Morning Comment

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AFS Insights

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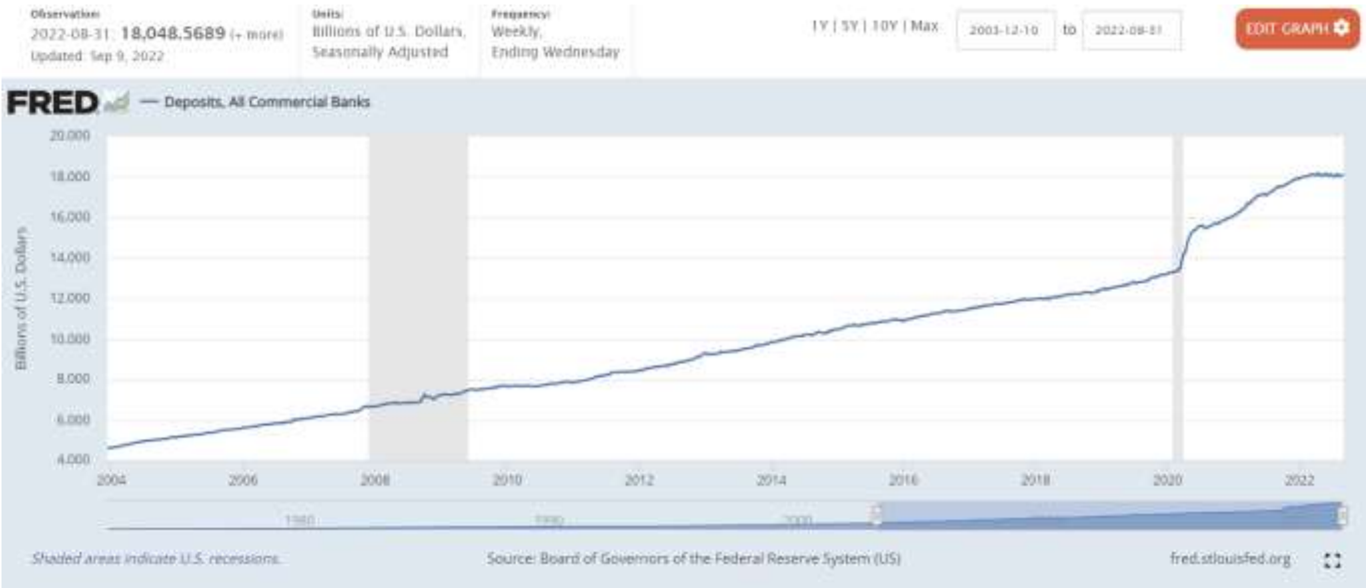
Headline Sweep

- We've retaken 6,000 sq km from Russia, says Zelensky
- As Russian Losses Mount in Ukraine, So Does Criticism Back Home
- Italy's Meloni Pledges Not to Expand Deficit to Fund Energy Aid

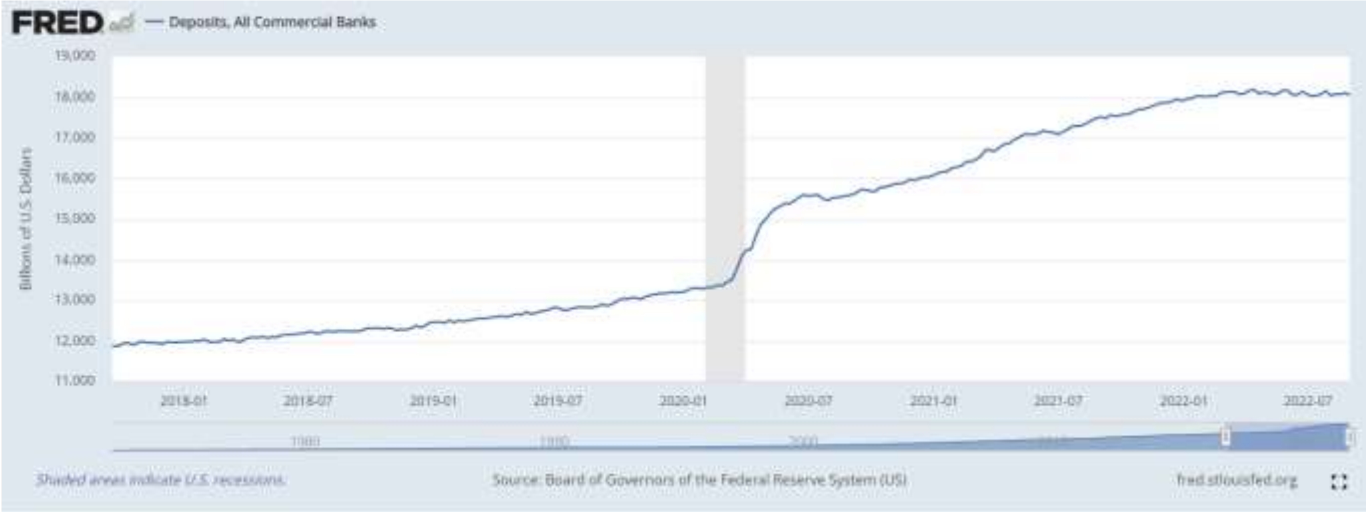
Appetite for destruction (technical)

- **One of our favorite US economic reports – the favorite these days – is the weekly overview of US commercial banks' balance sheets.** It's also the most glossed over report because the Federal Reserve publishes the data on Friday after the close of markets (or at least European markets). So, when no one is paying attention. *Underrated* and glossed over.
- **If you combine bank balance sheet data with the weekly Fed balance sheet, you get a pretty accurate picture of the US economy**. That's because the data allows to create a proxy of US money supply data. And if you remember Irving Fisher's equation of exchange[1], you have something of a proxy for nominal GDP growth. Who doesn't want that: a weekly nominal GDP tracker?
- **Instead of money supply data, we prefer to use bank deposit data**. Bank deposit is a slightly narrower gauge of the money supply as it leaves out certain items related to money market fund deposit and money market fund shares. Regardless, bank deposit data has the advantage that is released on a weekly basis by the Fed. And it correlates nearly perfectly with the official money supply data. However, there is something wrong with bank deposits (and the same applies to money supply data). Bank deposit data has started to flatline:

[1] The money supply times velocity equals nominal GDP



- **In fact, the level of bank deposits have been flat since the start of the year:**



- **If the money supply is flat, Fisher's equation of exchange tells us that the velocity of money is rising.** And rising fast, given the fact that we had no real growth in the first half of the year but accelerating inflation at the same time. Rising money velocity is the bane of every central banker. Unlike the money supply, velocity is a hard to control variable. During the Volcker era, the high inflation of that period was by and large the 'result' of rising velocity. The Federal Reserve under Chair Volcker only succeeded in lowering velocity – and thus inflation – by increasing short term rates to unprecedented levels. Fed Chair Powell styles himself as a Volcker-lite: inflicting enough "pain" on the economy in order to bring inflation down.
- **However, we believe bank deposits – and the broader money supply – is being understated.** The blame probably falls on the high recourse to the Fed's reverse repo facility of nearly more than 2 trillion dollars. It's not our final word on the matter (and we will come back on the matter at some point, we discussed the matter before here). But suffice to say for now is that bank deposits/money supply data understate the true money supply. Therefore, it's better to track the proxy of

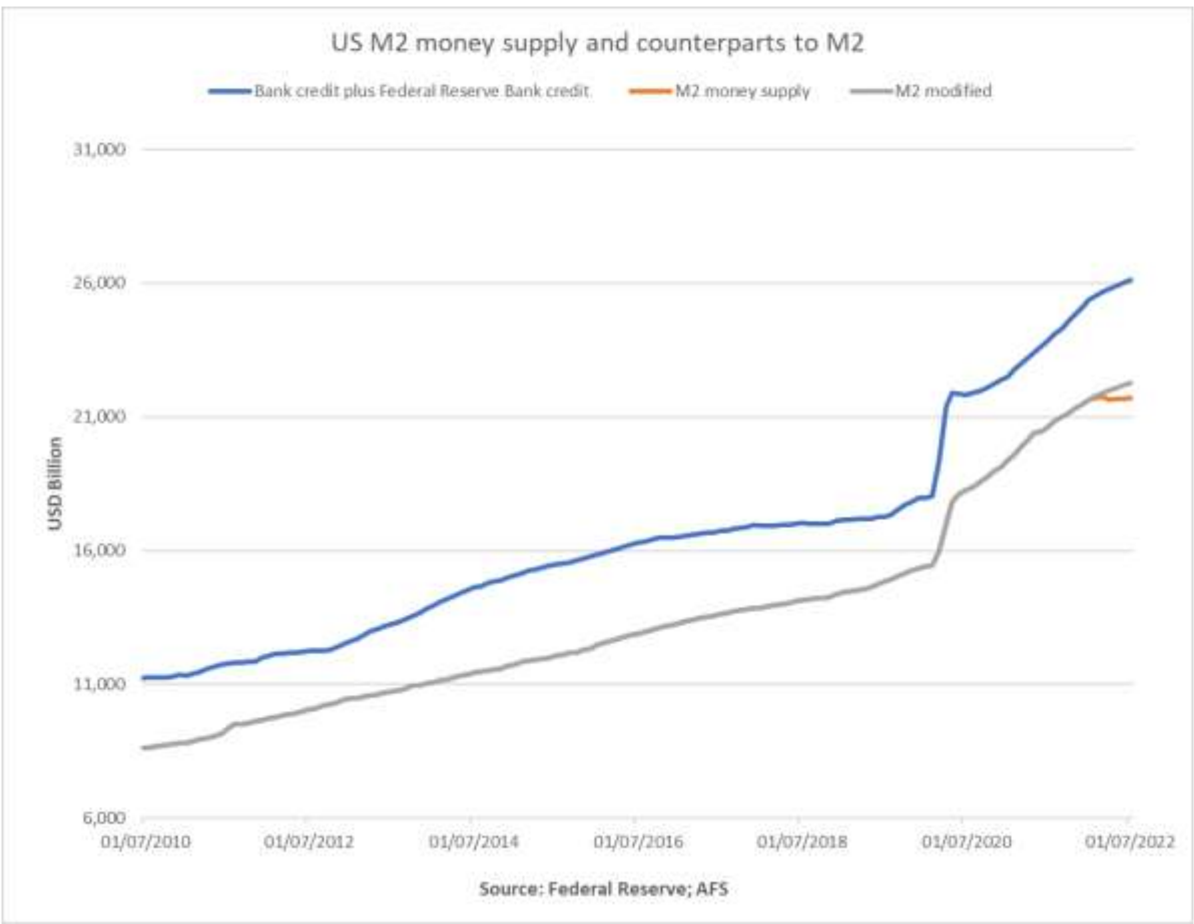
bank/deposits money supply, namely the counterparts on the asset side of the consolidated balance sheet of the Federal Reserve and the US commercial banking system. That balance sheet looks like this when we include the important assets and liabilities:

Consolidated balance sheet of the US banking system and Federal Reserve

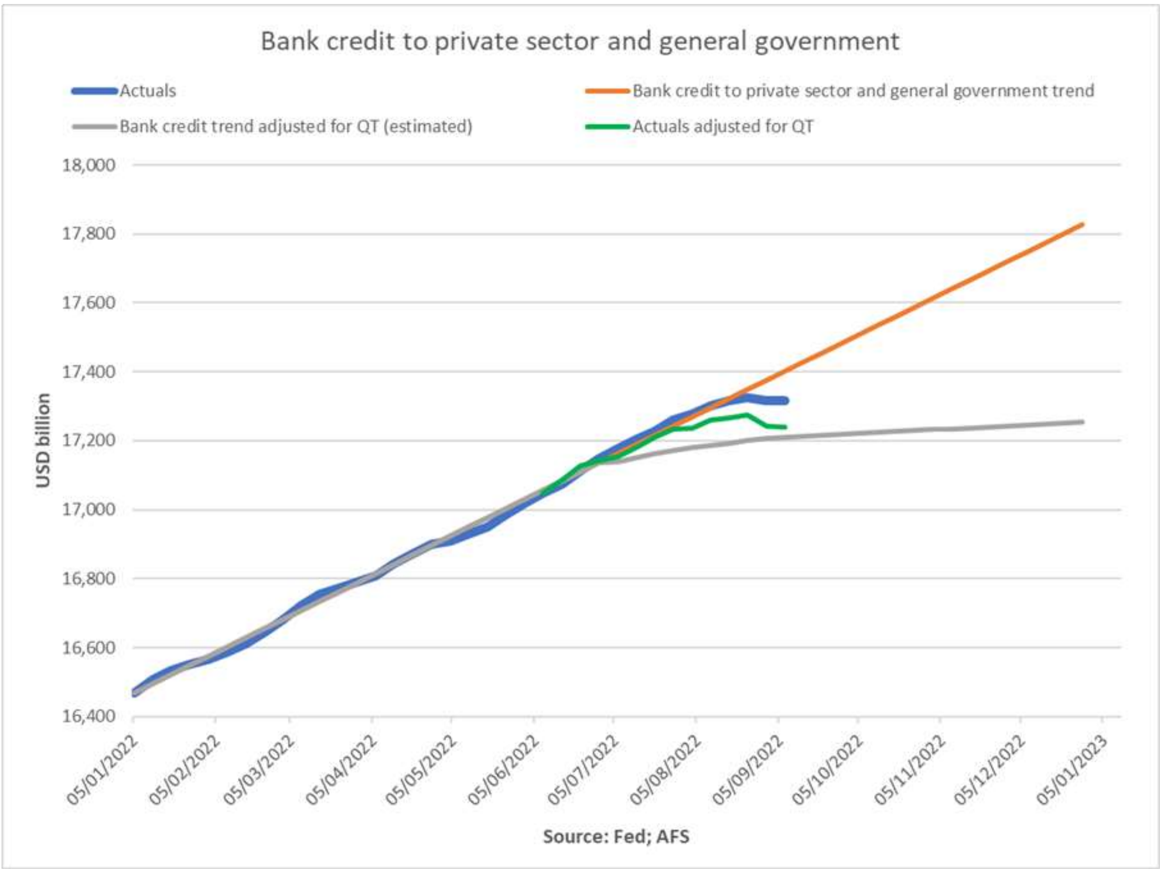
Assets	**Liabilities**
Loans	Deposits
US Treasury holdings	Recourse to reverse repo facility
MBS holdings	Treasury General Account
Holdings of other securities	

Remember, deposits are fully accounted for in money supply data; we believe recourse to the reverse repo facility is only partially accounted for in money supply data; and the Treasury balance is of course no component of money supply data.

- **In central bank jargon, the assets on the consolidated balance sheet of the Fed and the banking system are colloquially known as bank credit and federal reserve bank credit**. Historically, the asset counterparts correlate very strongly with the liabilities, that is: the money supply:

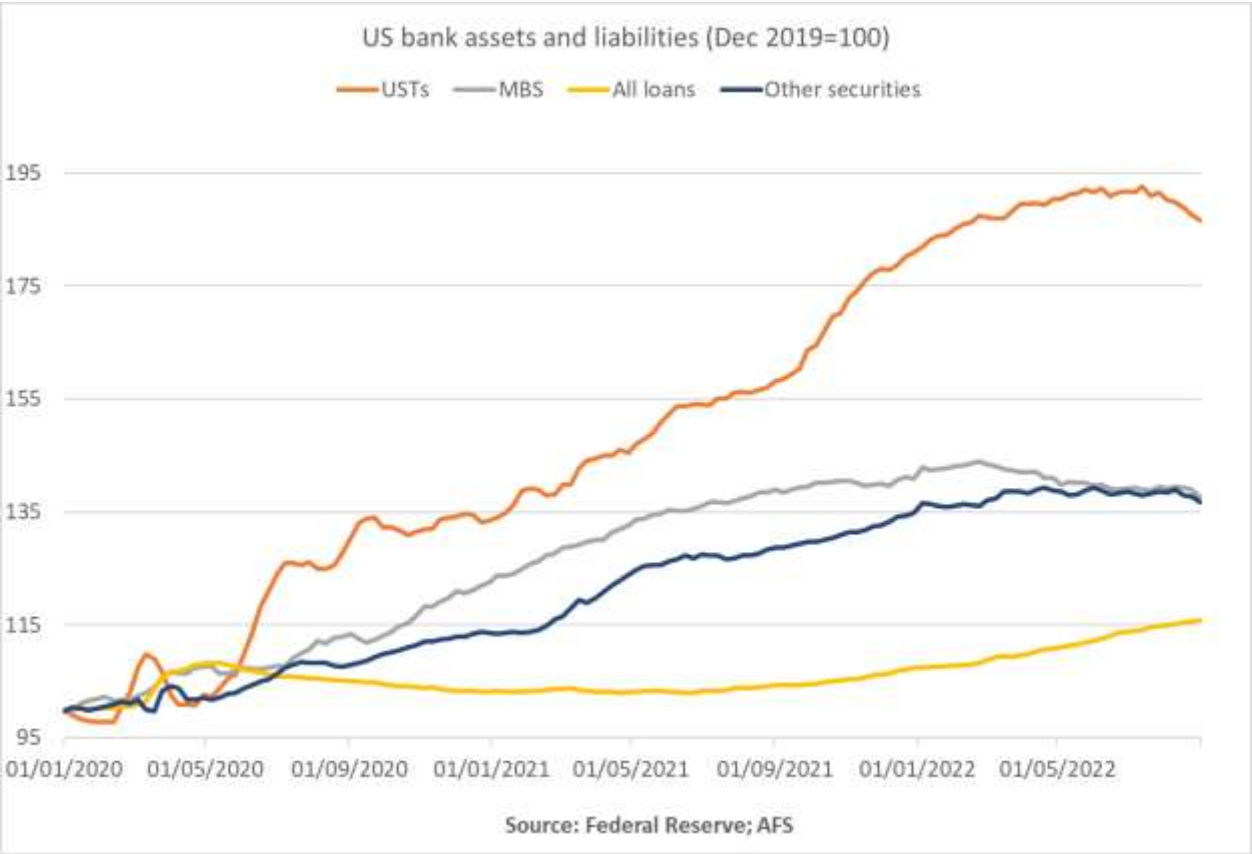


- **Historically, divergences between bank credit and the money supply can be explained by so-called autonomous factors: other items on the balance sheets of banks and the Federal Reserve that drain deposits from the banking system**. For example, a higher cash balance of the US Treasury at the Fed, or recourse to the Fed's reverse repo facility by certain counterparties. For today's analysis it is not necessary to find the exact reason why the growth in bank loans and securities holdings is no longer reflected in the money supply. Suffice to say is that we prefer to look at what's happening on the asset side of the consolidated balance sheet of the banking system and the Federal Reserve, relegating money supply/bank deposits to a somewhat distant second.
- **Now, we started this Comment with a few remarks on our preference for the weekly bank balance sheet data**. The charts above show monthly data up until July. For the weekly data series, we have data for the week ending September 2. That data is – dare we say – deflationary.
- **The chart below shows the sum of bank loans and securities holdings (blue line, colloquially known as bank credit); the trend in bank lending and securities holdings until the start of Fed Quantitative Tightening on June 1 (orange line); and a stylized scenario whereby we subtract QT from bank loans and securities holdings (green line and grey line).** Remember bank securities holdings and loan adjusted for Fed QT are the best proxy for the 'true' money supply:



If you find the matter a bit confusing, what we are doing her is showing what is happening with the money supply (proxy). Furthermore, in the stylized scenario (grey line), the money supply proxy is growing at an annual rate of just 1 percent, which is very disinflationary.

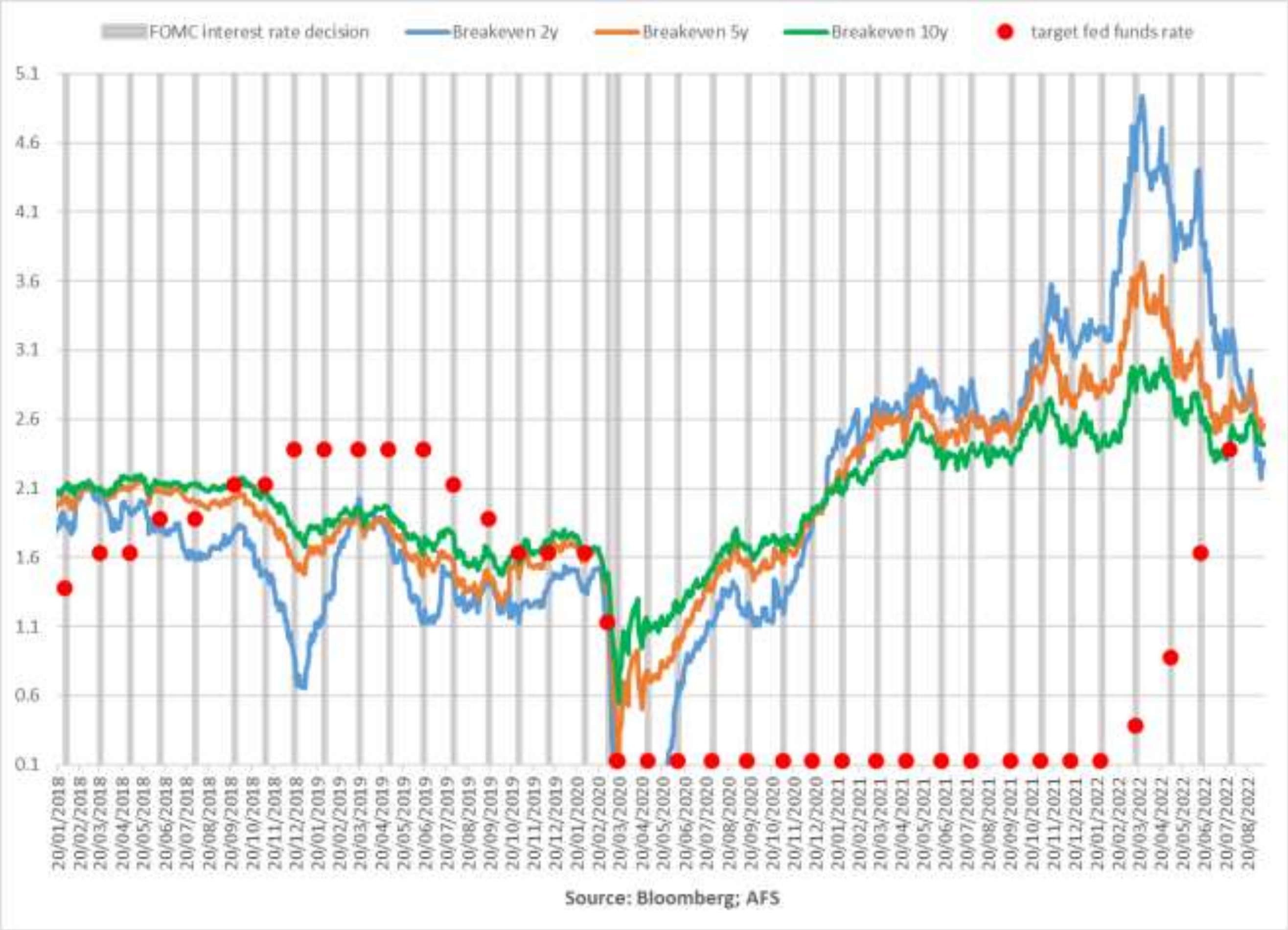
- **Last week, we basically had the first substantial decline in bank credit since the start of our data series, which is 2017.**[2] If we adjust for QT (green line) which is what we must do if want to have the best proxy for the money supply, there is no growth over the past two months. More importantly, if bank credit doesn't grow and with QT rising to its monthly pace of USD100 billion this month, the shrinkage on the asset side of the consolidated balance sheet of the Fed and the banking system must be reflected by a decline in corresponding liabilities: deposits. A decline in bank deposits is a very likely outcome of Fed QT. If neither the banking system nor the Federal Reserve is willing to hold Treasury bond issuance, then the nonbank private sector must. And that will be reflected in a decline in deposits and/or a decline in recourse to the Fed's reverse repo facility.
- **Shrinking bank deposits/money supply doesn't necessarily cure us of our inflation predicament.** But it will go a long way. If the Fed keeps raising overnight rates, the Volcker experience tells us that money velocity will start to fall at some point too. Falling velocity and a shrinking money supply are *hardcore deflationary*. That might surprise you, but take a look what US banks have been doing. The chart below shows the money creating assets on the balance sheet of the banking system. Each series is on its own index scale, with the final week of December 2019 at one. [3]



[2] The data goes back decades, but our data series start in 2017.

[3] The absolute values for bank loans at the last data point available were 11.6 trillion dollars for loans; 1.7 trillion dollars for Treasuries; 1.1 trillion dollars for other securities; and 2.9 trillion dollars for MBS. Thus, loans are by far the most important asset.

- **Banks have started to shed Treasuries and other securities (i.e. corporate bonds, equities) in recent months**. Since the start of the year, banks have been gradually disposing of MBS. Bank lending is still growing, and there is no real slowdown in lending (yet). However, lending is now fully offset by banks shedding securities. Put differently, banks are no longer creating money. However, if banks were that worried about inflation, we would have seen the following: total assets growing by extending loans and buying assets with some inflation protection (i.e. equities, reflected in other securities).
- **So, to summarize, we see the contours of a deflationary trend in US monetary developments emerging**. To be more precise, the counterpart of bank deposits/money supply – namely bank loans and bank and Federal Reserve security holdings – have started to shrink. Furthermore, there is no growth in key assets on US banks' balance sheets. In banks expected the inflationary environment to persist, we would have seen the opposite: banks growing their balance sheet. In any case, developments in bank and Fed balance sheets are supportive for US Treasuries because they're disinflationary/deflationary. However, the volatility and generally rising yields could be attributed to 'birth pangs': with banks and the Fed offloading Treasuries, the private nonbank sector has to absorb a greater share of Treasuries.
- **Fed and US bank balance sheet developments our highly supportive of lower longer term Treasury yields**. If the Fed's aggressive rate hike campaign gets spending (i.e. the velocity of money under control) – which we believe it will – the stage is set for strong disinflation. And – dare we say – possibly deflation. Of course, the Fed must stay engaged in 'pain mode', which might drive up or keep higher longer-term Treasury yields for a while.
- **If you're skeptical of our monetary analysis, take a look at what US breakevens have been doing:**



Breakevens have simply collapsed, and they're likely to fall further as the Fed keeps raising interest rates. Real short rates are about to turn very restrictive. After next week's 75bps jumbo hike, the fed funds rate will be the highest of these rates – by a wide margin. In any case, the Fed's deflationary vice is starting to bite, and that means longer term Treasuries are starting to look attractive at these levels from a fundamental point of view.

Calendar

TIME	REGION	EVENT	PERIOD	CONSENSUS	PRIOR
01:50	Japan	PPI YoY	Aug	8.90%	8.60%
01:50	Japan	PPI MoM	Aug	0.30%	0.40%
08:00	Germany	CPI EU Harmonized MoM	Aug F	0.40%	0.40%
08:00	Germany	CPI EU Harmonized YoY	Aug F	8.80%	8.80%
08:00	UK	Average Weekly Earnings 3M/YoY	Jul	5.20%	5.10%
08:00	UK	ILO Unemployment Rate 3Mths	Jul	3.80%	3.80%
08:00	UK	Employment Change 3M/3M	Jul	--	160k
08:30	Switzerl.	Producer & Import Prices MoM	Aug	--	-0.10%
09:00	Spain	CPI EU Harmonised MoM	Aug F	--	0.10%
09:00	Spain	CPI EU Harmonised YoY	Aug F	--	10.30%
10:30	Spain	Sells Bills			
11:00	Germany	ZEW Survey Expectations	Sep	-59.3	-55.3
11:00	Germany	ZEW Survey Current Situation	Sep	-50.1	-47.6
11:00	Eurozone	ZEW Survey Expectations	Sep	--	-54.9
11:00	Italy	Sells Up to EU2.75 Billion of 1.2% 2025 Bonds			
11:00	Slovenia	Sells 91-day Bills			
11:00	Slovenia	Sells 364-day Bills			
11:00	Italy	Sells Up to EU3.25 Billion of 2.8% 2029 Bonds			
11:00	Italy	Sells Up to EU1.5 Billion of 3.25% 2046 Bonds			
11:30	Belgium	Sells Bills			
11:30	Germany	Sells EU5.5 Billion of 0.4% 2024 Bonds			
12:00	US	NFIB Small Business Optimism	Aug	90.5	89.9
12:00	Finland	Sells Up to EU1 Billion of 151-day Bills			
12:00	Finland	Sells Up to EU1 Billion of 239-day Bills			
14:30	US	CPI MoM	Aug	-0.10%	0.00%
14:30	US	CPI Ex Food and Energy MoM	Aug	0.30%	0.30%
14:30	US	CPI YoY	Aug	8.10%	8.50%
14:30	US	CPI Ex Food and Energy YoY	Aug	6.10%	5.90%
15:00		ECB Weekly Balance sheet			
20:00	US	Monthly Budget Statement	Aug	--	-$211.1b
		Primaries in Several US States			
		Twitter EGM on Sale to Elon Musk			
		Corporate Events:			
		Ocado sales			

Consensus data: Bloomberg News; All Times Are in Central European Time