their specific situation.

Ameriprise Financial Services, Inc. Member FINRA and SIPC.