US Watch - Quick Insights

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DISINTERMEDIATION WITH BANKS AND FED STRAIT-JACKETED. HOW HIGH FOR UNEMPLOYMENT?

Steven Blitz

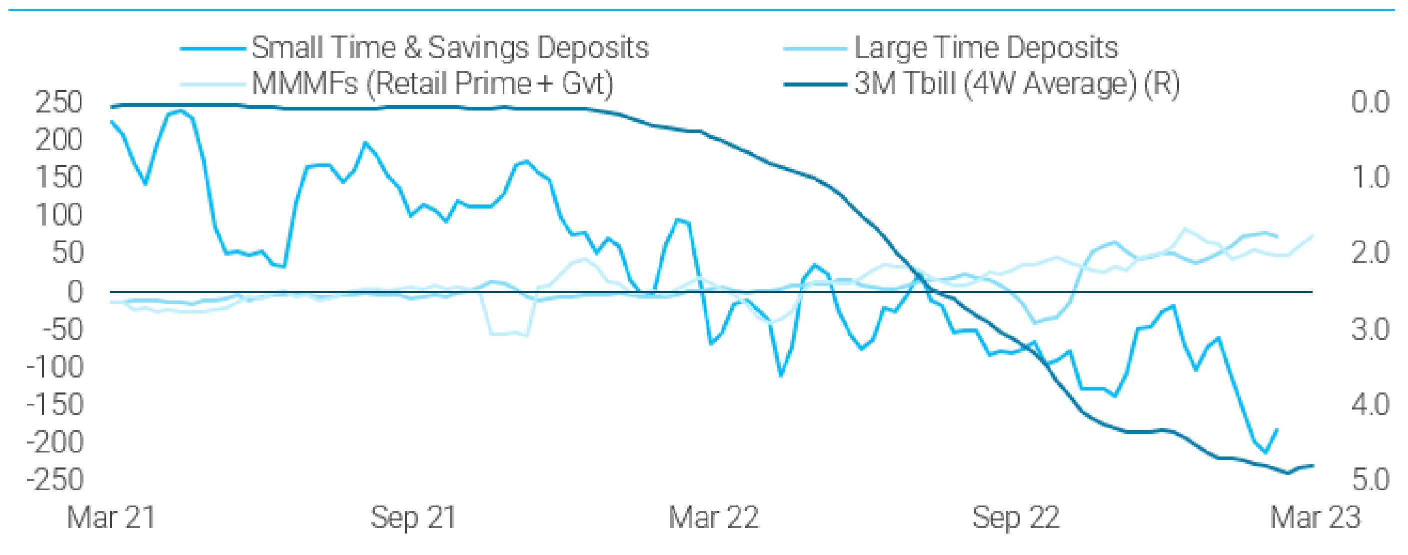
Before Reg Q ended in 1980, Reg Q was the circuit breaker for credit creation (mortgages especially) whenever market rates rose far enough above what banks could pay – deposit flows reversed (disintermediation) The first major experience was October1959. Treasury issued 5Y notes with a 5% coupon, highest Treasury yield in 30 years (at the time). What happened next? Recession from April 1960 to February 1961, unemployment rose to 7.1% from 4.8%. Below is from the NY Times:

"Passbooks in hand, they flocked to banks and savings associations and took their money out. The Treasury received 108,596 separate orders for the "magic 5's," five or six times the normal number. The orders totaled $11.1 billion, five and a half times the $2 billion of the notes offered."

The unintended consequence of post-GFC bank regulation and loss of private sector appetite for leverage is the return of disintermediation risk. Bank balance sheets shifted towards using yields on securities rather than loans to generate positive net interest margins. With that, banks are in a strait jacket, unable to stem disintermediation when yields rise a lot, and the curve turns negative. QT has nothing to do with any of this. Not surprisingly, contrary to the noise from SVB, large deposits are flowing in (they earn a bank credit spread over UST). Small time & savings accounts are flowing out (surplus reserve regime = banks paying negligible interest on small accounts regardless of the funds rate) (Chart 1)

Chart 1 Old Fashioned Disintermediation -- High bill yields pull small deposits

4W Change in dollar flows



Source: Federal Reserve, ICI, TS Lombard

Fed's most direct option to reverse flows – lower the funds rate (not possible given current economy). During previous financial problems, Fed was in line with the economy, allowing them room to operate. It is very different today – meaning the response has to be less direct, such as lending to banks (up but hardly when scaled to the size of the Fed balance sheet). They could also pull more reserves into their balance sheet by sharply raising IORB, offset by fewer reverses to MMMFs to keep the balance sheet shrinking (is QT even relevant?).

Is it too late to avoid recession? Probably not. The coming pull back on credit will add to an economy already slowly slipping (key word being slowly). It is also never a good sign for upcoming equity market performance when an inverted curve flips back positive – the current direction, but not yet positive.

How high for unemployment? To date, there is labor dis-hoarding by large tech firms – I never bought into the labor hoarding argument mitigating unemployment in this cycle. When recession hits, firms lay people off – they are already. There is a lot of suspect employment data – expect a data-cliff moment at some point (huge downside surprise in the data). A simplistic, tried and true model, ties the unemployment rate 18 months forward to the NAHB Home Market Index. Model forecasts unemployment beginning to rise in July, hit 4.5% by year end and 6.5% by mid-2024 (email me and I will forward model, charts, etc).