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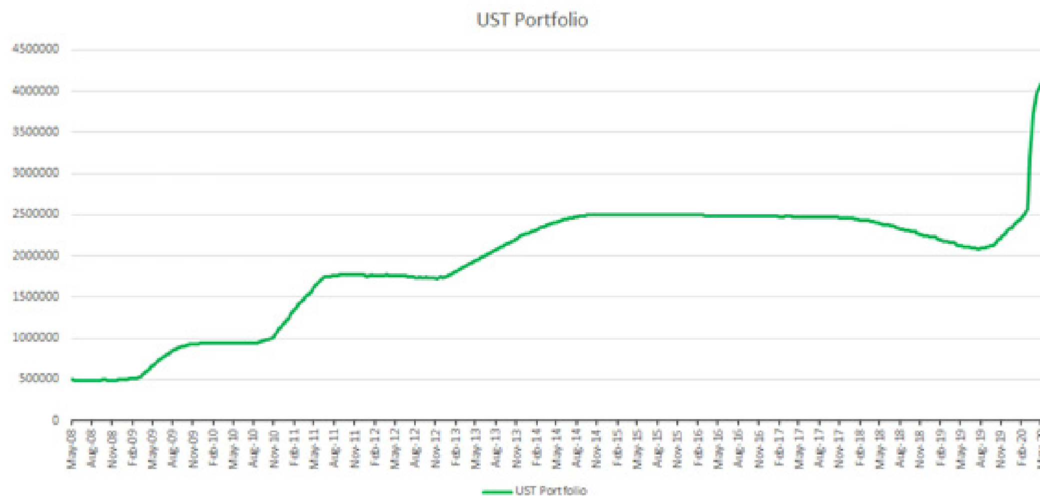
THE FED, THE TREASURY AND THE S&P

David Kneale - Head of UK Equities



Source: US Federal Reserve

Lots of people know about this chart. It shows the extraordinary aggression with which the US Federal Reserve poured liquidity into the financial system through the purchase of US Treasury securities. About $2tn arrived within the last 6 months, of which around $1.5tn landed in the last 6 weeks. This latter period has delivered a greater amount of stimulus in 6 weeks than Quantitative Easing (QE) 1&2 delivered over 2 years. Since the Federal Reserve resumed buying US Treasuries 6 months ago, the aggregate buying has been greater than all the prior QE programs which took about 5 years to complete.

However, the Federal Reserve needs to hold a portfolio of US Treasury securities even when not trying to stimulate the financial system. US Treasuries form the backbone of the Federal Reserve's assets with which it must balance its liabilities; principally, currency in circulation, repo with foreign central banks and the US Treasury Department's cash deposits. Historically, the Treasury Department held their cash in accounts with commercial banks, but since the financial crisis, these monies have instead by kept in a bank account at the Federal Reserve directly.

Something equally extraordinary has happened over here. In recent weeks, the Treasury Department has raised $1tn in cash from the debt markets and parked it in their bank account. Importantly, deposits held at the Federal Reserve are taken out of the banking system, reducing broader market liquidity.

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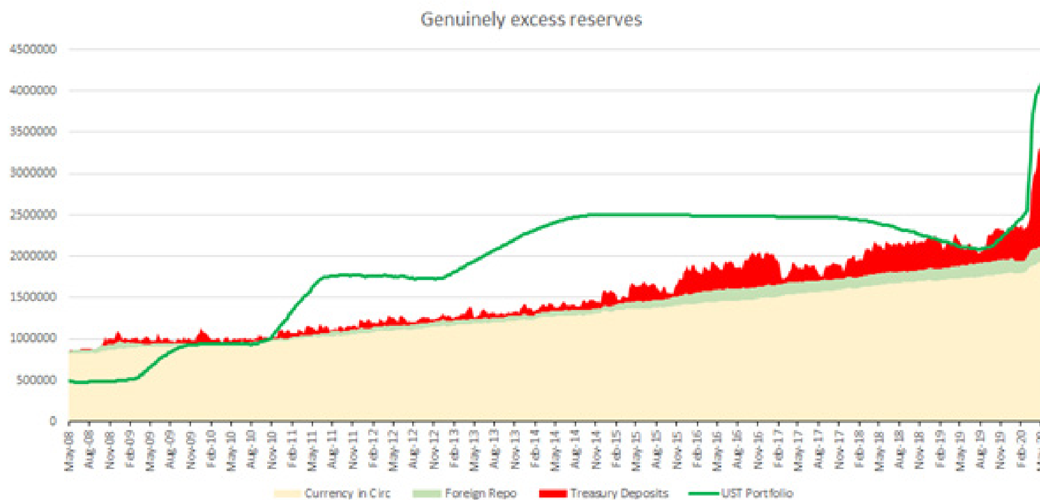
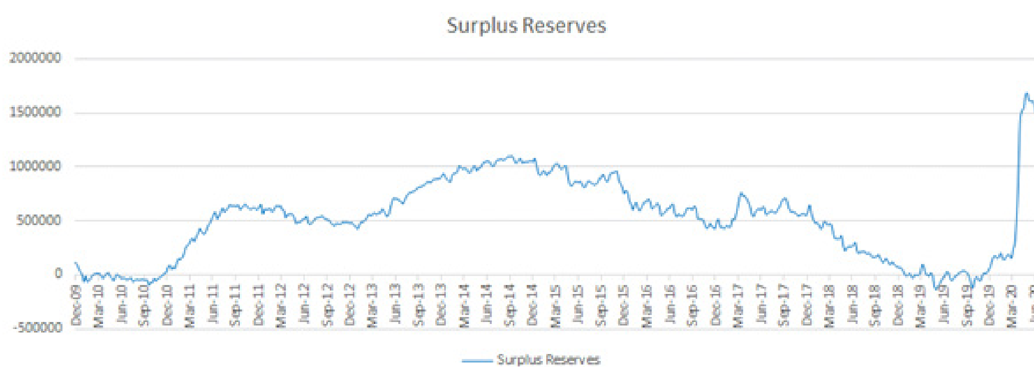


Source: US Federal Reserve

Overall, the Federal Reserve injected a lot of liquidity into the financial system, and the US Treasury Department promptly withdrew it. “QE" that really matters is the gap between these two totals: the money injected into the banking system above and beyond any regulatory requirements of “reserves” and “excess reserves” which the banks must hold. These “surplus” reserves find their way into an assortment of activities including repo markets and low risk carry trades, which suppresses volatility and reduces spreads and borrowing costs. The end result is asset prices, including equities, rise.

The blue line below shows the difference between the Federal Reserve’s US Treasury portfolio and the liabilities identified above. The surplus liquidity flooding into financial markets lately has been massive. The eagle-eyed will also have spotted that it has just started shrinking as the Federal Reserve has slowed its bond buying, yet the US Treasury department has continued to build its cash buffers.



Source: Bloomberg

Correlation is not causation, but in periods when the blue line is rising, the S&P Index has performed well and volatility has been low. In periods when the blue line has been falling, equity returns have been far lower and volatility far higher. There are 1,000 other factors at play and this could all be a coincidence, but as the virus struck, the S&P Index

collapsed, the blue line rocketed and the S&P went straight back up again. That blue line is now falling about twice as fast as at any period in the last 6 years. I wonder what the S&P will do?

In the short term, the most important variable is the US Treasury Department's cash balance. They have publicly stated that the target for the end of June is $800bn; materially lower than the $1.5tn held today. Obviously, they might not do this… but if they do, in the next couple of weeks the blue line is going to smash through the top of the chart.

And there you were thinking the job had something to do with forecasting company cashflows! (PS: over any sensible timeframe that is exactly what it is, but the price you are asked to pay for those cashflows could be rather volatile in coming months).

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