Macro Strategy

FIVE BPS: WHEN A LITTLE MEANS A LOT

Oliver Brennan

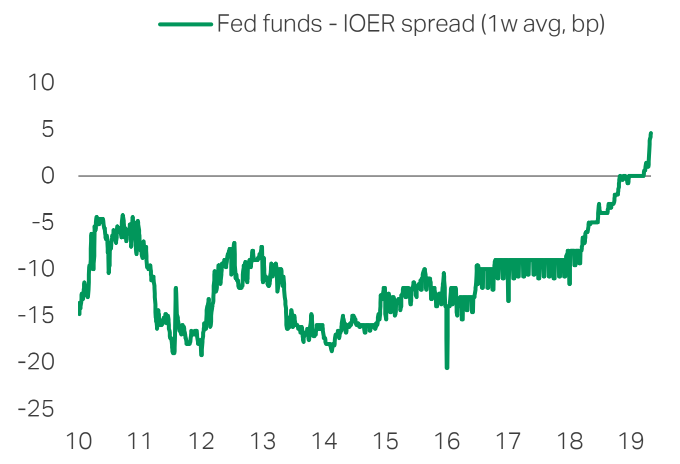
- **Money market liquidity is tight, but will soon ease**
- **But this easing only delays, rather than solves, the underlying problem**
- **Yields look set to rise later in the year**

Five basis points is rarely important when it comes to macro. Economic data are never so precise and pinning down growth estimates to a range even 10 times that number is tricky enough. But five basis points is causing great concern among Fed watchers. With the effective fed funds rate creeping above the Fed's official interest rate on excess reserves (IOER), some fear that the Fed has lost control of monetary policy.

A little history. Pre-crisis, the Fed administered monetary policy by managing liquidity: injecting or withdrawing cash to ensure the fed funds rate traded within its intended range. In 2006 Congress passed a law to allow the Fed to pay interest on reserves, including excess reserves, with effect from 2011. This would change the administration of policy from liquidity fine-tuning to rate adjustment, and was intended to broaden the scope of Fed policy. In short, IOER should establish a lower bound on the fed funds rate because, if fed funds dipped below IOER, money would flood into excess reserves, thereby stabilising fed funds.

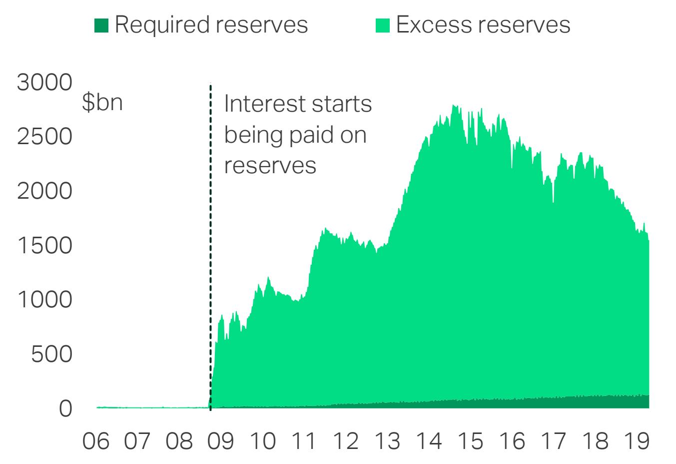
The financial crisis accelerated implementation of the planned shift, as the Fed's various liquidity facilities increased excess reserves and depressed the fed funds rate, thereby blunting the transmission of monetary policy. The new regime was instituted in 2008, when excess reserves rapidly rose from less than $10bn to $150bn, on the way to exceeding $1trn.

Fed funds rate at a premium to IOER



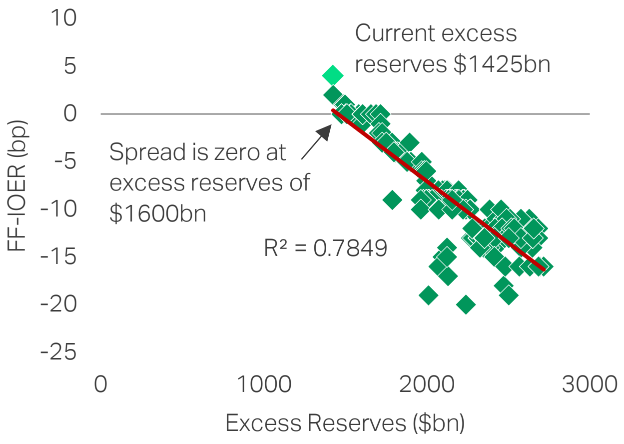
Source: Bloomberg, TS Lombard

Excess reserves regime changed post-crisis



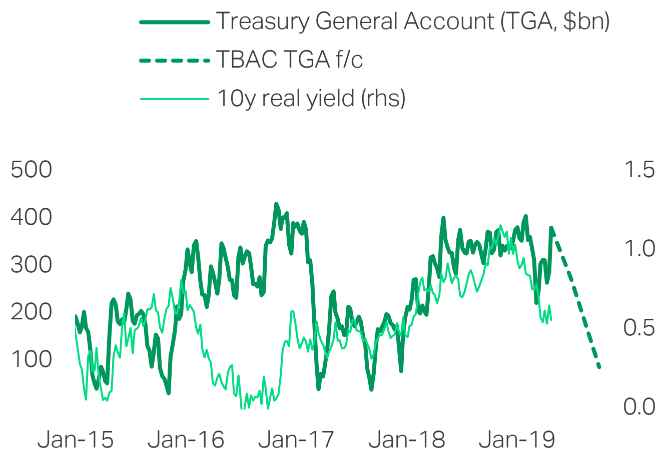
Source: Federal Reserve, TS Lombard

Excess reserves currently below "neutral" level



Source: Federal Reserve, Bloomberg, TS Lombard

Treasury cash balance to fall over the summer



Source: Treasury, Bloomberg, TS Lombard

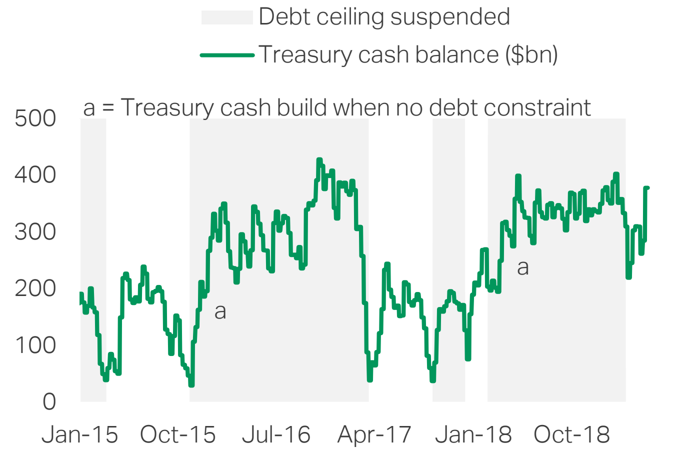
A little complication. If this system were operating in pre-crisis conditions there might be no problem. Back then, banks held reserves as required by the Fed alone, so the amount of excess reserves on deposit, if any, was transparent. If funds were to trade above IOER, dealers would lend their excess reserves into the fed funds market and bring the rates back together and vice versa. But the combination of changes in the structure of money market liquidity (the Fed's measure of "excess" reserves now encompasses reserves required by tighter banking regulations, and borrowing in the fed funds market is not cost-less), injection of excess collateral through Treasury bill issuance, low foreign participation in Treasury auctions and higher tax receipts all add complications. The upshot is that the effective ceiling on money market rates is the general collateral (GC) repo rate, over which the Fed has no control.

It looks like the Fed has indeed lost control of monetary policy. Fed funds is no longer anchored to IOER alone. The IOER rate is acting as a floor but the Fed has no control over the ceiling. There is speculation that it will attempt to regain control with an announcement after today's FOMC meeting: an IOER cut would theoretically inject excess reserves into the system, thereby reducing other rates. Also possible is the introduction of a new repo facility at the secured overnight financing rate (SOFR).

But the question is how much true excess reserves there are. A simple regression between the level of excess reserves and the fed funds-IOER spread since the excess reserves peak in 2014 suggests the neutral level of excess reserves (i.e. where there are no longer excess reserves available to take advantage of the spread) is around $1.6-1.7trn. The current level is $1.4trn. The de-anchoring of fed funds already suggests excess reserves are insufficient, and there is a risk that an IOER cut would not fully translate into a fall in the fed funds rate. Instead, we reckon the Fed will opt for a "watching brief" today, preparing the ground for an adjustment at the next FOMC meeting if fed funds remains stubbornly high. And, in fact, the Fed may escape having to make any difficult choices for now, as the ceiling rate may begin to fall.

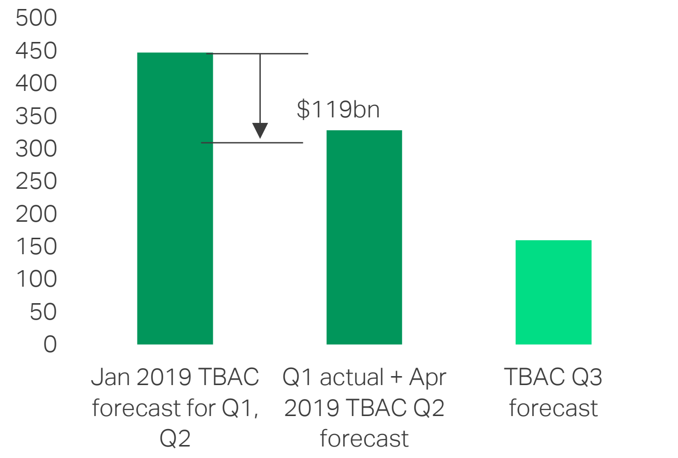
Treasury in control - at the moment. The Treasury's cash balance at the Fed currently stands near $400bn. This represents receipts from bond issuance and tax payments and effectively represents a past withdrawal of liquidity from the money market, something which put upward pressure on rates. But the tax windfall is temporary - the receipts will be spent - and with the debt ceiling again a constraint on debt issuance once more, the Treasury is set to run down its cash balance over the next few months.

Treasury cash rises when ceiling risk resolved



Source: Bloomberg, White House, TS Lombard

Treasury issuance pace to slow in Q2 and Q3



Source: Treasury, TS Lombard

The Treasury Borrowing Advisory Committee (TBAC) forecasts a large drawdown in the Treasury's cash balance over the next six months – in aggregate a net addition of $300bn of liquidity to money markets – and has scaled back its estimate of Treasury issuance. Accounting for the effect of the Fed's QT taper and stealth QE (reinvesting MBS into US Treasuries, a net $350bn swing in Fed Treasury supply over the next 12 months), the net liquidity addition is almost $500bn. Thanks to the "stock" of liquidity available to the Treasury, and thanks to the debt ceiling approaching, liquidity conditions are set to ease over the next few months.

Worry in the future, not now. The current squeeze is unlikely to turn into a negative macro event. But there is a clear time horizon: once the Treasury's cash balance has fallen, there is no more liquidity to inject. Assuming the debt ceiling is raised, the Treasury is likely to increase debt issuance and rebuild its cash buffer, draining liquidity from the market. When this has happened in the past, it is not just money market rates which have risen: long-term real rates have tended to rise as well.

The de-anchoring of fed funds from IOER is real and structural. And it is a problem the Fed has to face up to. For now, the macro consequences are limited thanks to Treasury policy. But that won't be the case forever, and liquidity easing now could pave the way for a broader squeeze later.

Joining the dots, this means upward pressure on yields will diminish over the summer before reappearing later in the year. Buying Treasury bonds over the summer is an option, but as cash delivers the same carry return with zero duration risk, we prefer to use any bond rally to enter a short position in anticipation of likely pressure in the future.

Portfolio update

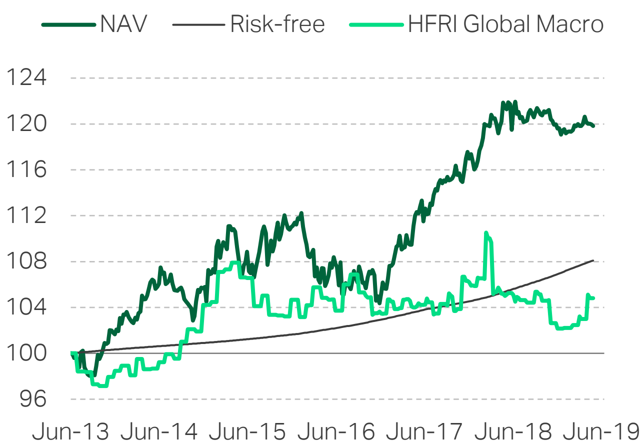
We **close our long Indonesian bond position this week for a total gain of 1.52%**. The model portfolio lost around 12bp on the week, thanks in equal part to Indonesian bond yields rising to our 7.8% stop level (so the trade lost money this week but made money overall) and a surge in the dollar, particularly against KRW. We have taken a large hit on the USD/KRW move, but today's stronger-than-expected Korean exports for April, and our expectation that Chinese stimulus will begin to soon show through in the data, mean we will hold on for now.

Current trade recommendations

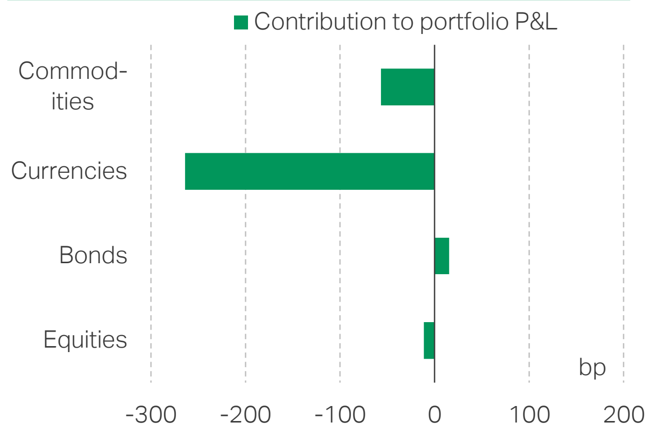
Theme / Trade	Date opened	Entry level	Last	P&L	Target	Stop	Original rationale / comment
Bullish markets, bearish macro							
Long Indonesian local rates**	6-Mar-19	7.89%	7.83%	6bp	7.15%	7.80%	EM disinflation, high real rates and risk appetite support bond rally
Long VIX September call spread	10-Apr-19	1.1	1.0	-0.15			Equity mkts discount trade war de-escalation and policy easing; risk of a correction
Time to buy sterling							
Long GBP/USD 3m call spread*	13-Feb-19	0.31%	0.03%	3bp			With time almost up, an extension or deal is more likely than no deal
China leading the bounce							
Long EEM vs SPY	24-Apr-19			-0.18%			Foreign (Chinese) growth likely to outperform US
Dollar diversification							
Long AUD/USD 3m call spread	17-Apr-19	0.26%	0.13%	-13bp			Falling vol. stable CNY, China stimulus, iron ore and positioning
Short USD vs EUR, CAD, RUB, KRW	3-Apr-19			-0.6%			Reserve diversification, seasonals and improving China sentiment

Bold indicates new trades or changes made this week. *P&l includes profit taken on half of position **Taken profit

Model portfolio historical performance



Performance contribution – last 12 months



Model portfolio metrics since inception

	Portfolio	HFRI Global Macro
Since Inception return	19.82%	4.81%
Annualized Return	**3.11%**	**0.80%**
2016	-4.89%	0.14%
2017	9.67%	2.47%
2018	2.98%	-3.50%
YTD	0.23%	2.75%
MTD	-0.27%	
Volatility (ann.)	4.36%	3.99%
Sharpe ratio	**0.40**	**-0.12**
Sortino ratio	**1.29**	**0.33**
Alpha (12m, vs HFRI)	-0.09%	
Beta (12m, vs HFRI)	-0.11	
Corr (12m, vs HFRI)	-0.12	
Corr (12m,vs MSCI World)	-0.09	
Corr (12m, vs JPM GBI)	-0.07	
Max drawdown (12m)	-3.08%	-2.78%

Best and worst trades – last 12 months

Best and worst performing trades of last 12 months	
Best	**Contrib. (bp)**
Long BRL / MXN (17-Oct-18)	55
US 2s10s steepener (07-Nov-18)	48
Long US Consumer Disc. (09-May-18)	47
Short MSCI EM / long MSCI DM (1-Aug-18)	39
Long Bunds / short OATs (14-Mar-18)	35
Worst	**Contrib. (bp)**
Long EUR / short GBP, CHF, AUD, USD (04-Oct-17)	-115
Short Brent /WTI spread (19-Sep-18)	-70
EUR/USD Call Spread (16-May-18)	-45
Long EUR / short AUD (03-Oct-18)	-38
Long EM ETF (03-Dec-18)	-37

Authors

Oliver Brennan
Senior Macro Strategist

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