Central Bank Watch

Making sense of US Fed's balance sheet reduction

US Fed's massive stash of assets shrank for a third straight week to US$7.01tn, the smallest size since mid-May, raising concerns that Fed's actions will not be enough to continue providing stimulus to US financial markets. We view that recent balance sheet contraction was mainly due to slackening demands for repos and central bank USD swaps, reflecting that dollar crunch is over and financial markets have stabilized. We expect Fed's B/S will continue to ease lower and its support for financial market will fall. It does not mean that Fed is shifting its policy stance. Instead, it is transitioning from crisis management mode to long-term easing.

- **Reasons of balance sheet contraction: slackening demands for repos and FX swaps.** Since Mar 2020, in order to provide support for US economy reeling from COVID-19, Federal Reserve has lowered its target policy rate effectively to zero lower bound and used a full range of unconventional and inventive policy tools. Fed opened the dollar liquidity swap lines for nine additional central banks to exchange for US dollar to help lessen strains in global US dollar funding market and support credit to households and businesses. Data released on 2 Jul showed that foreign center bank liquidity swaps dropped by 50% from its peak in late May. Repurchase agreement (repos), a facility intending to provide an alternative temporary source of US dollars, also decreased further to US$61bn from its peak in mid-Mar of US$441bn, confirming reduced money market stress. Reduction of both repos and FX swaps lead to passive contraction of Fed's balance sheet as emergency stimulus exit. Fed also downsized mortgage-backed securities by US$32bn for the week ending 2 Jul.

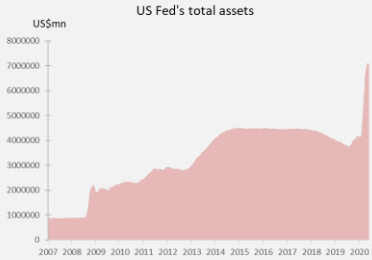
- **Severe global dollar crunch is behind us.** Reduction in the dollar swap lines and support for money market funds show that financial and credit markets are returning to near-normal. Therefore, US banks are further dialing back their use of repurchase agreements and other central banks are relying less on Fed now. The severe shortage of US dollar around the globe since Mar 2020 was almost over. Looking ahead, USD may weaken as US economic recovery is likely to lag behind many other regions and global risk appetite may continue to improve following encouraging coronavirus vaccine trials.

- **Enormous liquidity has avoided financial crisis, but also pushed valuations to levels that fundamentals do not justify.** Despite recent contraction, Fed's balance sheet with the size of US$7tn is still enormous, almost double the size of Sep 2019. Central bank easing results in surging global liquidity, which helps financial markets by lifting valuations to levels that do not justify their fundamentals. However, US economic recovery still has a long way to go. Fed expected US GDP to contract 6.5% in 2020. Labor market, as we see, is not able to return to pre-virus level for quite some time.

- **Liquidity environment, what to watch?** Reduction of both repos and FX swaps cause passive contraction of balance sheet. As more FX swaps due to expire next week, Fed B/S contraction may continue, which is a natural exit from crisis mode. Fed actively manages balance sheet by purchase of Treasury and mortgage-backed securities (MBS), as well as other unconventional tools. Fed has reduced the pace of buying Treasury and MBS compared to it of the past three months, but Fed still pledges to continue at least at current pace, which means the liquidity condition will not be tighten over the coming months.

Angela Cheng, PhD
(852) 3900 0868
angelacheng@cmbi.com.hk

US Fed's total assets



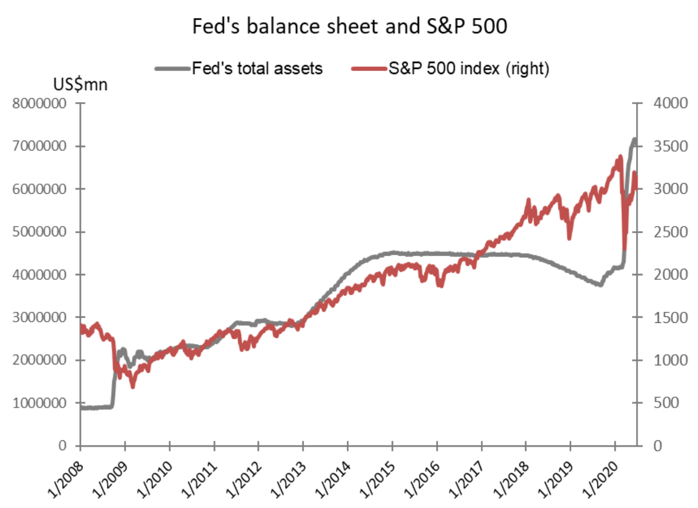
Source: Bloomberg, CMBIS

Related Reports

1. Financial crisis is becoming a real possibility – 13 Mar 2020
2. Central Bank Watch - Fed is now ready to cut more quickly and aggressively – 3 Mar 2020
3. Virus spread beyond China dents global risk appetite – 25 Feb 2020

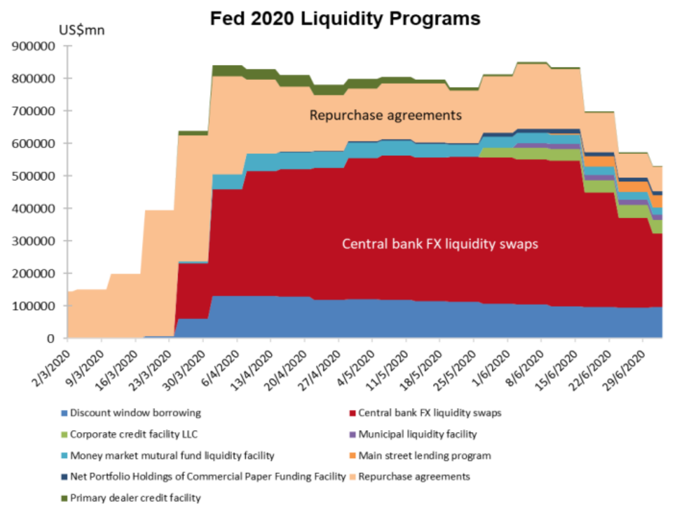
- **2H20 Fed policy outlook: transitioning from crisis management mode to long-term easing, from financial to non-financial.** Fed is exiting from some pandemic relief measures, because the needs of emergency lending facilities, which aim to ensure the flow of credit to the financial sector, have become limited. However, we do not see shift of Fed's policy stance. We expect that US Fed is likely to keep its ultra-easing monetary stance until the economy gets back to full employment, a process which we believe will take years. Benchmark short-term borrowing rate may stay in the range of 0-0.25% throughout 2022. Fed is expected to continue to purchase US Treasuries and agency mortgage-backed securities (AMBS) at current pace throughout 2H20. Moreover, Fed is shifting focus from large scale asset purchases to the provision of credit to the non-financial sector, so Fed will provide more help to Main Street than Wall Street in 2H20. US stock market may be very sensitive to these transitions.

Figure 1: US equities have been riding on liquidity provision by Fed



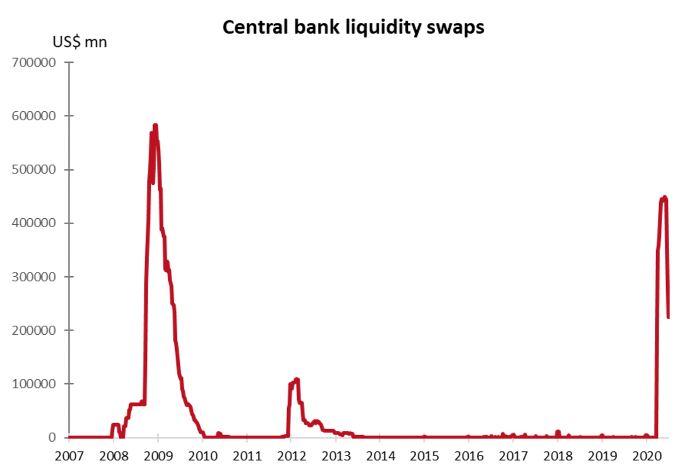
Source: US Federal Reserve, Bloomberg, CMBIS

Figure 2: Fed is gradually exiting its emergency liquidity programs



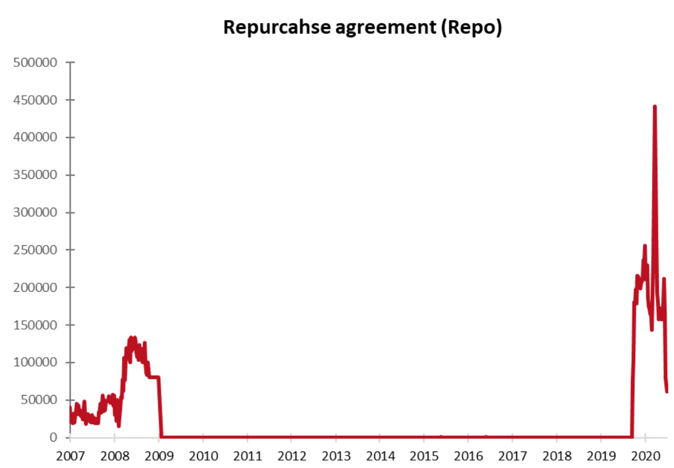
Source: US Federal Reserve, Bloomberg, CMBIS

Figure 3: Central bank liquidity swaps trim as severe global dollar crunch is behind us



Source: US Federal Reserve, Bloomberg, CMBIS

Figure 4: Repos on Fed's balance sheet have dropped, showing reduced money market stress



Source: US Federal Reserve, Bloomberg, CMBIS

Figure 5: Selected assets and liabilities of all US Federal Reserve banks

Items (US$mn)	Current 2/7/2020	Week ago 24/06/2020	Change from previous week	Month ago 3/6/2020	Change from previous month	Year ago 4/7/2019	Change from previous year
Total assets	**7,009,040**	7,082,302	-73,262	7,165,217	-156,177	3,813,198	3,195,842
Securities held outright	**6,126,948**	6,143,193	-16,245	5,972,297	154,651	3,630,466	2,496,482
US Treasury securities	**4,213,220**	4,197,404	15,816	4,134,356	78,864	2,095,393	2,117,827
Federal agency debt securities	**2,347**	2,347	0	2,347	0	2,347	0
Mortgage-backed securities	**1,911,381**	1,943,441	-32,060	1,835,594	75,787	1,532,726	378,655
Unamortized premium on securities held outright	**314,324**	313,854	470	305,269	9,055	130,759	183,565
Unamortized discounts on securities held outright	**-5,345**	-5,319	-26	-5,504	159	-12,874	7,529
Repurchase agreements	**61,201**	70,201	-9,000	211,550	-150,349	0	61,201
Central bank liquidity swaps	**225,414**	274,963	-49,549	446,945	-221,531	17	225,397
Net portfolio holdings of MS Facilities LLC (Main Street Lending Program)	**37,502**	37,502	0	0	37,502	0	37,502
Net portfolio holdings of Corporate Credit Facilities LLC	**41,940**	40,617	1,323	36,154	5,786	0	41,940
Foreign currency denominated assets	**20,984**	20,958	26	20,768	216	20,917	67
Total Liabilities	**6,970,195**	7,043,391	-73,196	7,126,300	-156,105	3,773,971	3,196,224
Federal Reserve notes in circulation	**1,922,987**	1,915,107	7,880	1,903,660	19,327	1,702,771	220,216
Reverse repurchase agreements	**227,236**	220,362	6,874	246,054	-18,818	296,852	-69,616
Deposit	**4,698,086**	4,786,037	-87,951	4,860,697	-162,611	1,767,813	2,930,273
Other deposits held by depository institutions	**2,863,196**	2,937,657	-74,461	3,257,435	-394,239	1,485,213	1,377,983
Foreign official	**16,223**	16,222	1	16,281	-58	5,245	10,978
US Treasury, General account	**1,656,747**	1,586,573	70,174	1,431,462	225,285	220,911	1,435,836
Other deposits	**161,920**	245,586	-83,666	155,519	6,401	56,445	105,475
Treasury contributions to credit facilities	**114,000**	114,000	0	104,000	10,000	0	114,000
Total capital	**38,845**	38,911	-66	38,917	-72	39,227	-382
Total liabilities and capital	**7,009,040**	7,082,302	-73,262	7,165,217	-156,177	3,813,198	3,195,842

Source: US Federal Reserve, Bloomberg, CMBIS

Disclosures & Disclaimers

Analyst Certification
The research analyst who is primary responsible for the content of this research report, in whole or in part, certifies that with respect to the securities or issuer that the analyst covered in this report: (1) all of the views expressed accurately reflect his or her personal views about the subject securities or issuer; and (2) no part of his or her compensation was, is, or will be, directly or indirectly, related to the specific views expressed by that analyst in this report.
Besides, the analyst confirms that neither the analyst nor his/her associates (as defined in the code of conduct issued by The Hong Kong Securities and Futures Commission) (1) have dealt in or traded in the stock(s) covered in this research report within 30 calendar days prior to the date of issue of this report; (2) will deal in or trade in the stock(s) covered in this research report 3 business days after the date of issue of this report; (3) serve as an officer of any of the Hong Kong listed companies covered in this report; and (4) have any financial interests in the Hong Kong listed companies covered in this report.

CMBIS Ratings

BUY	: Stock with potential return of over 15% over next 12 months
HOLD	: Stock with potential return of +15% to -10% over next 12 months
SELL	: Stock with potential loss of over 10% over next 12 months
NOT RATED	: Stock is not rated by CMBIS
OUTPERFORM	: Industry expected to outperform the relevant broad market benchmark over next 12 months
MARKET-PERFORM	: Industry expected to perform in-line with the relevant broad market benchmark over next 12 months
UNDERPERFORM	: Industry expected to underperform the relevant broad market benchmark over next 12 months

CMB International Securities Limited
Address: 45/F, Champion Tower, 3 Garden Road, Hong Kong, Tel: (852) 3900 0888 Fax: (852) 3900 0800

CMB International Securities Limited ("CMBIS") is a wholly owned subsidiary of CMB International Capital Corporation Limited (a wholly owned subsidiary of China Merchants Bank)

Important Disclosures
There are risks involved in transacting in any securities. The information contained in this report may not be suitable for the purposes of all investors. CMBIS does not provide individually tailored investment advice. This report has been prepared without regard to the individual investment objectives, financial position or special requirements. Past performance has no indication of future performance, and actual events may differ materially from that which is contained in the report. The value of, and returns from, any investments are uncertain and are not guaranteed and may fluctuate as a result of their dependence on the performance of underlying assets or other variable market factors. CMBIS recommends that investors should independently evaluate particular investments and strategies, and encourages investors to consult with a professional financial advisor in order to make their own investment decisions.
This report or any information contained herein, have been prepared by the CMBIS, solely for the purpose of supplying information to the clients of CMBIS or its affiliate(s) to whom it is distributed. This report is not and should not be construed as an offer or solicitation to buy or sell any security or any interest in securities or enter into any transaction. Neither CMBIS nor any of its affiliates, shareholders, agents, consultants, directors, officers or employees shall be liable for any loss, damage or expense whatsoever, whether direct or consequential, incurred in relying on the information contained in this report. Anyone making use of the information contained in this report does so entirely at their own risk.
The information and contents contained in this report are based on the analyses and interpretations of information believed to be publicly available and reliable. CMBIS has exerted every effort in its capacity to ensure, but not to guarantee, their accuracy, completeness, timeliness or correctness. CMBIS provides the information, advices and forecasts on an "AS IS" basis. The information and contents are subject to change without notice. CMBIS may issue other publications having information and/ or conclusions different from this report. These publications reflect different assumption, point-of-view and analytical methods when compiling. CMBIS may make investment decisions or take proprietary positions that are inconsistent with the recommendations or views in this report.
CMBIS may have a position, make markets or act as principal or engage in transactions in securities of companies referred to in this report for itself and/or on behalf of its clients from time to time. Investors should assume that CMBIS does or seeks to have investment banking or other business relationships with the companies in this report. As a result, recipients should be aware that CMBIS may have a conflict of interest that could affect the objectivity of this report and CMBIS will not assume any responsibility in respect thereof. This report is for the use of intended recipients only and this publication, may not be reproduced, reprinted, sold, redistributed or published in whole or in part for any purpose without prior written consent of CMBIS.
Additional information on recommended securities is available upon request.

For recipients of this document in the United Kingdom
This report has been provided only to persons (I)falling within Article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (as amended from time to time)("The Order") or (II) are persons falling within Article 49(2) (a) to (d) ("High Net Worth Companies, Unincorporated Associations, etc.,) of the Order, and may not be provided to any other person without the prior written consent of CMBIS.

For recipients of this document in the United States
This report is intended for distribution in the United States to "major US institutional investors", as defined in Rule 15a-6 under the US, Securities Exchange Act of 1934, and may not be furnished to any other person in the United States. Each major US institutional investor that receives a copy of this research report by its acceptance hereof represents and agrees that it shall not distribute or provide this research report to any other person.

For recipients of this document in Singapore
This report is distributed in Singapore by CMBI (Singapore) Pte. Limited (CMBISG) (Company Regn. No. 201731928D), an Exempt Financial Adviser as defined in the Financial Advisers Act (Cap. 110) of Singapore and regulated by the Monetary Authority of Singapore. CMBISG may distribute reports produced by its respective foreign entities, affiliates or other foreign research houses pursuant to an arrangement under Regulation 32C of the Financial Advisers Regulations. Where the report is distributed in Singapore to a person who is not an Accredited Investor, Expert Investor or an Institutional Investor, as defined in the Securities and Futures Act (Cap. 289) of Singapore, CMBISG accepts legal responsibility for the contents of the report to such persons only to the extent required by law. Singapore recipients should contact CMBISG at +65 6350 4400 for matters arising from, or in connection with the report.