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# Wider Spreads Likely as Liquidity is Squeezed

*Leah Savageau, CFA | Senior Fixed Income Credit Analyst*

The Federal Reserve is expected to accelerate its Quantitative Tightening (QT) this month. We expect capital markets to remain choppy as QT ramps up with a downward bias towards greater or elevated volatility. In addition, bank lending standards are tightening, and we expect that to continue as reserves fall.

In regard to QT, the central underpinning of our thesis is that QT is going to remove liquidity from the system, but unlike the prior QT cycle, bank reserves are set to decline at a faster clip. This reflects two dynamics. The first being that banks are still not very willing to keep the deposits they received during Quantitative Easing (QE) because of harsh treatment deposits receive for supplementary leverage ratio purposes. The second is that yields on money market funds are well above deposits rates offered by banks right now, which creates the impetus for cash to move out of the banking sector and into these funds who in turn will put the cash into the Fed's Overnight Reverse Repurchase Facility (RRP) – either because they don't want to invest in longer duration assets or because of lack of higher yielding alternatives.

Recall, the RRP is another Fed liability account that helps absorb excess liquidity. So as the asset side of the fed's balance sheet declines for QT, the shift of more money into the reverse repo facility will reduce bank reserves at a faster clip (assuming other Fed liabilities remain largely unchanged). We expect deposit costs to rise as bank reserves deplete. But if bank reserves get 'too thin,' we are likely to see pressure in the fed funds market as banks look to plug intraday cash shortfalls or meet liquidity requirements. Depending on the magnitude of 'too thin,' we could see cascading effect across broader markets, particularly if the Fed's Standing Repo Facility (SRF) cannot fully absorb the pressure in the fed

funds market. The Fed has recently guided to minimal ample reserve level of 8% of GDP[1], but more generally an 'ample' level of bank reserves can be defined as large enough that the Fed does not need to intervene in the market[2]. There are likely additional market implications from falling reserves such as the effect on margin debt.

Moreover, we saw from the last Senior Loan Officer Survey that banks have already been tightening standards to reflect the uncertain economic environment. But as liquidity gets squeezed from the banking sector, we do expect banks to further enhance their lending standards to balance loan growth against the cost and availability of funds. Additionally, many banks are also contending with high capital requirements, brought about through the last stress test cycle. For the largest U.S. banks, the focus on reducing G-SIB capital surcharges is expected to further weigh balance sheet availability heading into year-end.

As we model corporate spread risk premiums, we are factoring in elevated volatility (VIX), tighter lending standards in addition to other factors (i.e., decline in M2 growth), which we expect will keep corporate bond spreads wide through year-end.

***Leah Savageau, CFA*** *is a Senior Fixed Income Credit Analyst with 14 years of investment experience. Leah is responsible for analyzing banks, REITS and other financial institutions and will be a key contributor in AAM's economic and geopolitical strategy committees due to her specialization in international finance. Leah joined AAM after working as a Senior Credit Research Analyst at Northern Trust Asset Management. She is also a CFA Charterholder. Leah earned her Bachelors and Master's degree from Clark University and a Master's degree from the University of Chicago's Harris School of Public Policy.*

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*1 https://www.newyorkfed.org/medialibrary/media/markets/omo/omo2021-pdf*
*2 https://www.federalreserve.gov/newsevents/pressreleases/monetary20190130c.htm*

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