Central Bank Liquidity Update – Changes are Coming

Explained by Thomas H. Kee Jr.

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In September of 2017 the Federal Reserve announced its intention to reduce its balance sheet. It set a conditional schedule to reduce its balance sheet by $420B in 2018. The schedule is quarterly, and it began in the fourth quarter of 2017.

From there, the amount of asset purchase reductions would increase quarterly, calculated on a monthly basis, according to that schedule so long as economic conditions were not impaired. From there, additional asset purchase reductions would be considered for 2019.

The intention of the Federal Reserve's decision is to normalize its balance sheet. After years of unprecedented stimulus and direct asset purchases the Federal Reserve has an inflated balance sheet that many economists also believe needs to be reduced to preserve financial stability.

However, the Federal Reserve is not the only central bank influencing global assets. They were until 2015, but then they handed the baton over to the ECB. At that time the Federal Reserve stopped buying new assets and simply reinvested interest and principal from existing positions. In effect, that made the FOMC old money.

Importantly, we cannot churn old money and expect assets to grow. New money is required for the stock market to increase, for example, and for years prior to 2015 the FOMC's stimulus program was new money. This influence largely offset the natural rate of change in the amount of new money available to be invested into the U.S. economy, as that is defined by our derivative demographic analysis, The Investment Rate. The Investment Rate, which is a natural identification of new money and liquidity, still plays a very important role, though it has been overwhelmed by stimulus recently.

However, as the baton was handed to the ECB in 2015 another round of stimulus began, and the global economy continue to have added fabricated liquidity from central banks. As 2017 rolled around the ECB was buying $60B per month of global assets, creating a tremendous amount of liquidity in the global Financial System, and the FOMC was reinvesting interest and principal.

Another way of saying this is that the FOMC was not causing any drain on liquidity. They were not selling bonds, and they were not allowing bonds to redeem without reinvestment. This means that they were a buyer of global financial assets as well, even though they were not a new buyer. They were simply not allowing redemptions to be a drain on liquidity.

The culmination of these central bank activities created a very unusual condition in the global economy in 2017. The constant infusion of capital by the ECB and the reinvestment policies of the FOMC told investors that there was a buyer at the other end of the table for global financial assets. The central banks also told investors what they would buy, when they would buy it, and how much they would buy, in advance, every month.

At no time in history have institutional investors been able to identify when buyers would come into assets like this, and in 2017 not only did they know that a buyer would be there, but the buyer was the biggest and deepest pocket buyer imaginable, with unlimited purchasing power.

As a result, financial institutions piggybacked on this central bank activity and bid the S&P 500 up to 25 times earnings. This bull market multiple made the bull market the most expensive one in history. With the normal PE multiple in the S&P 500 of 14.5 times earnings historically, there also is quite a bit of room for multiple contraction. In 2017, however, this was arguably the last thing on anyone's mind. Even though there had never been a bull market as expensive as the one that existed at the end of 2017 and beginning of 2018, investors were comforted by the activities of the central banks.

Another way of saying this is to suggest that the $60B of monthly capital infusions into global financial assets pushed global financial assets higher and caused piggybacking.

The question that we need to ask ourselves is this:

if $60B of capital infusions per month caused the S&P 500 to press higher that aggressively, what would happen if there was actually a drain on liquidity in the same magnitude? In other words, what would happen if they were taking $60B per month out every month?

Simple logic would tell us that if added liquidity causes asset values to increase, the removal of liquidity would cause asset values to decline.

In this specific instance it would also be a reasonable to assume if a drain on liquidity is realized investors who piggybacked the central bank stimulus policies might reverse their decisions as well.

Arguably, in 2018 that is exactly what we started to see. After the first month of the year, in which the repatriation of overseas corporate cash gave the market an added boost, volatility levels kicked in. This was a direct result of the lower levels of liquidity. Whatever concerns may have been there that caused that volatility would not have had the same influence in 2017, when the global central bank stimulus policies were in full tilt.

In fact, in the first quarter of 2018 net global central bank stimulus was $0.00.

Not only did the FOMC embark on its schedule to reduce its balance sheet, but the ECB also cut its bond buying program in half. In the first quarter of 2018 the reduction in the asset purchases by the FOMC completely offset the lower asset purchases by the ECB.

Importantly, the FOMC began reducing its balance sheet in the fourth quarter of 2017, but at that time the ECB was still buying $60B per month of global assets, so the reduction by the FOMC did not have immediate impact. In the fourth quarter of 2017 there was still $50B per month flowing into global assets. The FOMC had reduced its balance sheet by $10B, but the ECB was still buying $60B.

In the table below, we can see the progression between 2017 and 2018 so far.

Liquidity	Q1 2017	Q2 2017	Q3 2017	Q4 2017	Q1 2018	Q2 2018	Q3 2018
FOMC	0	0	0	-10	-30	-60	-100
ECB	60	60	60	60	30	30	30
Stimulus	60	60	60	50	1	-30	-70

The volatility that the market experienced in the first quarter of 2018 was directly tied to the reduction of the combined central bank stimulus efforts. Where $60B per month was being poured into global assets for almost the entire year in 2017, in the first quarter of 2018 the influence was $0.00. Central bank asset purchases were no longer pressing asset prices higher.

The buyer at the other end of the table, central banks if you will, was no longer buying $60B per month, so it was not nearly as easy to sell if the going gets tough, and we saw evidence of that in February.

We can point the finger at a number of issues that surfaced in February to rationalize the volatility, but from a liquidity standpoint the rationale is quite clear. Institutional investors who were piggybacking the constant inflow of capital that was coming all through calendar 2017 pulled the plug. The declines were severe, rapid, and they were something investors have not seen for years.

When the buyer at the other end of the table is no longer there to support asset prices like we saw in 2017, moderate selling pressure can have an exacerbated influence, and that is exactly what we saw in February in the stock market. All it takes for the market to fall is for more Sellers to exist than buyers.

Don't over think it. Volume levels do not need to be high, and dollar values do not need to be high, all that matters to price is the difference between the buyers and Sellers. Obviously, higher volume levels can make a difference, but it is not necessary.

Concerningly, if the buyer at the other end of the table is no longer buying assets we could rationalize that if the sell side volume did increase to higher levels the risks of aggressive declines would be high. That is, based on the observations made from the volatility earlier this year, exactly what happened.

On the opposite side, the same thing holds true. The market does not need the number of buyers to far outweigh the number of Sellers in order for it to move higher. Volume levels do not need to be high and dollar amounts do not need to be high for the market to move up. All that matters is the difference between buyers and Sellers, and after the institutional piggybackers left the party when January came to an end, and after the following volatility subsided, that is exactly what we've seen too. The market moved higher, slowly, and the number of buyers slightly outweighed the number of Sellers.

This started happening at a time when the net influence of global central bank asset purchase programs was $0.00. This was also happening at a time when the natural rate of change in the amount of new money available to be invested into the U.S. economy based on ingrained societal norms is significantly lower, this is defined by the Investment Rate, but it usually takes a little more time for that influence to be felt, so it has been a non-issue so far.

In the second quarter of 2018 the combined central bank efforts began draining liquidity from the financial system for the first time since shortly after the credit crisis. The drain was only about half of the $60B monthly stimulus that existed for most of last year. So far, the liquidity issues that exist are constrained as a result, but vulnerabilities are clear and present, we saw what can happen in February, and the drain is slated to get worse.

Looking back at the schedule outlined by the FOMC last September, we can quantify this. They removed $10B in the fourth quarter of 2017, an extra $20B in the first quarter of 2018, $30B in Q2, and they are slated to remove an extra $40B per month in the third quarter of 2018 as well. That begins in July, about two weeks from now.

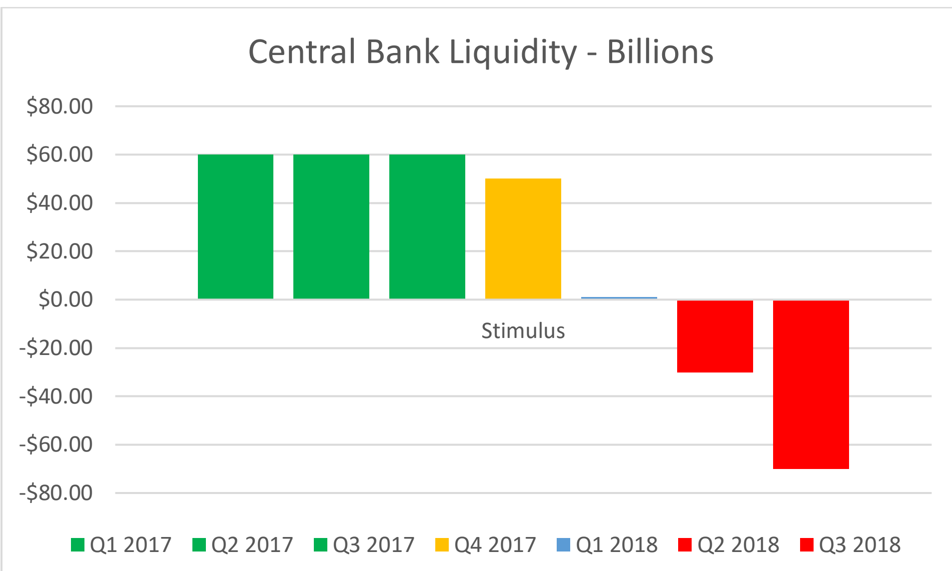
Officially, in July the combined central bank efforts will actually be a material drain on liquidity, and the monthly drain will be greater than the monthly stimulus that existed in 2017. The net effect will be a $70B per month drain on liquidity, and the FOMC is to blame. They are reducing their balance sheet aggressively, and their schedule suggests they will get even more aggressive next quarter as well.

Although the ECB is still printing money it is not able to offset the negative influence of the FOMC.

As a result, we expect a significant drain on liquidity to begin officially in July.

Where it seemed as if institutional piggybackers played a significant role in the declines that we saw in February, this time the influence will come from the biggest player in the room. The same never-ending buyer who pressed global assets higher for years will officially become a material drain on global liquidity in the third quarter of 2018.

We have summarized this in a very simple illustration below.



In the chart above, the green bars represent the first three quarters of 2017. The yellow bar is the fourth quarter of 2017, when the FOMC cut its bond buying program slightly. In the first quarter of 2018 the net effect is nil. And the red bars represent the monthly drain on liquidity in 2018.

Another way saying this, in the third quarter of 2018 the net stimulus by global central banks will be $130B less than it was last September.

If you believe that the constant infusions of capital that existed until 2018 helped influence global asset prices higher and helped push the S&P 500 to 25 times earnings, which made it the most expensive bull market in history, you must ask yourself what you think will happen when global central bank stimulus begins to drain $70B per month from the global economy in two short weeks.

Thus far we have not even incorporated the natural demand levels identified by the Investment Rate into this observation, and that opens an entirely new can of worms. Make sure you review the Investment Rate and understand the difference between where natural demand levels exist and where fabricated demand levels existed at the end of last year. That will quantify the risks for you.

The Investment Rate – A Macroeconomic Analysis Measuring Lifetime Investment Patterns

Additionally, it is imperative that we engage and strategies that can work no matter what happens. I suggest that you review the Sentiment Table Strategy and the Strategic Plan Strategy carefully. If nothing more these can be used as indicators, but they are also exceptional strategies that can work no matter what happens. I designed them specifically for this.

Whatever you do, make sure that you understand that this is happening. The Liquidity changes are real. Just like the FOMC told us when it was going to buy assets in advance every month before, it is telling us in advance exactly when and how it is going to unwind its asset purchase program. We know it's going to come, but arguably we don't know exactly what's going to happen to the markets yet.

If the constant infusion of monies by the central banks into global assets caused stocks, bonds, and real estate all to increase aggressively, we could surmise that the opposite will happen when liquidity is drained out of the financial system by the same central banks in a greater magnitude like it will be now.

My advice is, don't be a Bull in Headlights.