Fed Likely to Expand Liquidity Programs

Regulatory requirements will likely create more demand for reserves.

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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.

Although 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 Fund.

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[1] (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

USD 200 Billion

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

[1] Repurchase agreements are short-term loans collateralized by U.S. government securities.

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[2] 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.

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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 Fund. 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 have also added Treasury inflation protected securities (TIPS) because the market appears to be underpricing future inflation.

[2] 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 Fund 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.

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