

Daily Note

CENTRAL BANK BS AND MARKET “LIQUIDITY”

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- **Has QE “distorted” asset prices? Will QT trigger a market collapse?**
- **High asset prices reflect the low interest-rate world, not CB “liquidity”**
- **The risk is that inflation fundamentals are shifting. QT is largely a distraction**

I am a QE sceptic. I think that over the past decade, central banks have been telling fibs about the impact of their balance sheets have been having, while Wall Street pundits like to exaggerate the role official “liquidity” plays in financial markets (because, well, it makes them sound smart). I do not believe QE has persistently “distorted” bond markets and I doubt the policy has done much, if anything, to boost growth and inflation. But since I’m in a minority of one at TS Lombard on these issues, we have decided to break from tradition and air these different views in public (rather than stick to a rigid “house view”). Used sparingly, we hope our readers will find this approach useful. My colleagues will publish their response.

Let me make it clear, however, that I am not saying central banks’ decisions about QE, QT, etc. are irrelevant. As an industry, we spend an inordinate amount of time “central bank watching”, which should dispel any notion that these policies do not matter. And we can certainly see that QE affects asset-price returns – particularly the “left-hand side of their distribution”, which shrinks when the authorities are buying securities (consistent with the idea that QE can put a floor under markets in times of turmoil). But the more substantive issue is whether this influence comes from

Chart 1: US Bonds respond to macro news, as they always have done

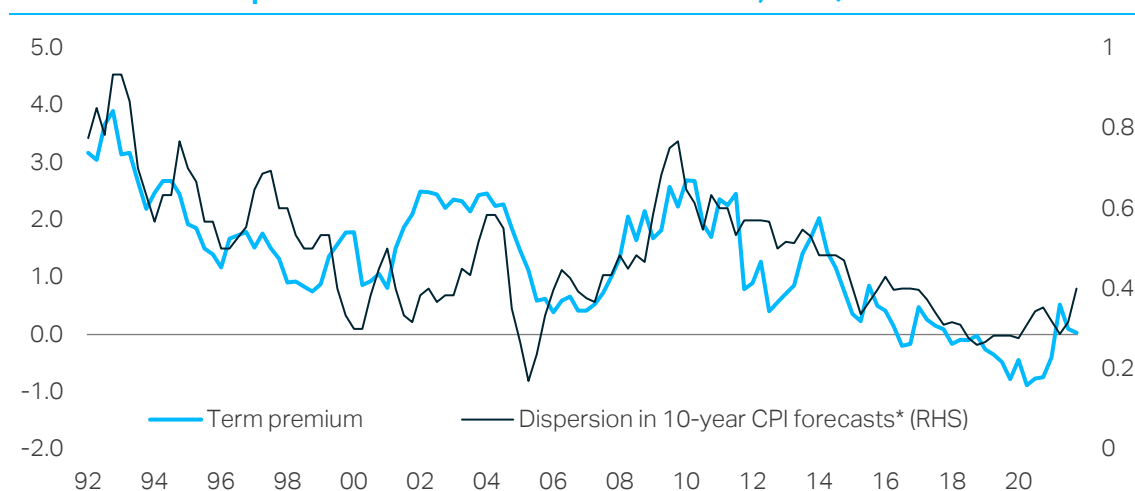


Sources: Datastream, TS Lombard. ** De-trended yields, normalized

investor psychology and policy signalling (my contention) or some mechanical link between QE operations and financial performance. A lot of pundits see a direct link between central banks' balance sheets and asset prices. Finance Twitter (#fintwit) is full of dodgy, spurious-looking charts. To me, any link is fuzzier and – at best – indirect.

Ben Bernanke joked that QE “works in practice but not in theory”. If you are an investor observing that markets react favourably to QE (and badly to QT), perhaps the precise linkages do not matter. But after a decade in which all asset prices have “rerated” on the basis of declining long-term interest rates, it has never been more important to figure out whether this rerating has happened because of evolving macro fundamentals (my view) or whether it is the result of central bank “manipulation”. This will tell us how exposed we are now that central banks (especially the Fed) are desperate to exit these policies and shrink their balance sheets. The authorities themselves are decidedly inconsistent when it comes to explaining QE. Sometimes they argue it is the “stock” of purchases that matters, sometimes it is the “flow”. Or, as seems more likely, perhaps QE is just a hyper-credible commitment not to raise interest rates. And if this is the case, you have to wonder why central banks have chosen to conduct asset purchases on such a massive scale, since they could have provided a similar rate commitment with much smaller QE programmes – without exposing themselves to politicization and popular accusations of “debt monetization”. When parliamentarians recently pushed BoE insiders on these questions, the best the officials could say (under oath) was that QE was “state-dependent”, which is just a fancy way of admitting what Bernanke had said a decade ago – they do not really know how or why QE “works”.

Chart 2: Low term premium reflects macro fundamentals, not QE “distortions”



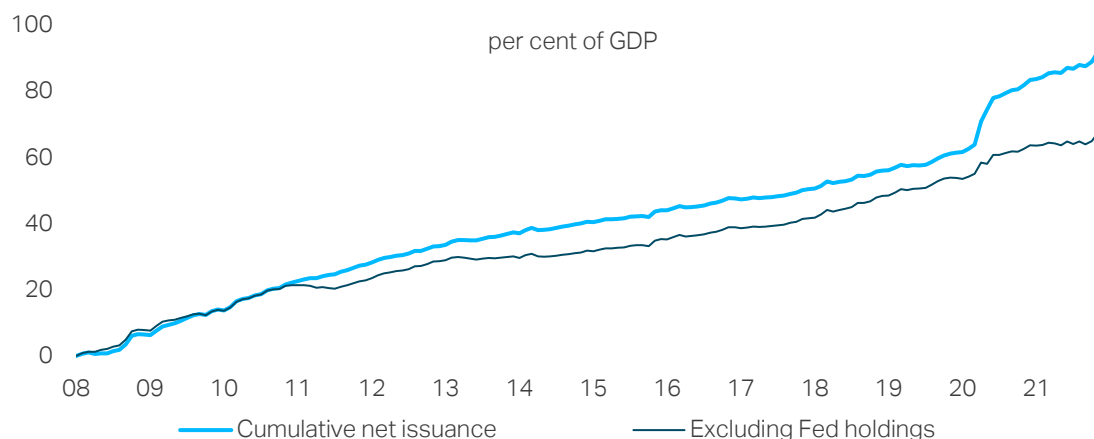
Sources: Datastream, TS Lombard.

To believe in the “liquidity is distorting markets” narrative, you have to accept the “portfolio balance channel” of QE. When a central bank buys securities from the private sector (excluding banks), it creates a deposit (observable in bank reserves), which the recipient will use to purchase riskier securities, bidding up their prices. Bond yields will stay persistently low and other markets (equities, credit, etc.) will rally. While this sounds neat, the theory is full of holes and contains several serious internal inconsistencies; moreover, there is no real empirical evidence to back it up. Central bankers like to produce “event studies” that show QE can have a large impact on bond yields, which they then extrapolate into outsized effects on the real economy. But when we look at these results more carefully, we see that the impact these event studies are capturing is, in fact, rather fleeting, typically disappearing within 30 days. And this is presumably why, over the past decade, there is no discernible pattern between the various central bank BS decisions and what

has happened to yields. Worse for “liquidity” proponents, the arithmetic of the portfolio-balance channel does not add up. QE is supposed to remove “duration” from markets, raising the demand for government securities relative to supply. Yet since the start of QE, the supply of US Treasuries has comfortably outpaced the Fed’s interventions. Investors who sold bonds to the Fed could buy newly issued government securities, without “moving up the risk curve”. At best, we can say yields were lower than some imaginary counterfactual (the standard benchmark for all pro-QE analysis). But even this is a stretch given chronically low inflation and a persistently sluggish global economy.

Portfolio-balance effects are supposed to show up in the bond “term premium”, which has indeed fallen to unusually low levels. Yet there are good “fundamental” reasons why this happened, ones that do not depend on central banks endlessly swapping one near-zero yielding government liability for another. The collapse in investor uncertainty about long-term inflation is surely the most important development. A simple plot of the dispersion in economists’ 10-year inflation forecasts suggests this can well explain the evolution of the US term premium, with no reference to QE. Once we include this factor in a model for bond yields, it is hard to find any significant role for central banks’ balance sheets. And if we de-trend yields, which removes the secular decline in the term premium, we can see that the bond market continues to react to economic news in a fairly standard way. There is no evidence that central banks have dampened this signal by “capturing” the market. But let’s be clear about what this means. I am not saying that current yields are “appropriate” and there is no danger of a further selloff in bonds. Rather, if the bond market is “wrong” and the term premium is “mispriced”, it is because investors are too relaxed about inflation, not because central banks will soon be shrinking their balance sheets via QT.

Chart 3: Fed QE did not cause a shortage of US Treasuries – plenty on offer!



Sources: Federal Reserve, TS Treasury, TS Lombard.

Naturally, QE affects the plumbing of the financial sector; and as we enter a new QT regime, investors will be monitoring money markets closely (so, yes, we all have to start reading Zoltan Poszar again...). Even if there are no serious repercussions for the economy, swapping excess reserves for government securities will require large adjustments below the surface of the financial sector. The last time the Fed tried to shrink its balance sheet, it miscalculated the level of reserves the banking system required, triggering the “Repocalypse” (and forcing an abrupt U-turn in policy). It is possible the central bank will also run into problems this time, depending on various factors such as the US Treasury’s debt financing plans (especially the maturity of the paper it offers) and whether the balance-sheet adjustment happens via a rundown in the Fed’s RRP facility or just the destruction of bank reserves. None of this is easy to forecast. But it is hard

to get excited about these issues because we know the Fed has learned from what happened last time. It will be monitoring how QT affects the “plumbing” of the financial system and has the tools it needs to respond to any problems that might arise. The more fundamental question is whether the secular inflation backdrop has shifted during the pandemic and, if it has, whether markets reflect this new reality. Central banks’ balance sheets were a symptom of low rates, not the cause. True “liquidity” is endogenous to sentiment; you cannot observe it just by mapping QE trends or plotting the money supply.