The Central Bank's balance sheets

Over the last 20 years the global financial system has changed radically from being dominated by the banking system to increasing participation by the 'shadow' banking system. Corporates have been generating large amounts of cash (particularly technology firms in the US) and asset management firms have benefited from a huge increase in private savings in the form of pensions.

In addition, as the global economy has grown and trade flows have increased, central bank foreign exchange reserves and sovereign wealth funds have accumulated vast amounts of cash. The growth of the derivatives market has also generated a big demand for collateral.

The result is that these participants in the financial system require safe assets to park their cash. The system is now too big to be catered for by the banking system. A huge repo market has thus evolved where cash has been bundled into BBB securities and the Fed needs to maintain a large balance sheet to facilitate the repo market.

In 2008, it was the mortgage backed security market that fell over. Today, the risk is the BBB corporate bond market, where all this excess liquidity ends up. As the BBB spread widens, the repo market dries up and so does overall liquidity.

As an aside, because there is such big demand for safe assets in the form of US Treasuries, the gap between the Fed Funds rate and the term premium has significantly narrowed, which makes the yield curve a blunt tool for predicting recessions.

In 2018, the Fed pushed the tightening cycle as far as it could until the BBB spread spiked higher, risking a breakdown in the financial system. Tail risk has become the Fed's key driver. Put another way, the big changes to the structure of the financial system means that, intended or not, there is a long risk asset put in place because the Fed are tied more than ever to keeping stability in the system. This means that real and nominal yields will remain low and, in some cases, negative for a long time forcing investors to take more risk than they otherwise would.

Continued overleaf

The chart below plots the BBB credit spread and the significant widening of that spread in Q4 of last year goes some way to explain why the US rates market moved from pricing in 3 rate hikes in 2019 to one cut in pretty short order, and why the rhetoric coming out of the Fed changed so dramatically. What is clear is that financial stability is Fed's key concern while economic data plays second fiddle. Of course the chart of BBB spread is the same as the S&P 500 but inverted. The point being that the Fed will come to rescue if it feels there is strain in the credit markets, which historically has been supportive of asset prices.

BBB spread versus US Treasuries

Source: Bloomberg

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