Beneath the Surface

February 2025

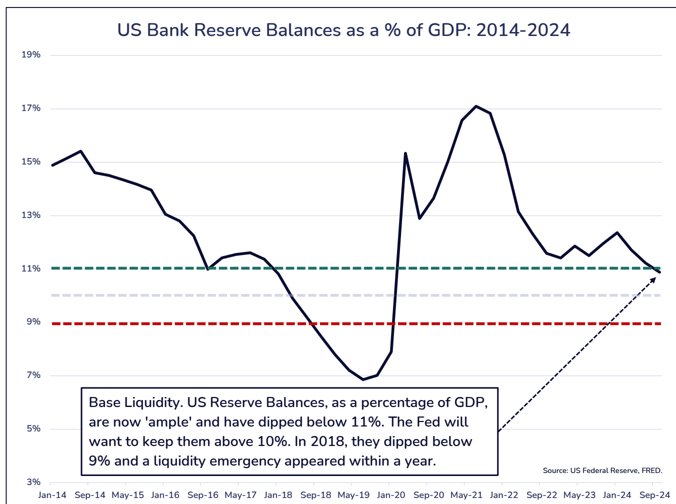
SIGNET

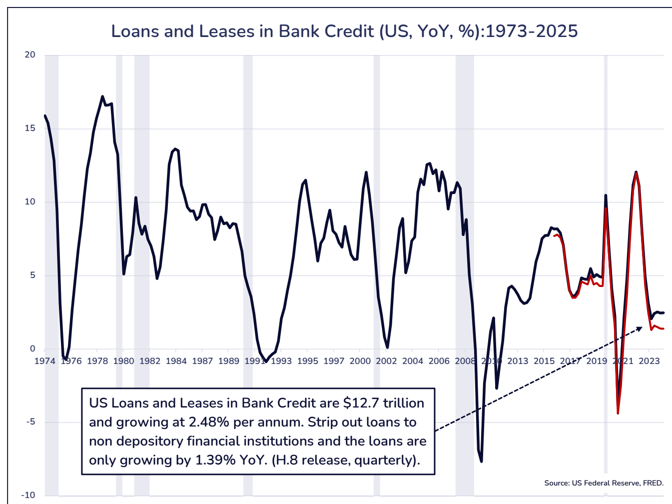
TFC – Tighter Financial Conditions

- The first time the Federal Reserve embarked on Quantitative Tightening (QT), a restrictive monetary process to reduce the size of its post-GFC balance sheet, was between 2017 and 2019. Janet Yellen, Chair of the Federal Reserve (the Fed) at the time, promised it would be like "watching paint dry." However, by September 2019, too much private liquidity had been withdrawn from the banks, against conditions of elevated Treasury issuance and reduced Reserve balances, and the financial system's 'plumbing' – the overnight money markets (repo) and their interest rates – started to rapidly dislocate. Reserve balances had been too 'tight', having fallen below 9% of nominal GDP (chart, below left) and the Fed was forced into an emergency intervention: cutting interest rates, the QT programme and injecting funding liquidity indirectly via Reserve balances.

- The Fed is once again engaged in QT and this time with a more aggressive interest rate policy. The Fed's balance sheet has declined by over $2 trillion since April 2022 and it now sits at $6.8 trillion; remember that each dollar running off the Fed's balance sheet reduces private sector liquidity. There have been no dislocations, so far, but this time the system has been supported by an additional temporary liquidity facility since 2021 called the Reverse Repo Agreements (RRP). This 'excess-excess' liquidity facility peaked at $2.3 trillion in 2023 and has accounted for most of the QT liquidity drain since then. However, the facility has now been drawn down to its last $81 billion. Any further QT is likely to see a drawdown in Reserve balances at the banks. The Fed is currently committed to an orderly transition from an 'abundant' to 'ample' supply of Reserves, and recent Fed commentary has alluded to a Reserves' floor of 10% to 11% of nominal GDP. Fed Governor Christopher Waller, speaking formally in early 2024, said this level would be "an approximate end point for draining Reserves out of the system." With the RRP drained, and Reserves-to-GDP already below 11%, we expect the QT programme to be stopped very soon. If it's not terminated, financial conditions will become excessively tight and we might be exposed to the 2019-style fireworks again.

- Credit creation is an essential part of the global economy and it is the primary mechanism for stimulating economic growth. The rate of momentum for commercial bank credit growth in the US has declined steadily over the last two years, and it is only expanding by 2.48% now (chart, below right). As a reference, the average growth rate of bank credit since the fourth quarter of 2007 is 4.41%. The Fed's interest rate policy is starting to bite and the deceleration in credit expansion may well lead to disinflationary expectations gaining traction. Additionally, if you look at the Fed's H.8 release on the commercial banks' balance sheet, something else is clearly apparent: this headline growth rate in 'Loans and Leases in Bank Credit' (2.48%) has been propped up recently by loans to 'Non-Depository Financial Institutions' (NDFI, i.e. the shadow banking sector), which is expanding by 15% YoY. NDFI loans to insurance companies, hedge funds and the private equity sector are not necessarily economically productive! If we strip this contribution out of the headline 'Loans & Leases' statistic, the credit growth rate for the US is only 1.39% YoY (red line in the chart, below right). This is a concern and warrants caution as an investor.





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