



# Fed Likely to Expand Liquidity Programs

Regulatory requirements will likely create more demand for reserves.

February 2020

## KEY INSIGHTS

- The Federal Reserve's handling of excess reserves and the size of its balance sheet will be key to sentiment toward riskier asset classes in 2020.
- We think that the Fed will adapt its efforts to maintain sufficient liquidity in the overnight rates market as the environment evolves over time.
- The Fed will need to materially expand its balance sheet and add excess reserves, likely supporting risk assets and steepening the yield curve.

**A**lthough the Federal Reserve was successful in keeping overnight lending rates under control over year-end by boosting liquidity, the central bank's handling of excess reserves and the size of its balance sheet will be key to sentiment toward riskier asset classes in 2020. We think that the Fed will adapt its efforts to maintain sufficient liquidity in the overnight rates market as the environment evolves over time, which will require materially expanding its balance sheet and adding excess reserves. This should support risk assets and steepen the yield curve, informing our positioning in the Total Return Strategy.

## Liquidity Measures Keep Year-End Overnight Rates Controlled

In our October 2019 Fixed Income Insights article "Is Repo Volatility Contributing to a Flight to Quality?,"

we wrote that the Fed's ability to permanently address unusual volatility in overnight rates would affect market sentiment toward riskier segments of the credit markets. The central bank started buying USD 60 billion per month of Treasury bills in mid-October, committing to continue the purchases through the second quarter of 2020, and implemented temporary term and overnight repurchase<sup>1</sup> (repo) operations.

These measures succeeded in calming money markets and supported the rally in equity and credit markets. Even at year-end, when demand for bank reserves is highest due to regulatory scrutiny of bank balance sheets, there was barely a blip in repo rates.

In October, we said that one way for the Fed to convince markets of its ability to keep short-term rates under control would be to commit to implementing a permanent repo facility. However, while



**Christopher Brown, CFA**  
Lead Portfolio Manager,  
Total Return Strategy



**Adam Marden**  
Investment Analyst, Multi-Asset

# USD 200 Billion

Estimated amount of Fed balance sheet expansion by the end of June if it provides continuous liquidity as needed.

<sup>1</sup> Repurchase agreements are short-term loans collateralized by U.S. government securities.

For risk markets to extend their strong run, the Fed will need to adapt and expand its liquidity programs....

the Fed has referred to the possibility of putting a permanent repo program into place, it has not yet finalized that plan.

### Two Potential Scenarios for Fed Liquidity Programs

We currently see two potential broad scenarios for the Fed to support liquidity going forward. The first, which is a more bearish case, involves the central bank doing only what it has already committed to doing—winding down all term repo operations and substituting a higher level of Treasury bill purchases for repo. Under this scenario, the Fed's balance sheet would only grow by a relatively small USD 75 billion by the end of June as a result of reinvesting principal from maturing bonds, and no additional excess reserves would enter the banking system.

In the second scenario, which is our base case, the Fed would adjust its operations in response to evolving liquidity conditions. If the central bank finds that liquidity demand continues to grow (which we think is likely), it would keep most of its term repo operations open. The Fed would also lengthen the duration<sup>2</sup> of the securities that it purchases, both to provide an additional liquidity buffer and because dealers are likely to run low on Treasury bills available to purchase. We calculate that this scenario—providing continuous incremental liquidity as needed—would expand the Fed's balance sheet by about USD 200 billion by the end of the first half of the year and increase excess reserves by approximately USD 120 billion.

### Bank Regulatory Requirements Affecting Overnight Rates

We believe that the second scenario is more likely. The strong performance of riskier assets in recent months will likely increase trading business for banks and require them to hold more reserves to meet regulatory minimum capital requirements, restricting the supply of funds available in the money markets.

Although even the Fed doesn't know exactly how much of the reserves in the system are actually "excess," we think that the central bank is aware that the amount of liquidity it provides will need to increase. At the press conference after the December 2019 Federal Open Market Committee meeting, Fed Chairman Jerome Powell acknowledged that more stringent bank capital regulations could be affecting funding markets.

If the central bank merely meets its current commitments, which we think is less likely, the liquidity boost will be largely over, removing support for riskier asset classes. For risk markets to extend their strong run, the Fed will need to adapt and expand its liquidity programs over time. However, we will be monitoring other factors that would support an ongoing reflation trade. If trade conflicts remain relatively contained and U.S. economic data measuring actual production improve in line with better survey-based sentiment numbers, we will have much more conviction in risk assets.

### Positioned for a Positive Risk Environment

Given stabilizing global economic data, accommodative central banks, and our expectation for the Fed to continue to address volatility in overnight rates, our outlook for cyclical market segments remains positive. We have added exposure to these segments, primarily in securitized credit, in the Total Return Strategy. However, given myriad uncertainties, including the prospect that the Fed could disappoint by sticking to its stated liquidity plan, we are also emphasizing liquidity. For example, we have added credit index derivatives for more liquid exposure to credit risk in sectors such as commercial mortgage-backed securities. We also added Treasury inflation protected securities (TIPS) because the market appears to be underpricing future inflation.

<sup>2</sup> Duration measures a bond's sensitivity to changes in interest rates.

If the Fed keeps policy rates on hold and can prevent overnight rates from overshooting its target ranges, yields at the short-maturity end of the curve should stay well-anchored. Although the coronavirus outbreak in China could

potentially weigh on global growth in the near term, we anticipate that growth will continue to modestly improve, pressuring longer-term yields higher. As a result, we have positioned the Total Return Strategy for a steeper yield curve.

### WHAT WE'RE WATCHING NEXT

Sentiment toward the U.S. dollar in foreign exchange markets can provide useful information about pressures in short-term rates markets, and vice versa. A lack of dollar supply, due in part to the Fed reducing its balance sheet, drove the volatility in money market rates last fall. We monitor the relative strength or weakness of the dollar against a range of developed and emerging market currencies for clues about changes in short-term rates, which are one of many factors that can affect currency prices.

**Key Risks**—The following risks are materially relevant to the strategies highlighted in this material:

Transactions in securities of foreign currencies may be subject to fluctuations of exchange rates, which may affect the value of an investment. Debt securities could suffer an adverse change in financial condition due to ratings downgrade or default, which may affect the value of an investment.

Fixed income securities are subject to credit risk, liquidity risk, call risk, and interest rate risk. As interest rates rise, bond prices generally fall. Investments in high yield bonds involve greater risk of price volatility, illiquidity, and default than higher-rated debt securities.

## INVEST WITH CONFIDENCE<sup>SM</sup>

T. Rowe Price focuses on delivering investment management excellence that investors can rely on—now and over the long term.

# T. Rowe Price<sup>®</sup>

### Important Information

**This material is being furnished for general informational and/or marketing purposes only.** The material does not constitute or undertake to give advice of any nature, including fiduciary investment advice, nor is it intended to serve as the primary basis for an investment decision. Prospective investors are recommended to seek independent legal, financial and tax advice before making any investment decision. T. Rowe Price group of companies including T. Rowe Price Associates, Inc. and/or its affiliates receive revenue from T. Rowe Price investment products and services. **Past performance is not a reliable indicator of future performance.** The value of an investment and any income from it can go down as well as up. Investors may get back less than the amount invested.

The material does not constitute a distribution, an offer, an invitation, a personal or general recommendation or solicitation to sell or buy any securities in any jurisdiction or to conduct any particular investment activity. The material has not been reviewed by any regulatory authority in any jurisdiction.

Information and opinions presented have been obtained or derived from sources believed to be reliable and current; however, we cannot guarantee the sources' accuracy or completeness. There is no guarantee that any forecasts made will come to pass. The views contained herein are as of the date written and are subject to change without notice; these views may differ from those of other T. Rowe Price group companies and/or associates. Under no circumstances should the material, in whole or in part, be copied or redistributed without consent from T. Rowe Price.

The material is not intended for use by persons in jurisdictions which prohibit or restrict the distribution of the material and in certain countries the material is provided upon specific request. It is not intended for distribution to retail investors in any jurisdiction.

**Australia**—Issued in Australia by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 50, Governor Phillip Tower, 1 Farrer Place, Suite 50B, Sydney, NSW 2000, Australia. For Wholesale Clients only.

**Canada**—Issued in Canada by T. Rowe Price (Canada), Inc. T. Rowe Price (Canada), Inc.'s investment management services are only available to Accredited Investors as defined under National Instrument 45-106. T. Rowe Price (Canada), Inc. enters into written delegation agreements with affiliates to provide investment management services.

**DIFC**—Issued in the Dubai International Financial Centre by T. Rowe Price International Ltd. This material is communicated on behalf of T. Rowe Price International Ltd. by its representative office which is regulated by the Dubai Financial Services Authority. For Professional Clients only.

**EEA ex-UK**—Unless indicated otherwise this material is issued and approved by T. Rowe Price (Luxembourg) Management S.à r.l. 35 Boulevard du Prince Henri L-1724 Luxembourg which is authorised and regulated by the Luxembourg Commission de Surveillance du Secteur Financier. For Professional Clients only.

**Hong Kong**—Issued by T. Rowe Price Hong Kong Limited, 6/F, Chater House, 8 Connaught Road Central, Hong Kong. T. Rowe Price Hong Kong Limited is licensed and regulated by the Securities & Futures Commission. For Professional Investors only.

**New Zealand**—Issued in New Zealand by T. Rowe Price Australia Limited (ABN: 13 620 668 895 and AFSL: 503741), Level 50, Governor Phillip Tower, 1 Farrer Place, Suite 50B, Sydney, NSW 2000, Australia. No Interests are offered to the public. Accordingly, the Interests may not, directly or indirectly, be offered, sold or delivered in New Zealand, nor may any offering document or advertisement in relation to any offer of the Interests be distributed in New Zealand, other than in circumstances where there is no contravention of the Financial Markets Conduct Act 2013.

**Singapore**—Issued in Singapore by T. Rowe Price Singapore Private Ltd., No. 501 Orchard Rd, #10-02 Wheelock Place, Singapore 238880. T. Rowe Price Singapore Private Ltd. is licensed and regulated by the Monetary Authority of Singapore. For Institutional and Accredited Investors only.

**Switzerland**—Issued in Switzerland by T. Rowe Price (Switzerland) GmbH, Talstrasse 65, 6th Floor, 8001 Zurich, Switzerland. For Qualified Investors only.

**UK**—This material is issued and approved by T. Rowe Price International Ltd, 60 Queen Victoria Street, London, EC4N 4TZ which is authorised and regulated by the UK Financial Conduct Authority. For Professional Clients only.

**USA**—Issued in the USA by T. Rowe Price Associates, Inc., 100 East Pratt Street, Baltimore, MD, 21202, which is regulated by the U.S. Securities and Exchange Commission. For Institutional Investors only.

© 2020 T. Rowe Price. All rights reserved. T. ROWE PRICE, INVEST WITH CONFIDENCE, and the bighorn sheep design are, collectively and/or apart, trademarks or registered trademarks of T. Rowe Price Group, Inc.