US Macroeconomics

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Joseph Lavorgna, Chief US Economist | 212.610.1741 | joseph.lavorgna@smbcnikko-si.com

What's Happening with Liquidity, and What Does It Mean for Stocks?

Liquidity is defined as the Fed's securities holdings (treasuries and mortgages) less the Treasury General Account (TGA) less the reverse repo facility (RRP). **Securities holdings are assets on the Fed's balance sheet**. Under quantitative easing, the Fed creates bank reserves. In turn this creates liquidity. The opposite is true under quantitative tightening. The Fed destroys bank reserves. Quantitative tightening has been in place since last May, and the Fed has not provided a timeline on when it will conclude.

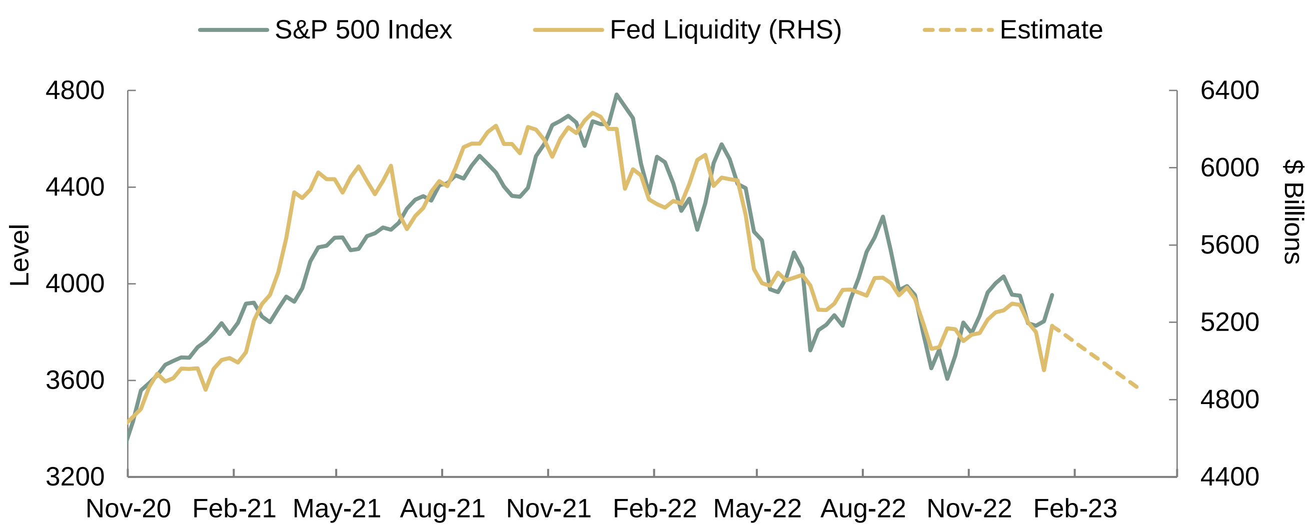
Regarding the two other liquidity components, **the TGA is a liability on the Fed's balance sheet**. This means that when the TGA goes up, it drains reserves. **This is the same for the RRP which is also a liability**. Higher RRP balances decrease bank reserves. In essence, liquidity is created when assets increase more than liabilities.

Since the start of the year, we estimate Fed liquidity is up almost 1% year-to-date. No doubt this has been a positive factor lifting equities, which have had a near one-for-one correlation with liquidity as illustrated in the chart below. **The increase in liquidity has been the result of a decline in the TGA and the RRP which together have more than offset the drop in the Fed's securities holdings**. However, this offset is not expected to last much longer.

The TGA is around $400 billion but the Treasury announced at the November 2022 Quarterly Refunding that it intended to increase its balance to $500 billion by quarter-end. This would be in line with its historical operating level. A rising TGA will drain reserves between now and March.

The decline in the RRP was payback for a temporary yearend-related spike due to money market funds parking cash at the Fed. Unless the Treasury increases its bills issuance, the RRP is likely to stay right where it is at $2.5 trillion which is in line with its recent average. **Going forward, liquidity will be dominated by changes in the Fed's securities holdings**. Our estimate for quarter-end liquidity is shown in the chart below.

According to our calculations, **the financial system will lose about $300 billion in liquidity in the current quarter compared to last quarter**, which is a sizeable amount. If past is prologue, this should be a factor weighing on stock prices all else being equal. Stay tuned.



Source: FRB, Haver, SMBC Nikko

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