

MAY 2022



**MOVING ON FROM  
ULTRA EASY  
MONETARY POLICY**



JUSTIN LEDERER  
[jlederer@cantor.com](mailto:jlederer@cantor.com)

# MONETARY POLICY AND THE CHANGES POST FINANCIAL CRISIS

- **Mandates:** The goal of monetary policy for the Federal Reserve is to promote maximum employment and price stability.
- **Tools:** The Federal Reserve's three mechanisms of monetary policy are open market operations, the discount rate and reserve requirements.

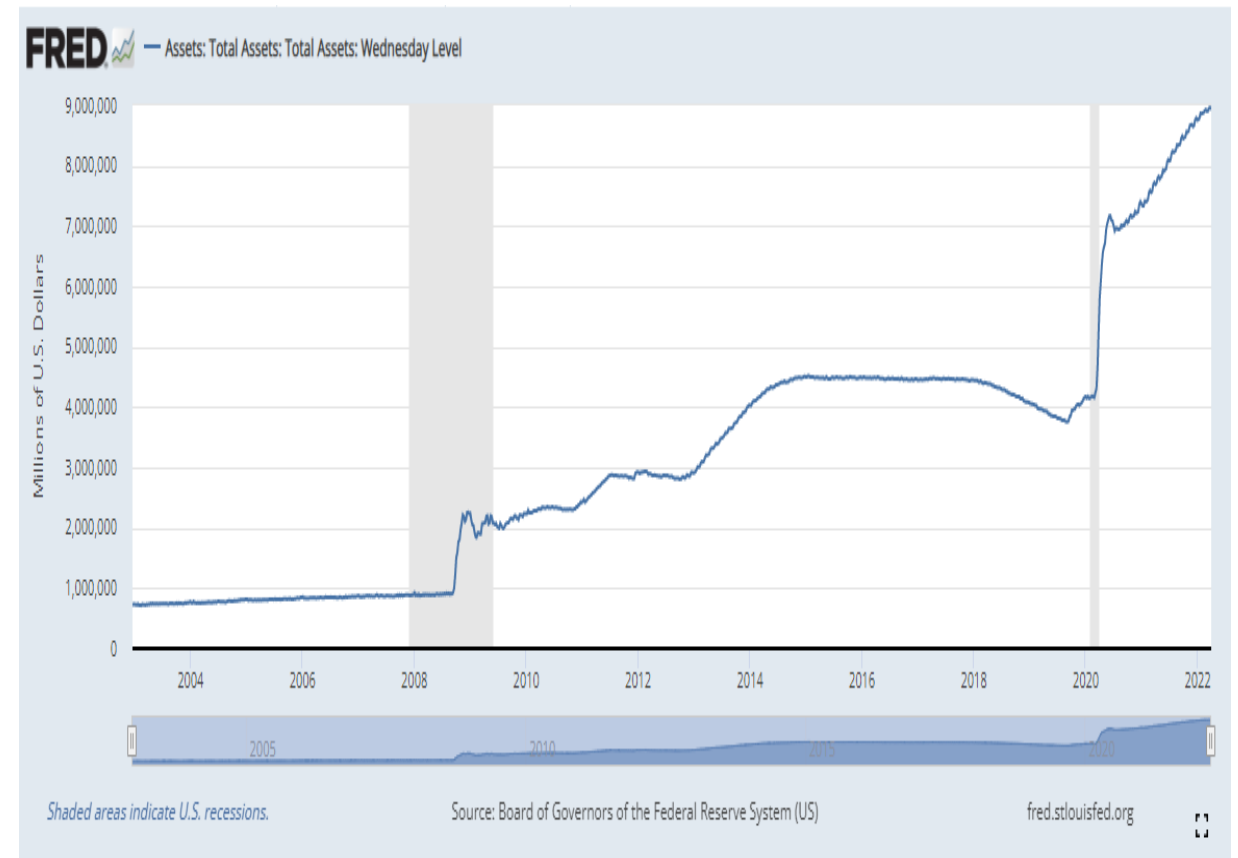
(Federalreserveeducation.org)

- With the deep impacts of the financial crisis, global central banks eased interest rates to the ZLB (zero lower-bound) or in some cases negative resulting in a new era of monetary policy.
- Quantitative easing, first used by the Bank of Japan in 2001, was adopted by the Federal Reserve and many global central banks to stimulate economic growth with interest rates at or below 0.00%.
- Forward guidance (statements concerning the likely setting of policy instruments) also became a main tool for the Fed.

# ENTERING A WORLD OF QUANTITATIVE EASING (Q/E)

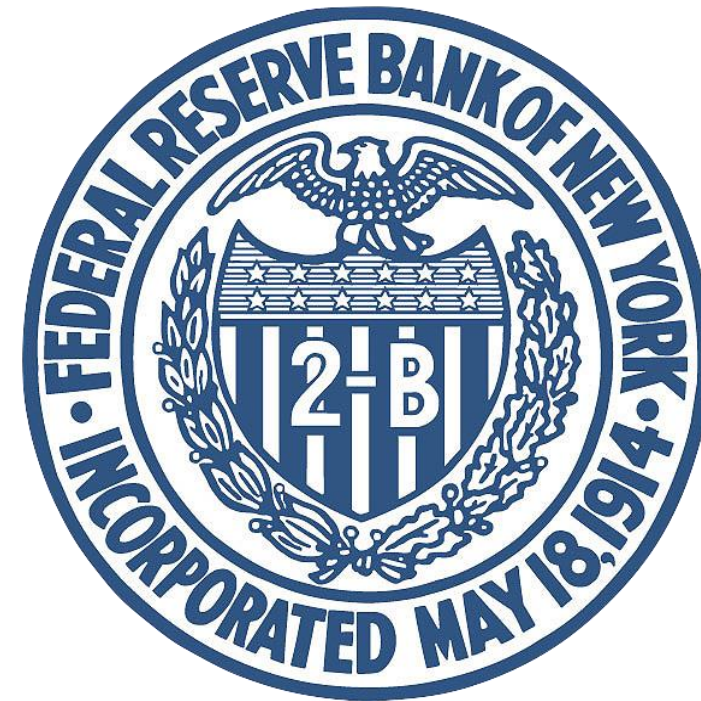
- With the Fed taking rates to the ZLB in 2008, the FOMC embarked on large scale asset purchases (Q/E) in March 2009 to further bolster the economy. The Fed, unlike other central banks, has made it clear they will not entertain negative rates.
- The FOMC had three rounds of Q/E along with “Operation Twist” from 2009-2014 with a fourth round of Q/E that started in March 2020 and ended in March 2022.
- In order to purchase securities, both Treasuries and MBS in the U.S., the Fed created new bank reserves. Reserves currently stand at ~\$3.8Trillion.
- Longer term interest rates have declined (or at least remained low) during Q/E which resulted in a lower rate environment, increased loan activity, tighter credit spreads and substantial increases in equity prices.
- Q/E, by definition, should also result in increased inflation but that was not the case for many years (will go further into this later in the presentation).

## FEDERAL RESERVE BALANCE SHEET



# FEDERAL RESERVE RESPONSE TO COVID-19

- The FOMC initiated two inter-meeting cuts in the early days of COVID-19 (Fed Funds were 1.50-1.75%), initially cutting by 50bps at 10AM on March 3<sup>rd</sup> followed by 100bps on Sunday March 15<sup>th</sup> taking rates back to ZLB.
- They provided forward guidance regarding rates: “until it is confident that the economy has weathered recent events and is on track to achieve its maximum employment and price stability goals.”
- On March 15th, the Fed stated that they will purchase at least \$500Bln Treasuries and \$200Bln MBS in the coming months which was changed a week later to become open-ended. The Fed, at one point, was purchasing \$75Bln in Treasuries per day.
- The Fed also announced new programs including the Commercial Paper Funding Facility, Main Street Lending Program, Money Market Lending Facility, Municipal Lending Facility, Paycheck Protection Program, Primary Dealer Credit Facility, Primary and Secondary Market Corporate Credit Facilities and Term Asset Backed Securities Loan Facility.
- Ultimately, consistent monthly purchases of \$80Bln Treasuries and \$40Bln MBS would start in June 2020. Tapering started in November 2021 and concluded in March 2022, which was at a much quicker pace than initially expected. The conclusion paved the way to the end of ultra-easy monetary policy and the first-rate hike shortly thereafter.



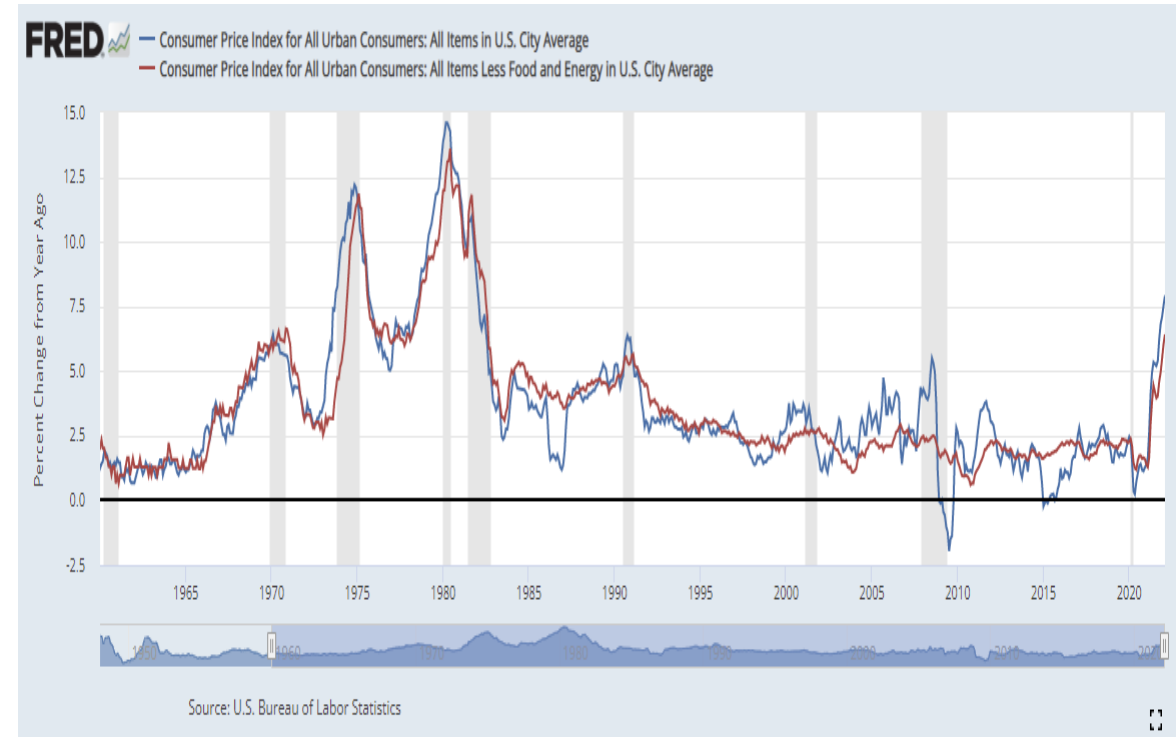
# WRAPPING UP ULTRA-EASY MONETARY POLICY

- The end came quicker than expected
  - Un-even recovery from Covid to various sectors of the economy
  - Inflation was not transitory and is now at 40-year highs
    - Impacts of fiscal stimulus/programs coupled with accommodative monetary policy
    - Persistent supply chain issues
  - Tight labor markets
- Global pull-back of accommodation by most major central banks. Emerging market central banks were the first to start to raise interest rates
- Initial fears of another taper-tantrum (2013) on interest rates/negative impacts on risk-assets.
- Fed Score Card:  
February 2020: Balance sheet ~\$4.2 Trln, Reserves ~\$1.7Trln  
March 2022: Balance sheet ~\$9Trln, Reserves ~\$3.8Trln



# IT'S TIME TO FIGHT INFLATION

- Inflation, to the extent we have not seen since the early 1980's, has ferociously appeared across the globe.
- The Fed redid their framework in 2020 to allow for inflation to run above 2% ("inflation targeting")
  - Under the new framework, the FOMC will focus on hitting an inflation rate of 2% on average over time. To do so, the FOMC will aim for inflation to run moderately higher than the 2% target for some time to make up for past misses of inflation to the low side of the target. This new strategy is referred to as flexible average inflation targeting, and it should help center longer-term inflation expectations at 2% and reinforce the inflation target (*James Bullard, St Louis Fed*).
- When and how does it slow?
  - Rate Hikes
  - Balance sheet Reduction
  - Supply chain eases



## ● Rate Hikes

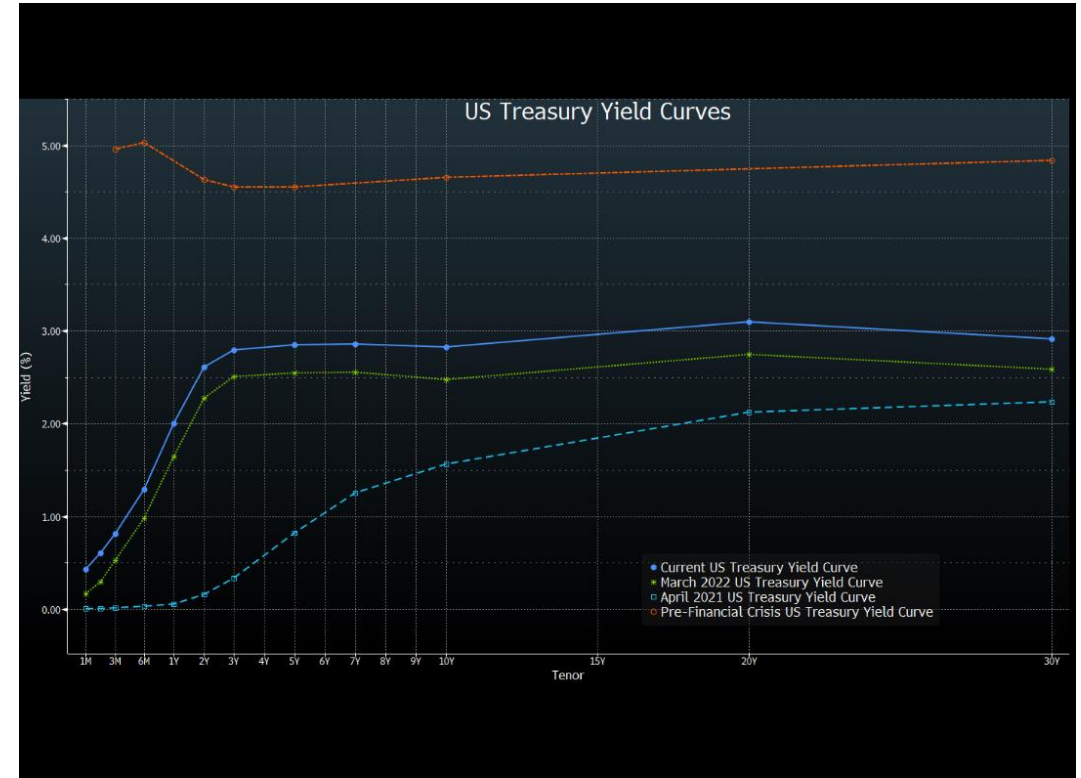
- First of this cycle came in March 2022
- 50/75bps vs 25bps at a meeting
- Perspective on current cycle vs Volcker inflation fighting era
- Current pricing in the market
- Will hikes help slow inflation?
- Terminal Rate (will go into this further)
- Intermeeting?

## ● Balance sheet

- When and how fast?
- Treasury/MBS breakdown
- Comparison to last balance sheet run-off
- Passive Tightening (bonds maturing/pre-pays)
- Active Tightening (selling holdings)
- Funding Market Ramifications
- Impact on Treasury issuance

## ● Aggressive Flattening To Inversion

- Short/medium term rates heading higher by a larger magnitude
- Shape of the curve. How much can sectors invert?
- Market pricing numerous hikes for the Fed. Fed playing catch up?
- Longer maturity impacts from global Q/E and Q/T along with high inflation/inflation fighting



Source: Bloomberg

# GETTING TO OR ABOVE R\* (NEUTRAL)

- The Fed's long-run "neutral" target rate where the Fed is neither accommodative or restrictive is ~2.4%
- How quickly will the Fed reach R\*?
- How restrictive could the FOMC get?
- Higher interest rates impact Treasury issuance/government debt servicing



Source: philipmahone.com

# THERE ARE ALWAYS UNKNOWNNS



- The Fed is not on a pre-set course with geo-political events, pandemics, etc. which have many potential impacts on policy.
- COVID-19: path of the various and monetary policy are constantly changing.
- Russia/Ukraine:
  - Russia's invasion of Ukraine initially resulted in a 'risk-off' tone with some of the rate hikes taken back on global growth concerns/fears around WW3.
  - Inflation, however, is the main concern with the invasion, as commodity prices have soared exacerbating the global inflation problems.

# HOW IS LIQUIDITY?

## Decreased liquidity with increased volatility:

- High frequency trading firms have scaled back their market making
- Smaller positions/higher margin costs with substantial market swings
- Headline risks (notably Ukraine)

## Decreased liquidity as the Fed reverses course:

- The Federal Reserve was purchasing many off-the-runs which was an outlet for banks and large holders of U.S. Treasuries

## Decreased liquidity with constantly changing views on monetary policy

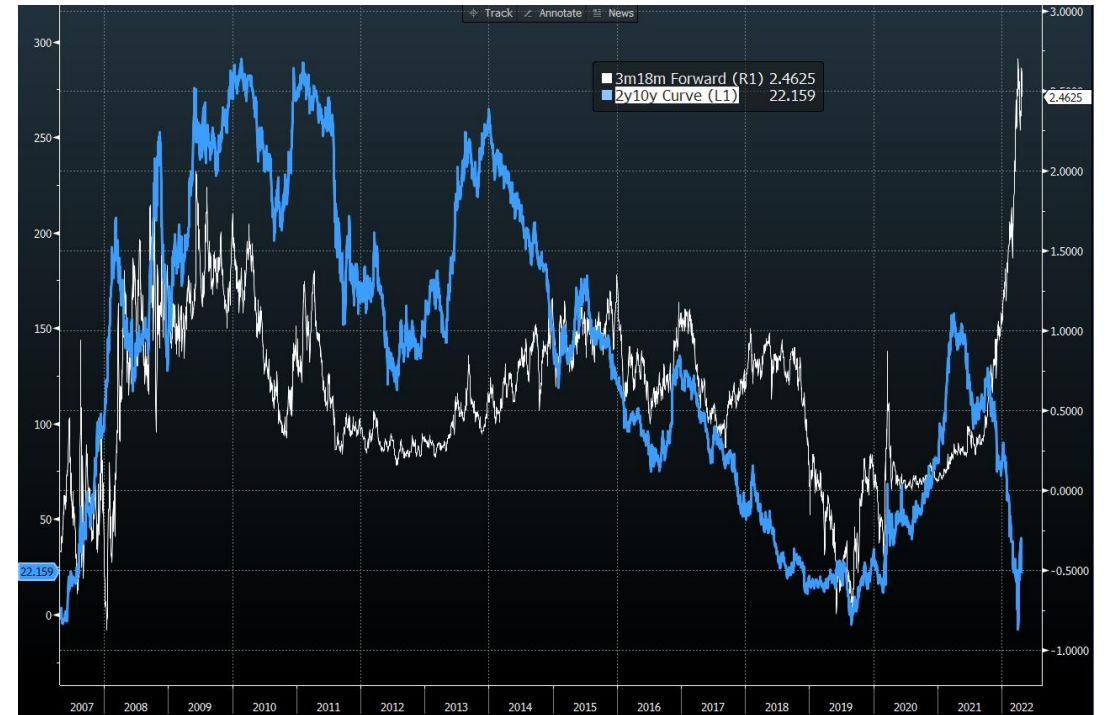
- Unlike in the previous two rate hike cycles, the Fed will not be going in lock-step (25bp hikes at every meeting or quarter). Fed and the market are changing views on almost a daily basis to the timing, size and number of hikes.

## Increased Regulation continues to impact the markets



# RECESSION CONCERNS?

- Presently not in NBER defined recession
- Inflation well above target and labor market extremely tight (potentially tightest since post-war era)
- Which curve to focus on?
- Economic data will be important going forward
- Inflation impacts on the consumer
- COVID lockdowns (notably supply chain and China)
- Further geo-political impacts on growth



Source: Bloomberg

# TYING IT ALL TOGETHER

- Is the Fed “behind the curve”?
- Thoughts on the remainder of 2022
- How will increased Treasury issuance impact rates
- The world is a connected place
- More differentiating opinions than ever
- Questions



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**Cantor Fitzgerald**

110 East 59th Street

New York, NY 10022

**JUSTIN LEDERER**

[jlederer@cantor.com](mailto:jlederer@cantor.com)