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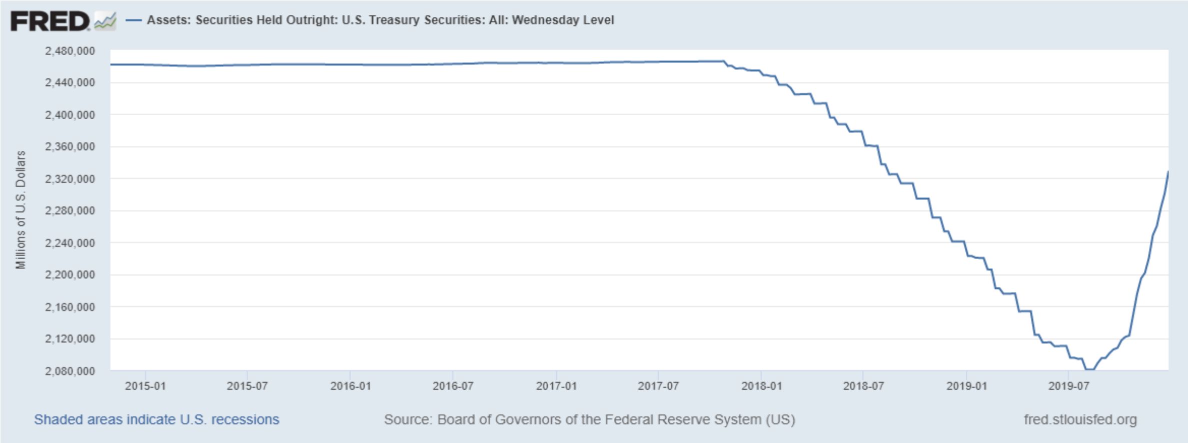
Fed On Its Heels, Backtracking On Tightening

In response to a liquidity crunch that sent repurchase agreement rates skyrocketing back in September (see my overview of the events in last quarter's commentary here), the federal reserve (via the Federal Open Market Committee/FOMC) has intervened by purchasing treasuries and expanding their balance sheet again in the process. The rationale is that there are not enough reserves available for funding obligations, so the Fed has been forced to inject capital directly back into the markets.

The liquidity aid the Fed is providing has done a solid job of calming overnight funding markets, at the cost of expanding its balance sheet in Q4 a magnitude similar to the previous 4 quarters of tightening. In addition to overnight and term repo operations, the Fed has purchased $60 billion of Treasuries a month since September. This is counterintuitive to what is expected during a period of economic stability.



For the time being, it looks like the Fed has done its job to stabilize its markets. However, normal Fed operations would call for their rates tool to be at a much higher level than present in order to use it at a later date to stimulate the economy during future weakness. With markets keeping the Fed in a low-rates holding pattern, the effectiveness of a future rate cut to stimulate would be severely muted.

As policy tools are weakened, it makes "righting the ship" during a period of economic weakness in the future much harder. At present, inflation is under control, the foreign reverse repo pool (the account other central banks access at the Fed) has decreased since September, and the Fed is looking to keep these purchase programs limited. They say they are focused on maintaining reserve levels, not implementing QE4 but we do not see a big distinction.

What the Fed has done in the short term is logical but both low rates and a growing balance sheet sets them up with a weak hand to confront any future economic or financial market problems.

Over the coming months, we will see how the Fed deals with maintaining market liquidity structures. They will likely maintain a standing repo facility that would act as a backstop for market participants requiring funding. There are other potential options being evaluated, and the Fed will likely try to telegraph this to market participants in a very deliberate manner. Our concern is that Fed liquidity operations and the weaker tools at their disposal raise uncertainties, and this could cause higher rate volatility in 2020.

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