Rodney's Take

January 10, 2022

It's All About Liquidity

Thanks to the Fed, the first week of the year was brutal for tech stocks and bonds, and it doesn't look like it's going to let up anytime soon. This isn't about interest rates or shrinking bond purchases; we knew those things late last year. This is much scarier for investors—it's shrinking liquidity.

When the Federal Reserve Open Market Committee (FOMC) met in December and decided to cut the rate of bond purchases over the next several months, no one was surprised. The bankers also indicated it would raise interest rates from essentially zero to 0.25%, and perhaps even to 0.50%, sometime in 2022. Again, a yawner. Fed Chair Powell and the other Fed governors had been telegraphing these moves for weeks, so investors were prepared for the results of the meeting. The 10-year Treasury bond yield remained below 1.5%, and high-growth equities soared higher during the Santa Claus rally even though inflation remained above 6%.

But when investors got a look at the minutes from the December meeting on January 5, they didn't like what they saw.

Not only were the central bankers going to buy fewer bonds and potentially raise rates a time or two, but a number of them want to raise rates three times this year and, more importantly, they discussed how to shrink their balance sheet. The last item was a big surprise, and the markets hate surprises.

The Fed may or may not raise rates a few times this year, but the overnight interest rate will still be less than 1% and savers will still be losing money on every dollar that sits in savings accounts and CDs. The real issue is what the bankers do with their balance sheet, because this affects liquidity, which weighs on a big component of the stock market, borrowed cash, or other people's money (OPM).

The Fed currently sits on $8.7 trillion in Treasury bonds and mortgage-backed securities. Four trillion dollars' worth of those bonds have been purchased since the pandemic started. The huge influx of cash stuffed the coffers of banks, investment banks, and institutions that are only too happy to lend it to large investors like hedge funds at rock-bottom rates, which then use it to supercharge their investments. If a hedge fund can earn just a smidge more on its investments than it pays in borrowing costs, then the exercise is worth it. Then, it's just a matter of how big the fund can ramp up the operation to maximize profits. It's a game of leverage.

When the Fed turns from buying bonds to selling bonds, it sucks cash out of the financial system and then extinguishes it. Most of the cash simply disappears, the reverse of how the Fed printed it into existence in the first place. Dwindling cash balances in the financial system will drive up the cost of borrowing for hedge funds and other large investors that use OPM. Some of the investments made with OPM will no longer make sense, so the funds will sell the investments to repay the borrowed money. Voilà! This is how a shrinking Fed balance sheet turns into higher borrowing costs and drives down the stock market.

As investors look across 2022, all they'll see are rising interest rates and less liquidity. It could be a bumpy year for the high-flying stocks of 2021.

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Got a question or comment? You can contact us at info@hsdent.com.