ROCKEFELLER
GLOBAL FAMILY OFFICE

CIO MONTHLY PERSPECTIVE

SEPTEMBER 2024

# Sea of Liquidity

Who will be beached when the tide recedes?

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# Market Watch

| Equity Market Indices[1] | 7/31/24 Price | 8/31/24 Price | MTD Change | YTD Change |
|---|---|---|---|---|
| MSCI All Country World | 814 | 834 | 2.40% | 14.67% |
| S&P 500 | 5522 | 5648 | 2.28% | 18.42% |
| MSCI EAFE | 2381 | 2453 | 3.02% | 9.72% |
| Russell 2000®[2] | 2254 | 2218 | -1.63% | 9.40% |
| NASDAQ | 17599 | 17714 | 0.65% | 18.00% |
| TOPIX | 2794 | 2713 | -2.92% | 14.63% |
| KOSPI | 2771 | 2674 | -3.48% | 0.72% |
| Emerging Markets | 1085 | 1100 | 1.40% | 7.44% |
| **Fixed Income** | | | | |
| 2-Year U.S. Treasury Note | 4.26% | 3.92% | -34 | -33 |
| 10-Year U.S. Treasury Note | 4.03% | 3.90% | -13 | 2 |
| BBG U.S. Agg Corp Spread | 0.93% | 0.93% | 0 | -6 |
| BBG U.S. HY Corp Spread | 3.14% | 3.05% | -9 | -18 |
| **Currencies** | | | | |
| Chinese Renminbi (CNY/$) | 7.23 | 7.09 | -1.87% | -0.12% |
| Brazilian Real (Real) | 5.65 | 5.61 | -0.77% | 15.43% |
| British Pound ($/GBP) | 1.29 | 1.31 | -2.07% | -3.02% |
| Euro ($/Euro) | 1.08 | 1.10 | -2.01% | -0.09% |
| Japanese Yen (Yen/$) | 149.98 | 146.17 | -2.54% | 3.64% |
| Korean Won (KRW/$) | 1371.20 | 1337.80 | -2.44% | 3.86% |
| U.S. Dollar Index (DXY) | 104.10 | 101.70 | -2.30% | 0.36% |
| **Commodities** | | | | |
| Gold | 2448 | 2503 | 2.28% | 21.35% |
| Oil | 77.91 | 73.55 | -5.60% | 2.65% |
| Natural Gas, Henry Hub | 2.04 | 2.13 | 4.47% | -15.39% |
| Copper (cents/lb) | 418 | 415 | -0.75% | 6.54% |
| CRB Index | 278 | 277 | -0.39% | 5.01% |
| Baltic Dry Index | 1708 | 1814 | 6.21% | -13.37% |

Source: Bloomberg

## INTRODUCTION

The sharp market correction in early August came and went like a summer storm followed by rainbows and sunshine. Much credit goes to the Bank of Japan's (BOJ) capitulation, which took further rate hikes off the table after its July 31 decision to raise the policy rate to a mere 0.25% contributed to the unwinding of the yen carry trades. The Treasury Department also played a vital role in stabilizing the market – $230 billion of liquidity was pumped into the market via drawdowns of the Treasury General Account (TGA) and Overnight Reverse Repo (ON RRP) facility during the first half of the month.

One of the catalysts for the sell-off was the surprisingly soft July employment data, which had the unemployment rate surging to 4.3%, nearly a full percentage point above the cycle low of 3.4%. The weak jobs picture was further confirmed by the Bureau of Labor Statistics' preliminary annual benchmark review of employment data, which cut the number of new jobs created between March 2023 and March 2024 by 818,000. The scale of the downward revision was five times the annual average revision over the past 10 years, and calls into question the validity of incoming data that will affect the Fed's policymaking. Indeed, the Fed has become so concerned about the labor market that at Jackson Hole, Fed Chair Powell emphasized that he and his colleagues "do not seek or welcome further cooling in the labor market conditions." Chair Powell also made it clear that "the time has come for policy to adjust...and the timing and pace of rate cuts will depend on incoming data, the evolving outlook, and the balance of risks."

The fact that Chair Powell eschewed words like "gradual" and "methodical" in describing the upcoming interest rate cutting cycle left the door open for a 50-bp cut at the Federal Open Market Committee (FOMC) meeting on September 18. This overtly dovish stance was a gift to equities, bonds, and gold but sent the U.S. dollar tumbling and could be criticized as being political ahead of the November general election.

The Fed's dovish position is setting up an interesting test for September, which is historically the weakest month of the year. While financial conditions have been easing rapidly, economic fundamentals, electoral uncertainty, and geopolitical tension may still weigh on sentiment and valuations. The Fed will need to properly nudge the market's rate cut expectations for not only September, but also the remainder of the year to avoid triggering undesired market tantrums and volatility.

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# The ON RRP & TGA

One of the most unusual developments from the COVID-19 pandemic era is the emergence of the Fed's Overnight Reverse Repo (ON RRP) facility and Treasury General Account (TGA) as major policy tools to manage the flow of liquidity in and out of our economy and financial markets. As shown in Charts 1A and 1B, the balances in these facilities have become quite substantial since 2020.

The Overnight Reverse Repo is a facility created by the Fed in 2013 to help set a floor for its policy rates among non-bank lending institutions. For example, the Fed currently sets the fed funds rate at 5.25% to 5.5%. To ensure that this lower bound of the fed funds rate is not breached, the Fed pays an interest rate of 5.3% on money that eligible institutions put into the ON RRP facility, which should disincentivize them from lending money at rates below this level.

During 2020 and 2021, with so much stimulus money moving around the system, money market funds (MMFs), which can invest only in securities that mature in 397 days or less, were inundated with deposits that they could not find places to invest in. In April 2021, the Fed solved this problem for MMFs by making them eligible for the ON RRP facility, and, as shown in Chart 1A, a tsunami of money started to flow into the facility, peaking at $2.5 trillion by the end of 2022.

From a market liquidity standpoint, increasing the balance in the ON RRP effectively drains money from the economy and markets. That is, instead of having MMFs make short-term loans to public and private sector borrowers, the money was taken out of the system and put on the Fed's balance sheet. Conversely, as the balance in the ON RRP is reduced, liquidity is returned to the economy and markets.

For decades prior to the Great Financial Crisis, the U.S. Treasury Department used the Treasury Tax & Loan (TT&L) accounts at large commercial banks to handle its

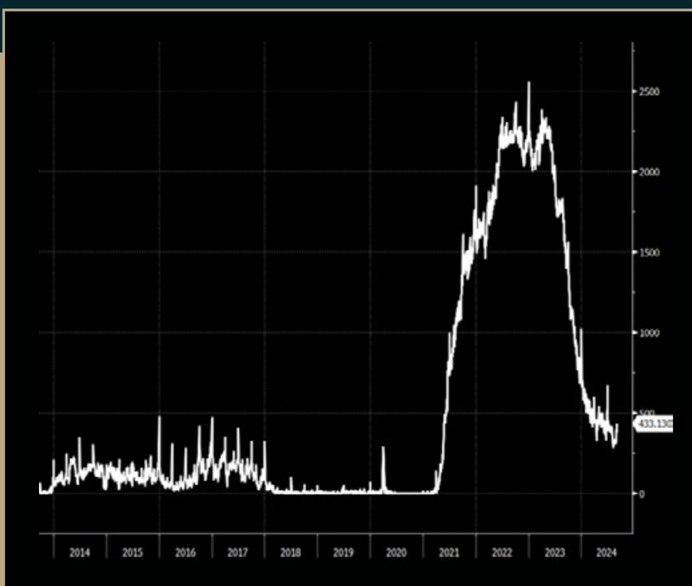


Chart 1A: The Overnight Reverse Repo (ON RRP)

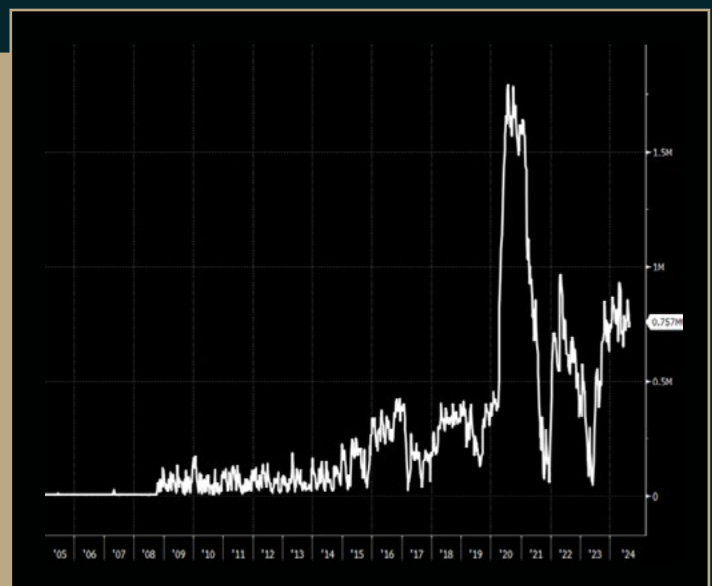


Chart 1B: The Treasury General Account (TGA)

Source: Bloomberg

cash flow – depositing cash raised from tax collection and debt issuance, and disbursing money for payrolls, transfer payments, and procurement. This arrangement kept the circulation of the federal government's money in the banking system. That is, when taxes were collected, money moved from taxpayers' bank accounts to the TT&L accounts at commercial banks, so there was no net change in the quantity of money in the banking system. Conversely, when the government spent money, funds were moved from the TT&L accounts into bank accounts of businesses and individuals.

This arrangement has changed since the Great Financial Crisis. Instead of using the TT&L accounts at commercial banks to handle its cash flow, the Treasury started to move its money in and out of the Treasury General Account (TGA) at the Federal Reserve.

The federal government's use of the Federal Reserve as its primary bank rather than the TT&L accounts at various commercial banks has an impact on the liquidity in the banking system. When the government deposits funds raised from tax collection and debt issuance into the TGA, money is taken out of the banking system and put on the Fed's balance sheet. Conversely, as the federal government spends down the balance in the TGA, money is injected into the banking system, which increases the market's liquidity.

The big surge in the TGA balance came in the spring of 2020. With the Fed buying $2.3 trillion of securities from March through June 2020 to reliquefy financial markets, Treasury Secretary Steven Mnuchin opportunistically raised $3 trillion of net debt during that period to fund Washington's stimulus checks and build a rainy-day fund of $1.8 trillion in the TGA. Since then, the Treasury has aimed to keep the balance in the TGA at around $750 billion to "maintain funds sufficient to cover its one-week ahead cash need, which includes both net fiscal outflows and the gross volume of maturing marketable debt."

# The Activist Treasury

Investors entered 2023 with much pessimism as many market strategists and sell-side economists were forecasting an imminent recession. Markets were also rattled by the looming debt ceiling battle and a potential government shutdown as the $31.4 trillion debt ceiling was reached in late January. Little did investors realize at the time that the prolonged debt ceiling battle would turn out to be a liquidity bonanza for the market.

With the Treasury Department being unable to issue new debt after the $31.4 trillion debt ceiling was reached in late January 2023, it started to spend down the balance in the TGA, which stood at $570 billion at the time. By the time President Biden and then House Speaker McCarthy reached a debt ceiling deal in late May, the TGA had only $50 billion left. This $520 billion of liquidity injection from the TGA to the economy helped to lift the S&P 500 Index by 9% during the first five months of 2023 despite the collapse of Silicon Valley Bank, First Republic Bank, and several smaller entities - the worst banking crisis since the Great Financial Crisis.

With the government funding issue resolved, the Treasury Department faced a new challenge – how to replenish the TGA to its target of $600 billion by the end of September 2023 without roiling financial markets with the associated liquidity drain.

Officials at the Treasury came up with a plan that would not only solve the large debt issuance issue, but also inject extra liquidity into the economy. That is, tapping into the massive balance in the Fed's Overnight Reverse Repo Facility, which

stood at $2.3 trillion at the end of May 2023, to fund the Treasury's debt issuance.

With MMFs only able to purchase short-term debt securities, the Treasury Department had to alter the mix of its debt issuance, which has traditionally consisted of roughly 20% in short-term bills (T-bills) and 80% in notes and bonds. It is generally believed that an overreliance on short-term financing is not prudent as it exposes the borrower to rollover and interest rate risk.

The Treasury wound up flipping the mix of debt issuance in 2023 to 80% in T-bills and 20% in notes and bonds. For full year 2023, 81% of the $2.4 trillion net debt issued to the public, or $2 trillion, was in short-term bills. This unprecedented reliance on short-term funding let the Treasury channel $1.5 trillion of liquidity from the ON RRP to the economy – excluding the so-called year-end window dressing, the balance in the ON RRP dropped from $2.3 trillion at the end of 2022 to $830 billion at the end of 2023. The tremendous liquidity injection, or stealth easing by the Treasury, more than offset the Fed's quantitative tightening and was one of the catalysts that sent the S&P 500 Index up 25% in 2023 despite a mere 1% growth in aggregate corporate earnings.

Chart 2: The inverse relationship between the Overnight Reverse Repo and the S&P 500 Index since 2022

# More Liquidity on the Way

So far in 2024, financial markets have continued to benefit from the decline in the ON RRP, which has injected more than $450 billion of liquidity year-to-date, offsetting much of the $525 billion reduction in the Fed's securities holdings due to QT. As of September 3, the ON RRP had a balance of $350 billion that will likely be channeled into the economy and financial markets by year end of early 2025.

The balance in the TGA currently stands at $700 billion, which is below the Treasury Department's $850 billion end-of-September target. Ceteris paribus, increasing the TGA balance by $150 billion in September could pressure the market in the near term.

The Treasury has set a $700 billion end-of-December TGA target, which would allow it to release $150 billion of liquidity back into the economy in the fourth quarter. If this $150 billion of planned decline in the TGA is realized in October, it would be a tremendous October surprise for financial markets – $150 billion of liquidity injection in a month is equivalent to an annualized stealth QE of $1.8 trillion.

The gist of these potential developments is that the liquidity backdrop remains quite favorable for the remainder of 2024. In fact, during the first five years of this decade, 2022 was the only year that experienced an outflow of liquidity, and it coincided with a down year for stocks and bonds. The other four years all benefited from the government's generous liquidity injection. However, after the balance in the ON RRP is depleted, investors will have to adjust to a new era where excess liquidity is no longer abundantly available to fuel asset prices.

Interestingly, there may be one more jolt of significant liquidity injection in the first half of 2025 if the November election delivers a split government. That is, the suspension of the debt ceiling will expire on January 2, 2025. If Washington fails to extend the suspension or set a new debt limit, the Treasury Department will be forced to stop issuing net new debt and draw down the TGA to fund the government's spending. Ironically, the longer the debt ceiling issue remains unresolved in 2025, the greater the release of liquidity from the TGA into the economy and financial markets.

However, this liquidity story is a double-edged sword. Once a new debt ceiling agreement is reached in 2025, the Treasury will then have to replenish the TGA. With the ON RRP having been depleted by that time, there will be no excess liquidity for the Treasury to tap, and the refilling of the TGA will likely directly drain money from the economy and financial markets.

# When the Tide Goes Out

In the final analysis, the outcome of the November election will shed some light on whether the upcoming debt ceiling negotiations in early January 2025 will result in another liquidity boom/bust cycle via the drawdown and subsequent refill of the Treasury General Account. By mid-2025, the pandemic-induced liquidity binge will likely have run its course.

As excess liquidity evaporates in 2025, financial assets will likely have a hard row to hoe – equity valuations may contract, bond yields could be driven higher, and even gold and cryptocurrencies may come under selling pressure. Tighter financial conditions will also weigh on economic growth.

Facing these potential challenges, the Fed will likely come to the rescue by accelerating its pace of interest rate cuts to make up for the lack of additional liquidity flowing into the economy. In fact, the Fed has already scaled down the pace of quantitative tightening since June and may stop this liquidity tightening program in the near future.

Central banks' proclivity to accommodate the market's moral hazard is one of the reasons why I continue to have a favorable view of gold – the yellow metal is a hedge on monetary inflation and loose central bank policymaking.

For stocks and bonds, the key question is whether the current economic expansion is in mid- or late cycle. While the consensus remains a mid-cycle soft landing, one should not dismiss the late-cycle risk, especially with economic data having turned more mixed of late.

With the Fed about to initiate another rate cutting cycle, income-oriented investments remain attractive as they offer reasonable yields and the potential for more capital appreciation if recession turns out to be the outcome. As for equities, the prospect of lower market liquidity in 2025 and growing macro uncertainties mean that investors could become more valuation sensitive and less narrative-driven. That would favor defensive and quality stocks, especially those with attractive dividend yields. Emerging market stocks may also enjoy a period of outperformance if the U.S. dollar weakens further as a result of the Fed's aggressive rate cuts.

Warren Buffet once said, "Only when the tide goes out do you discover who has been swimming naked." The market will likely be put to that test as the tide of liquidity goes out in the not-too-distant future.

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