

What's Happening Under the Covers

Why the U.S. Economy Has Remained Resilient in Spite of the Fed Raising Interest Rates and Reducing Their Balance Sheet

In this blog, we explain how the Treasury's actions have allowed the Federal Reserve to keep the federal funds rate above 5% and reduce its balance sheet without stalling the economy. It is a bit academic, so we recommend you read this piece with a cup of coffee instead of a glass of wine.

TLDR: We love economics, but we realize you may not, so we provide this analogy to explain liquidity in the financial system.

Imagine the U.S. financial system is a large tank of water holding various boats. Let's say the boats in the tank are different assets in the financial system – stocks, bitcoin, etc. When the Federal Reserve shrinks its balance sheet, it is taking water out of the tank, which typically would cause the boats in the tank to float at lower levels. Using this analogy, stocks and bitcoin would go down as water comes out of the tank. Recently, the U.S. Treasury has put more water into the tank than the Fed has removed, so boats *aka* stocks and bitcoin go to higher levels. In the blog below, we explain in more detail the effect the Treasury and Fed's actions are having on risk assets like stocks and cryptocurrency.

Background

The U.S. Federal Reserve has 2 mandates: to achieve maximum employment and keep prices stable. The economy naturally ebbs and flows – a stronger economy causes employment and prices to go up and a slower economy causes employment and prices to come down. If these trends get out of control, the Fed has a number of tools to either stimulate or slow the economy, but their principal tool is changing short-term interest rates.

During the Great Recession (the housing crisis of 2008 - 2009), when the economy slowed dramatically and unemployment rose, the Fed cut interest rates to zero hoping to stimulate business activity. But 0% rates didn't suffice, so Fed Chair Ben Bernanke introduced a new way to add financial liquidity called Quantitative Easing (QE). The Fed purchased Treasury and Mortgage-backed bonds from banks and investors and essentially added cash and reserves to the financial system. It worked. We avoided deflation,

negative interest rates and a depression. However, QE caused the Fed's balance sheet to rise dramatically, from about \$1 trillion to \$5 trillion.

During the pandemic slowdown, the Fed used QE once again to add liquidity and ballooned its balance sheet further to \$9 trillion. Because the U.S. government also added money to the financial system by sending people checks, we entered an era of too much money chasing too few goods, compounded by pandemic shipping issues which reduced the supply of goods substantially. High inflation was the result.

Today

To deal with high inflation and an oversized balance sheet, the Fed took two steps beginning in 2022.

- The Fed raised interest rates at the fastest pace in history, from 0 to 5.5%
- The Fed began to gradually reduce its balance sheet¹

There are several reasons for the Fed to reduce its balance sheet - to take some liquidity out of the financial system, to make room to buy bonds in the next crisis, and to avoid losses as the cost of their liabilities is greater than what they are earning on their assets.

The Fed's actions were intended to reduce inflation and slow the economy - which has occurred. However, while inflation has come down, it remains sticky and above the Fed's target 2% level. Further, while economic growth has slowed from its rapid pace in 2021, it continues to be stronger than most expected.

Why Haven't the Fed's Actions Slowed the Economy as Much as Expected?

The short answer - what the Fed has taken away, the Treasury has more than given back.

The Fed is reducing its balance sheet (both the asset side and the liability side) by letting some of its Treasury and Mortgage holdings *mature* and not replacing them. This process is called 'roll off'. Since the middle of 2023, when the Fed receives cash for certain maturing bonds, it no longer puts that cash back into the financial system. This process reduces currency in circulation and/or bank reserves. Typically, these actions by the Fed would drain liquidity from the financial system.

However, we now have the largest peacetime fiscal deficit that still needs funding. Enter Treasury Secretary, Janet Yellen, who needs to finance the U.S. deficit by selling Treasury bills, notes and bonds. Last fall, she chose to sell more Treasury bills and fewer longer maturity notes and bonds. Her actions took supply pressure off the 10-year Treasury bond causing 10-year rates to fall and the stock market to rally. (See our last blog "[Janet Yellen takes the Prize](#)".)

Why Would Janet Yellen Want to Increase the Government's Funding Costs by Issuing More Treasury Bills (which have higher rates than notes and bonds)?

Not only did she want to reduce long-term interest rates and buoy the stock market, but she also found a way to add liquidity to the financial system without affecting the Fed's balance sheet, a win-win scenario.

A special situation involving the Federal Reserve's Reverse Repo facility made all these financial machinations possible. This facility allows banks and money market funds (MMFs) to briefly swap their extra cash for treasury securities on the Fed's balance sheet and earn some interest. The reverse repo facility grew to \$1.4 trillion in 2023 because banks and MMFs didn't have a better investment to make with their money. Secretary Yellen realized that she could issue Treasury bills at an interest rate that would cause money market funds to exit the reverse repo facility and purchase Treasury bills instead. Thus, reverse repos (a liability on the Fed's balance sheet) would be reduced and the Treasury General Account (TGA), also a liability, would go up. Yellen would use the money at the TGA to cover the costs of running the government, ultimately increasing cash in circulation. Even as she changed the complexion of the Fed's balance sheet, she didn't increase it. *"By issuing more bills, the Treasury enabled money market funds to fund most of the deficit using otherwise inert liquidity parked at the reverse repo facility."*²

Why do we care?

Nothing good lasts forever.

- Since October 2023, the reverse repo facility has gone from 1.4 trillion to \$400 billion and may disappear completely this fall.
- Once the reverse repo facility is gone, net new issuance by the Treasury will likely start draining reserves from the financial system.
- If liquidity is in fact what is buoying assets, tightening may hurt risk assets including the stock market and bitcoin.
- "Regional banks are among those who may face a particular challenge from declining liquidity, making another bank failure a distinct possibility. It's when those sort of choppy waters hit that the Fed will probably see fit to curtail QT altogether."³
- The Fed is aware of the risks listed above and has slowed their balance sheet roll off from 60 billion to \$25 billion per month.
- Subsequent Treasury issuance may no longer be so concentrated in bills and be more evenly distributed across longer maturities.
- The large supply and likely higher rates on U.S. treasuries (considered risk free) would 'crowd out' private sector borrowers.

Are politics involved?

It seems as though Fed Chair Powell and Treasury Secretary Yellen would like to see stable markets going into elections.

The support of the government combined with the ongoing strength of the economy, and historical performance of the stock market during election years makes us comfortable with our equity exposure, but seasonally it may be a wild summer into the fall.

After the election, all bets are off.

- If the Treasury issues debt further out the interest rate curve, rates may rise.
- Higher rates coupled with reduced liquidity are likely to cause the stock market to fall as it did in October 2023.

And if you have forgotten our **10 Surprises for the New Year** written in November of 2023, #8 was "The U.S. Presidential election will not be Trump versus Biden." For the entire list, visit our blog "[Our 10 Surprises for the New Year](#)" on our website.

Contact Us:

Lisa James

lisa@2xwealth.ingalls.net

212-269-7758

Lori Zager

lori@2xwealth.ingalls.net

212-269-7757

¹Fed's Balance Sheet

Assets

Treasuries

Mortgages

Residual – Agency Bonds, etc.

Repos

Liabilities

Reverse Repos

TGA (Treasury Gen Acct)

Currency in Circulation

Bank Reserves

As the bonds on the Fed's balance sheet mature, they take the cash and do not buy new bonds to replace the maturing bonds.

²Simon White, "Liquidity Saps from the System as Treasury Issues Fewer Bills" Bloomberg.

³Simon White, "Liquidity Saps from the System as Treasury Issues Fewer Bills" Bloomberg.

The material included herein is not to be reproduced or distributed to others without the Firm's express written consent. This material is being provided for informational purposes, and is not intended to be a formal research report, a general guide to investing, or as a source of any specific investment recommendations and makes no implied or express recommendations concerning the manner in which your specific accounts should be handled based on your individual circumstances. Any opinions expressed in this material are only current opinions and while the information contained is believed to be reliable there is no representation that it is accurate or complete and it should not be relied upon as such. Investing involves risk, including loss of principal, and no assurance can be given that a specific investment objective will be achieved.

The Firm accepts no liability for loss arising from the use of this material. However, Federal and state securities laws impose liabilities under certain circumstances on persons who act in good faith and nothing herein shall constitute a waiver or other limitation of any rights that an investor may have under Federal or state securities laws.

2x Wealth Group is a team at Ingalls & Snyder, LLC, 1325 Avenue of the Americas, New York, NY 10019-6066. If you would like to unsubscribe, please [click here](#).

