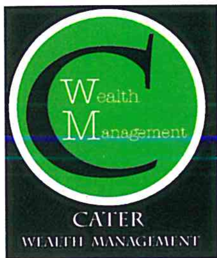

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Quantitative Easing (QE) and its Effect on the Stock Market

October 7th 2019

Quantitative Easing started shortly after the financial crisis of 2008. The idea was for the Federal Reserve to purchase bonds from the public with newly created money. This "newly created money" would encourage banks to lend and consumers to spend. Problem solved. We now know it wasn't so simple. Most of the newly created money stayed at the Fed in the form of Excess Reserves. On September 1st 2008 Excess Reserves were very close to $0.00; QE sent them to $2.717 trillion on September 10th 2014. The increase in the size of the Fed's balance sheet was even more dramatic; $800 million to $4.5 trillion. If the newly created money didn't stimulate the economy, where did it go? Many now think a lot of it went into the stock market. QE ended on October 29th 2014.

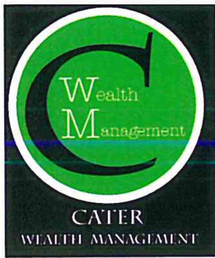
A large Fed balance sheet doesn't necessarily add liquidity to the private sector but large Excess Reserves do. If the banking sector has more cash than it needs to support its deposits and it is given an opportunity to double or even triple what the Fed is paying on reserves (as was the case two weeks ago when the overnight collateralized repo rate hit 10%) it wouldn't (or at least shouldn't) hesitate. The fact that repo rates hit 10% tells me Excess Reserves aren't as "excess" as their name might imply. According to Bloomberg the banking system has $1,261,943,000,000 Excess Reserve dollars as of October 6th 2019.

Really?

Quantitative Tightening (QT – Fed selling bonds back to the private sector) has resulted in a substantial decline in reported Excess Reserves **but $1.26 Trillion is still a lot!** We know monetary policy changed dramatically after the Great Recession. One of the changes was the implementation of Basil III, the international banking regulations designed to prevent a future liquidity crisis like the one in 2008 that almost brought the system down. In a nutshell, major banks are required to hold enough High Quality Liquid Assets (HQLA) to cover their estimated cash needs for 30 days in the case of a financial crisis. They are required to calculate their LCR (Liquid Collateral Ratio) daily. HQLAs cannot be encumbered. The HQLA of choice seems to be Excess Reserves. Excess Reserves earn an acceptable return and have no market risk.

Maybe Excess Reserves aren't excess after all.

When the Federal Reserve announced it was starting the process of balance sheet normalization (QT) it was almost an afterthought. It told us how much and for how long, it told us it would be conducted under the radar and we would hardly notice. QT was scheduled to end in October '19. In July we started noticing some "small problems" in the overnight funding market. The Fed Funds Rate starting creeping up toward the upper limit of the range. The Fed responded with an announcement that it would end QT in August, two months earlier than originally planned. It did in fact end QT 2 months early. On September 16th the overnight repo market broke. It's now October 7th (remember QT was supposed to end on Oct 1st) and now It is talking about starting QE again.



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QT lasted 22 month, ended before schedule, reduced Excess Reserves (bank liquidity) more than $1 trillion. Is another round of QE imminent?

If QE starts again will it be good for stocks?

Quantitative Easing (QE) increased private sector liquidity more than $2.7 trillion. A lot of this ended up in the stock market. Quantitative Tightening (QT) reduced private sector liquidity more than $1 trillion.

Basil III banking reform took the rest.

If real Excess Reserves are once again scarce, it's a game changer. Somethings got to give. One way to make Excess Reserves less attractive as a HQLA is to reduce their return. The Fed has been doing this recently and will probably continue. Not only is it reducing the Fed Funds rate, it is reducing IOER (Interest on Excess Reserves) more. When the next recession rolls around, and it will eventually, we will probably see 0% again. When we hit the "zero lower bound" QE will most likely be in full force.

If we're right and the Fed starts QE again, maybe some of that liquidity will make it back into the stock market.