Daily Note

BACK TO THE FUTURE – FED BETS ON DISINTERMEDIATION TO SLOW GROWTH

Steven Blitz

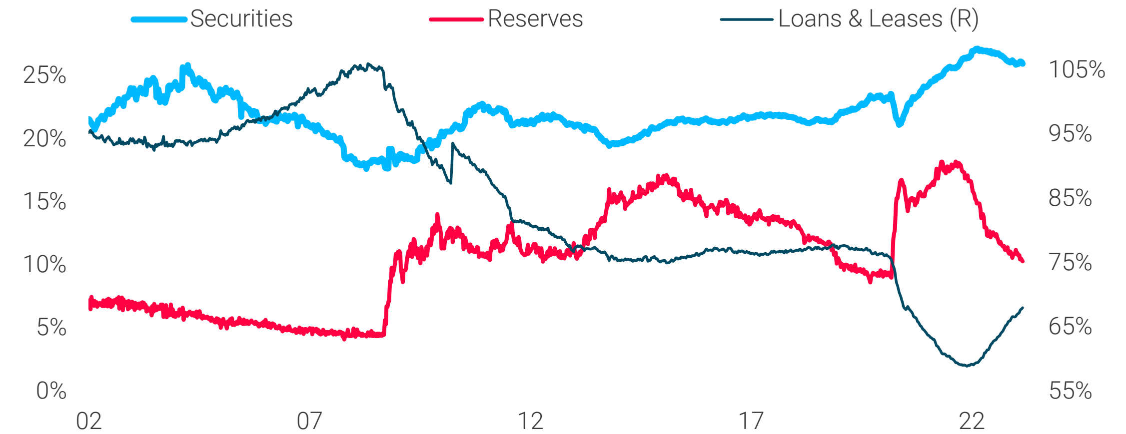
- **Powell bets "tighter credit conditions" soften a "robust" economy**
- **If not, consider that the real funds rate just now = Fed long run neutral**
- **Post-GFC management of banks by government has resurrected disintermediation as a governor on growth – to a point**

SVB happened and this FOMC, ever anxious about creating a recession is more than happy to let "tighter credit conditions for households and businesses… weigh on economic activity, hiring, and inflation". As for financial instability, they believe they have the tools to keep a few poorly managed banks from imploding the whole sector (famous last words). The FOMC sees banks pulling back on lending as their opening for a lower top for the funds rate (5.00%-5.25%) while keeping to their playbook of recent cycles – hit the mark, stay there for an extended period, and wait for the slowdown to evolve. Fair enough, but keep in mind that the real funds rate is now only equal to its long-run level for neutral (50BP). In other words, the bet is that the asset crunch extending into a credit crunch delivers the slowdown. A mid-year recession remains my most likely scenario (my base case), perhaps the downturn is even deeper than anticipated. The outcome is not, however, predetermined, meaning that while my probabilities favour mid-year recession, there is still some probability that one does not occur. The risk is not all one-sided.

With the Fed stopping short, the outlook for recession, deep or shallow, consequently centres on banking. Regulation, the Fed's shift to a surplus reserve system, falling leverage in the private sector and rising leverage by the Federal government have all combined to distort balance sheets and shift bank risk from credit to interest rates and thereby resurrects disintermediation – a governor on growth not seen since deregulation in 1980.

To be clear, banks are complicit in their current predicament by funding loan growth by pulling reserves rather than selling securities (Chart 1). This left them with more exposure to interest rate risk against deposits being purchased at market. Put another way, banks have borrowed short to lend long ever since banking began, but the rate paid for the largest deposits reflect a bank credit spread over Treasurys while the rates charged on loans carry a much wider spread to Treasury yields. This spread difference delivers a cushion against an inverted Treasury curve – up to a point. Had they sold securities instead to fund lending, trusting that the Fed was really going to raise the funds rate and market yields would follow, the banks (small banks especially) would today be earning more on reserves than they are paying for deposits on average and have ample funds with no market risk to fund withdrawals. Hindsight is 20-20, I understand, but these bank decisions reflect the undying presumption evident in market pricing that inflation returns to 2% by divine right and yields will follow.

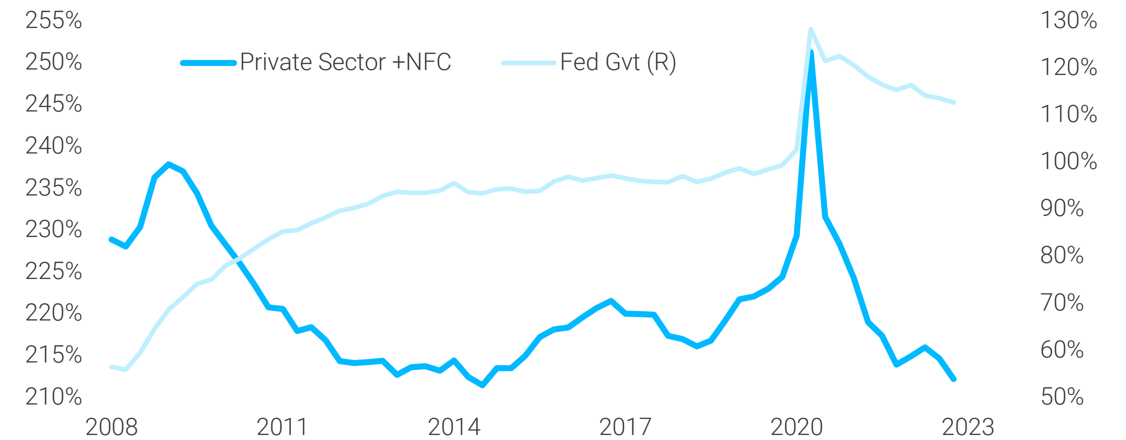
Chart 1 Banks today are more subject to market risk than credit risk than pre-GFC
Domestic bank assets expressed as a percent of deposits



Source: Federal Reserve, TS Lombard

The current situation that banks find themselves was compounded by the extreme drop in loans to deposits post-GFC. The securities/deposit ratio has been this high before (record high if we add in reserves as percent of deposits), but, more importantly, never with loan/deposit ratios so low. Loan ratios have not been this low since the 1950s. Loan/deposit ratios fell so far because, in part, the loss of appetite for leverage by the private sector (Chart 2). On the regulatory side, banks are required to hold HQLA at around 12% of assets for the largest banks, 6% or so for the smaller ones. In a normal positive curve environment, these are the lowest yielding assets in the market. Consequently, the burden to generate a positive net interest margin increasingly falls on the yield curve as opposed to years past when it was credit spreads on loans. Banks are more exposed to the impact of a negative curve than ever before.

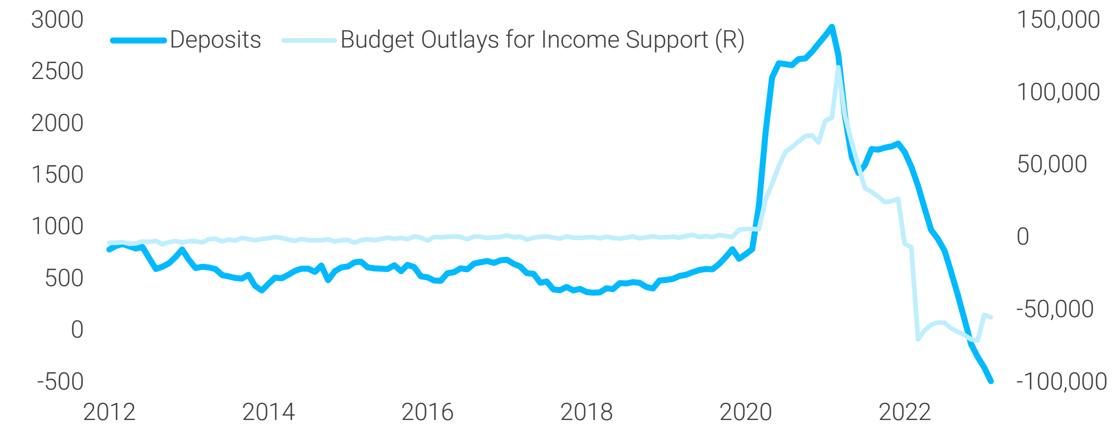
Chart 2 Private sector leverage has not returned to pre-GFC levels
Financial liabilities % of GDP (2020 surge reflects Covid collapse of GDP)



Source: BEA, Federal Reserve, TS Lombard

Because of what happened at SVB, deposit risk is considered the main problem for banks – when in fact, as explained above, the root problem is the forced structure of their assets. As for deposit growth, lending still creates deposits (not QE), but because of the low appetite for leverage in the private sector, Treasury, instead of the banks, is now creating deposits (Chart 3).

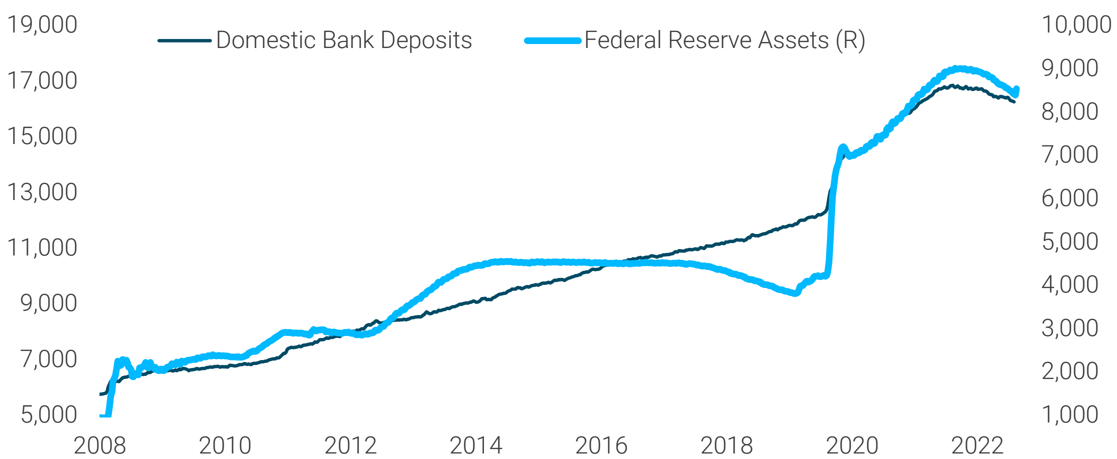
Chart 3 Deposits and Federal spending are inextricably linked
Y/Y $Ch



Source: Federal Reserve, Treasury, TS Lombard

For those believing the QT shreds deposits, the behaviour of deposits during the 2017-19 QT period would not have happened – Fed assets fell, and bank deposits continued to rise (Chart 4).

Chart 4 Coincidence is not correlation; QT did not shred deposits 2017-19

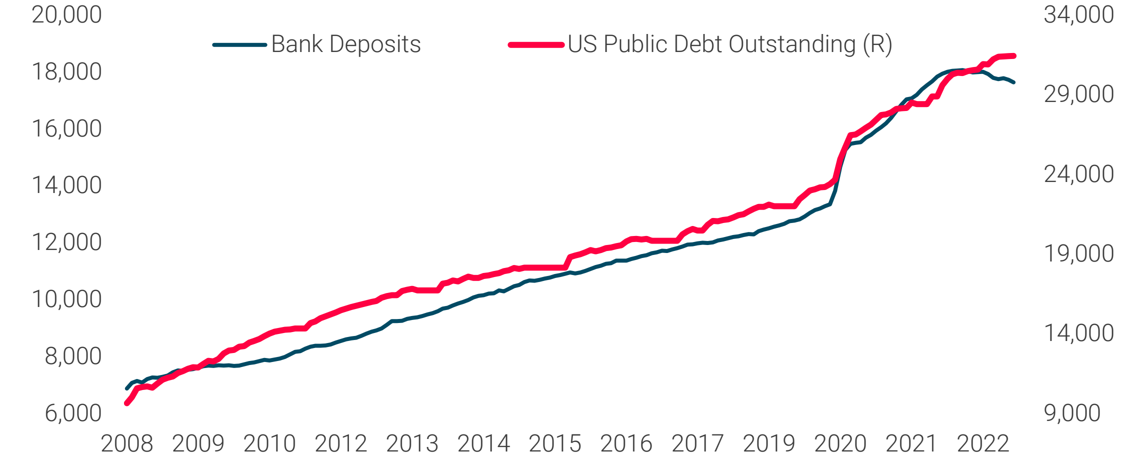


Source: Federal Reserve, TS Lombard

The behaviour of deposits is, however, consistent when run against the level of government debt outstanding – aa a proxy for spending (Chart 5). Lastly, deposits do not just disappear into thin air, they purchase other assets – UST in the current cycle. During the prior QT period, deposits continued to grow and its was banks bidding for UST instead. The rate structure never evolved during that period to generate disintermediation – what stopped the economy before Reg Q was lifted.

Another point to consider going forward, the Federal budget deficit is wider year-to-date than last year, and at some point, the deficit will be larger on a Y/Y basis – this will be reflected in bank deposits. Helping banks and, perhaps, softening the downside from a weakening private sector.

Chart 5 Deposits and government spending do, however, run together

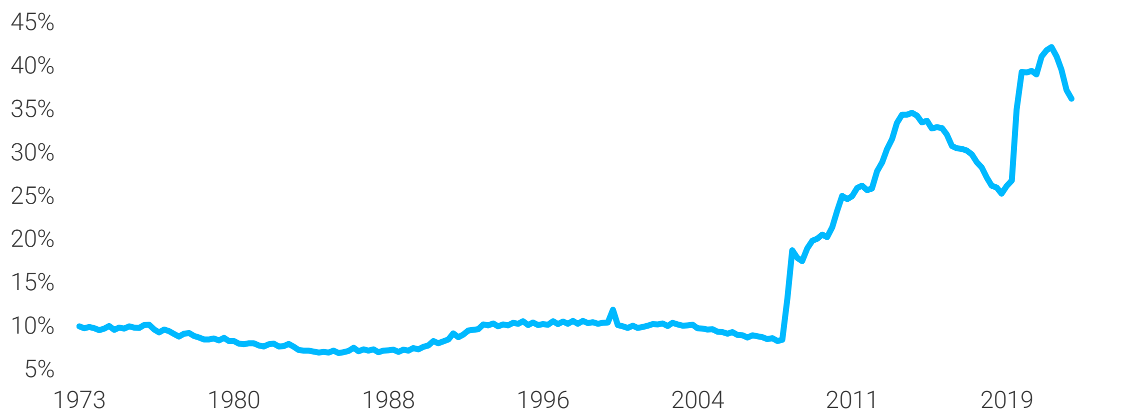


Source: Federal Reserve, Treasury, TS Lombard

When QE is being engaged, the Fed is buying a Treasury from a bank's portfolio and crediting the bank with a reserve deposit, this action creates no new deposit in the banking system. During QT they are not selling UST, they are rolling off maturities, deciding not to reinvest. This is very different from selling, say, a 10-year note. Treasury has the option to how it restructures its auction with the loss of a buyer across the curve. Typically, Treasury reacts by auctioning more T-bills (reduced during QE), believing that banks (and money funds) would swap their reserve deposits for a T-Bill, being indifferent to holding either. This indifference is not entirely true, but we can leave that story for another time.

Getting back to QE and the shift to surplus reserves, one can say the Fed is effectively taking in the asset banks purchase against the deposits Treasury created through its net new issuance. The Fed, however, does not need any Treasury net new issuance to engage in QE, therefore the link between QE and deposit growth is coincidental to Treasury financing and nothing else. What the Fed has done, however, is create liquidity that was not present prior by, in effect, monetizing the debt – or in monetary terms, the Fed itself is expanding the monetary base without banks creating deposits through lending. This is inflationary, but only to financial markets because the Fed holds these reserves on their balance sheet. The Fed can, in effect, manage the economy to a desired inflation rate through its management of IORB. Chart 6 offers a sense of just how much high-powered money the Fed has created – and its inflationary potential if banks convert reserves into loans, as they did to an extent from September 2021 onwards. Inflation is always financed.

Chart 6 Federal Reserve Assets % Bank Assets



Source: Federal Reserve, TS Lombard

Where does this all leave the story? Intended or not, the sum of post-GFC management of commercial banking has resurrected disintermediation as a governor on growth. Banks are not vulnerable in the way they were pre-GFC – a markdown in credit is usually permanent, not so a markdown in securities. That difference can, however, be misleading if yields continue to rise, leaving banks increasingly unable to pay depositors and with steadily diminished values for their portfolio. This pressured banks in the 79-84 period, and some failed (notably First Pennsy and Continental and, ultimately this was the root problem for the S&Ls that went under when the curve inverted again heading into the 90-91 recession). In the 70s there was a joke – How do you become a millionaire in the bond market? Start with two million.

In sum, banks are vulnerable to the asset crunch (part of which is the markdown of UST on bank balance sheets) and this, in turn, will constrain lending and ultimately create a recession. The Fed is, however, taking a bit of a risk here by counting on curtailed lending to slow growth to lower their top rate to only 50BP real – their long-term neutral number. There is no predetermined outcome for the economy, only in retrospect, as there have been even greater financial events during expansions that did not create recessions (Oct 87 stock crash, LTCM, Asia debt crisis, etc) thanks to Fed responses. The current lifeline to banks by lending cash against par on bank holdings of UST mitigates the crisis and may yet keep the developing credit crunch from reaching the extent the Fed expects (hopes?). There is, however, enough underlying deterioration in economic data to suggest the economy is heading towards recession, but the economy is not yet weak. Mid-year recession remains the call, but the risk remains two-sided – recession or none at all.