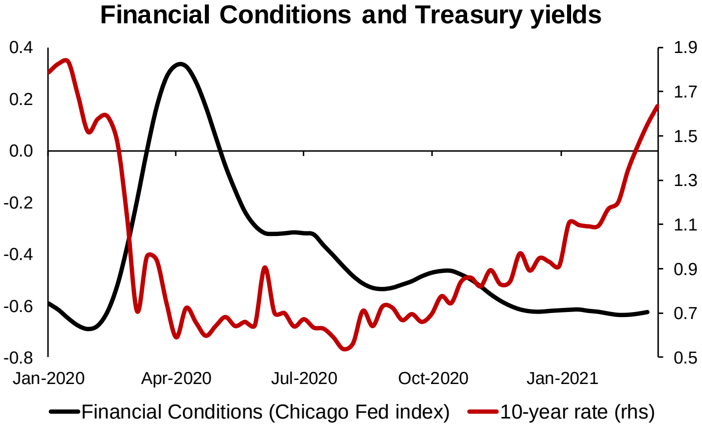
GIAM Macro & Market Research- Market Commentary

Beyond employment: the other possible challenges for the Fed.

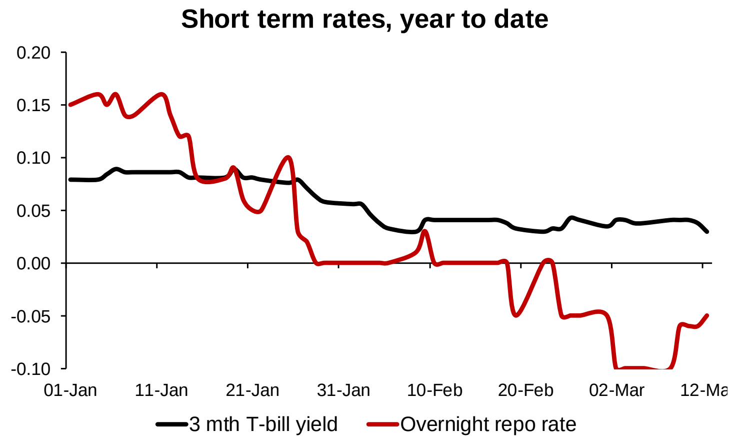
- **In the forthcoming meeting on Wednesday, the Fed will stick to its narrative focused on the need to keep an accommodative stance, as the labour market has still to improve substantially.**
- **However, the Fed might at some point need to use some flexibility in its balance sheet to tackle some emerging risks. First, the sizeable rise in long term interest rates may slow down growth the recovery; secondly, the looming large shift of cash from the Treasury account at the Fed to the banking system, would increase the downward pressure on short rates.,**
- **So far, the increase in long term interest rates has not triggered a tightening in financial conditions, as the rise has not spilled over to other parts of the financial market. Should this happen, we expect the Fed to react by twisting its bond holdings towards longer maturities, possibly combined with maturity extension of the purchases. Outright yield curve control appears a rather extreme measure.**
- **Moreover, the Fed will have to decide on whether to extend the temporary measures on the supplementary leverage ratio, expiring at the end of the month. Maintaining the exclusion of reserves and Treasuries from the leverage computation would ease the burden of the banking sector and the Treasury market alike.**

The FOMC march meeting, on Wednesday 17th will have a lot for markets. The impact on the US$ 1.9tn fiscal package just approved will be included in the growth forecasts and this may translate into the 'dots' (FOMC members' rate projections) showing a hike already in 2023. Moreover, chair Powell will be asked about the possible response to the quick changes in market conditions, namely the sharp increase in the long-term rates and the noticeable steepening of the yield curve.

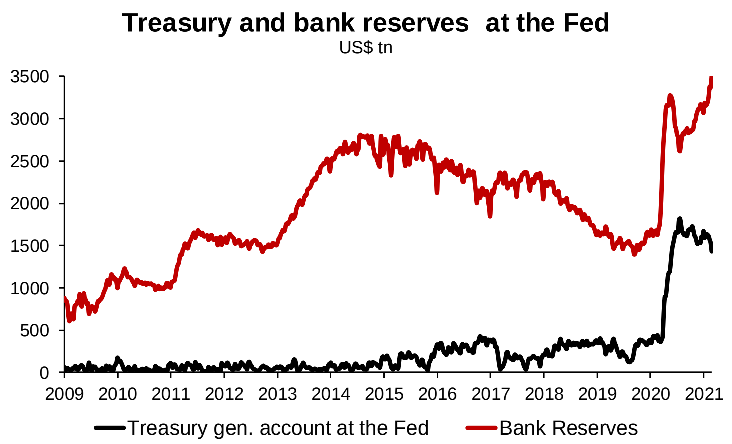
The Fed has repeatedly argued that it is open to adjust the composition of the balance sheet in case of tensions. Yet, it is unclear at this stage whether the Fed considers the spike in long term yields a problem. The economy is recovering fast, with worries about a quick strengthening of inflation, and higher yields are signalling this improvement. Moreover, overall financial conditions have not tightened yet, as the rise of Treasury yields has not spilled over to the price of other financial assets.



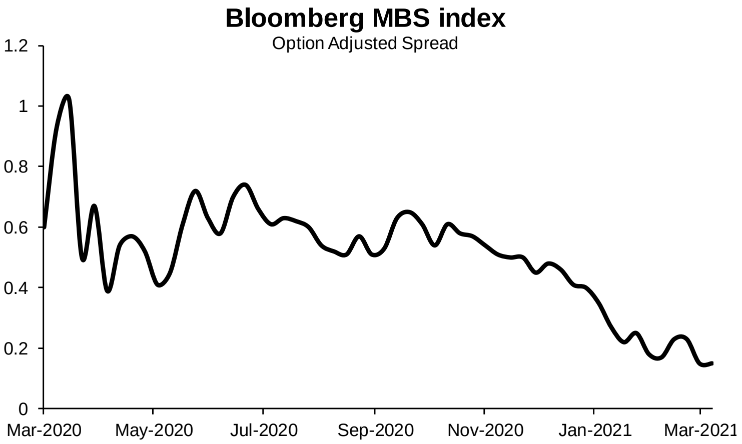
However, there is non-zero risk that this “healthy” increase in bond yields turns into a toxic one soon, if, for example, stronger than expected inflation weakens market confidence in the accommodative stance the Fed is advertising. Higher rates ahead of a large increase in bond supply following the fiscal boost would add to worries about Treasuries’ market liquidity. In such a case the Fed would have to intervene to preserve favourable financial conditions as the labour market gradually heals.
The case for action would get stronger if the situation at the front end of the curve deteriorates further. As a side effect of QE, banks are piling up cash; therefore, the overnight rate has fallen to below zero and the Yield on 3-month bills is approaching that level.



Cash holding by banks is expected to increase further following the decision by the Treasury to run down by one half its large stock of cash it has deposited at the Fed, largely to pay down due T-bills. This would shift cash into banks’ deposits. Near zero or negative money market rates means no real alternative to keeping liquidity as excessive reserves at the Fed or deposits in commercial banks. The ensuing growth in banks balance sheet may lead to too strong an increase in some institutions’ leverage ratio. This could in the end depress credit growth. Banks have leeway to prevent this from happening, by e.g. imposing fees on certain types of deposits, but the Fed may be forced to act quickly.



There are two lines of action, modifying QE and maintaining the emergency amendments to leverage regulation introduced in April last year which are set to expire end-March.
On QE, in our view the preferred solution will be an “Operation Twist”, whereby bills are sold in exchange of Treasuries. The flattening of the curve would ease bank stress and prevent a tightening in overall financial conditions. The twist could be complemented by a swapping of MBS for Treasuries; this would lessen the pressure on the MBS market, whose spreads appear too low (also due to the large Fed’s footprint) given the healthy state of the housing sector.



Moreover, twisting the compositor of the existing stock could be complemented by an extension of the maturities of the bond purchases. This would smooth out market functioning without increasing the size of the Fed's holdings.
Outright yield curve control (YCC) looks to us very unlikely; capping long term interest rates, like the Bank of Japan would to be too harsh a solution, as part of the rate increase is related to positive news on the economy. Moreover, such a solution is not exempted from drawbacks; as pointed out former Fed chairman Bernanke, pegging the long end of the curve, implies that the Fed has to make a credible commitment on the short term rate path on a very long horizon. Any news altering the expected profile of short-term rates (e.g. growth or inflation surprises) would weaken the peg, forcing the Fed to buy large quantities of Treasuries to fix it. A softer alternative would be the YCC version used by the Reserve Bank of Australia, which aims at gradually tweaking yields to steer guidance on the fed funds rate. FOMC officials have repeatedly said this tool is available, but it would be used only with clear evidence that the market no longer believes in the Fed's guidance.

On the regulatory front, extending the exclusion Treasuries and reserves held at the Fed from banks' Supplementary Leverage Ratio (SLR) calculation beyond March would reduce the stress on banks, with the added advantage of allowing more deposits to be accepted. This would in turn decrease the net demand for bills (helping flatten the curve) and ease the risks to credit provision.

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