GLOBAL MACRO INSIGHT

INCOMING TIDE OF $-LIQUIDITY: WE USE THIS STRENGTH TO REDUCE EXPOSURE TO RISK ASSETS

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NEDBANK CIB

Executive summary:

- $-Liquidity is set to improve over the next three to six months amid reaching the US debt ceiling. We estimate that the excess $-Liquidity stemming from the US Treasury will offset the Fed's "quantitative tightening" (QT) programme.
- This will likely be a *temporary* boost to $-Liquidity in the global financial system, which should ease financial conditions and support financial markets, particularly risk assets (EM) which are sensitive to the US Dollar.
- Investment implications: We will use this opportunity to reduce exposure to SA assets (FX/bonds/equities) as the injection of $-Liquidity is likely to be temporarily, lasting for 3-6 months at best, before the shortages since 2018 resume.
- Target ranges: USDZAR: 13.50-13.80, EUR/USD: 1.14-1.16, SA 10yr govi 9.00-9.20%, Top40: 45,000-48,000

The incoming tide of $-Liquidity will likely be a tailwind for risk assets, and we will use this to de-risk, as this is likely to be temporary.

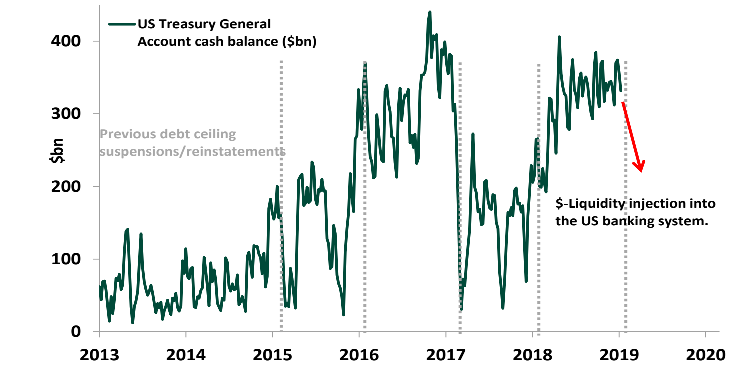
Table 1: Many sources of Global $-Liquidity

Sources of Global $-Liquidity
1. US economy (current account deficit)
2. US Federal Reserve & US Treasury (TGA)
3. Foreign Central banks USD reserves (China, Petrodollar nations)
4.Offshore USD banking system (eurodollars)
5. Global growth and trade

Source: BIS, IMF, DataStream, Nedbank CIB

- In **2018**, the USD strengthened, led by a contraction **in Global $-Liquidity**. As a result, EMs came under pressure, and by the end of the year, developed markets also came under pressure as a result of tighter financial conditions and slowing global growth.
- Global $-Liquidity has received a lot of attention from financial market participants over the past year, particularly in regard to the slowdown in central bank QE programmes (the Fed's and the ECB's) – one reason for the turmoil in financial markets in 2018.
- **However, there are other sources of Global $-Liquidity** (Table 1) that matter but are less understood by market participants. Our findings support the view that these sources of Global $-Liquidity play an important role in the stability and performance of the global economy and financial markets. They were also responsible for the volatility and poor performance in financial markets in 2018.
- In this note, we discuss one of the sources of Global $-Liquidity that we believe will have a meaningful impact on financial markets over the next three to six months: the **US Treasury General Account (TGA)**. The TGA is a large liquidity cash buffer of USD300-400bn that can be used only to inject liquidity into the economy under "extraordinary circumstances", like at the time of a natural disaster, a financial crisis such as in 2008/09 or, in this case, the US government shutdown, which is now the longest in history.
- The **US debt ceiling** (USD22tn) is a legislative debt limit on the amount of national debt that can be incurred by the US Treasury, limiting how much money the government may borrow. When the debt ceiling is reached, the US Treasury cannot issue more debt. As a result, the US government would find it difficult to fulfil many of its obligations, with unintended negative consequences for the US economy.
- However, the US Treasury can utilise the TGA to inject cash into the US economy only if there is no agreement on the debt ceiling between the Democrats and Republicans before the deadline: 1 March 2019. Rarely in history has an agreement been reached before the deadline. We believe this time will be no different given the current political environment in Washington.
- Therefore, we believe the US Treasury will have to inject dollars into the economy and banking system via its TGA (Chart 1). The rise in $-Liquidity should ease financial conditions and support risk sentiment towards risk assets inside and outside of the US.

Chart 1: Incoming tide of $-Liquidity from the US Treasury



Source: DataStream , Nedbank CIB

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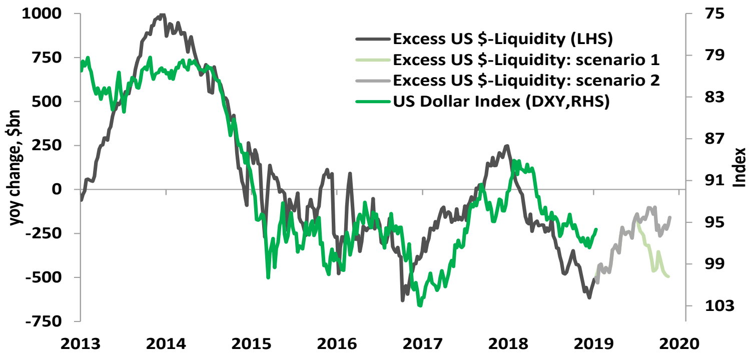
Chart 2: Two plausible scenarios for excess US $-Liquidity in 2019

We expect an injection of $-Liquidity by the US Treasury to offset the Fed's QT programme…

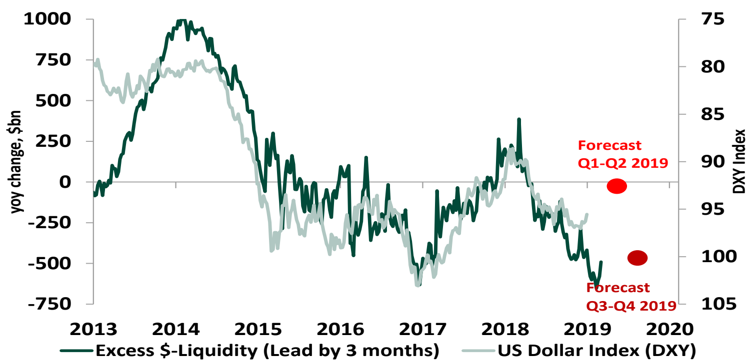


**Excess US $-Liquidity is calculated as the sum of excess reserves held at the Federal Reserve by US banks, the US TGA, the US monetary base and, effectively, the Federal Reserve's balance sheet*
Source: DataStream , Nedbank CIB

- **'Excess US $-Liquidity'** provides us with a broader way of assessing $-Liquidity conditions in the US banking system. Changes in 'excess US $-Liquidity' also have an impact on the non-US banking system since we operate in an interconnected global financial system. There are many foreign bank branches located in the US that are able to transfer electronic dollars to the offshore USD banking system. This is the transmission mechanism whereby dollars enter the global financial system, also known as the Eurodollar banking system.
- **We believe there are two plausible scenarios of excess US $-Liquidity that could evolve during 2019 (Chart 2)**
- **Scenario 1 (our base case): US $-Liquidity improves; the USD weakens, supporting risk assets, but only for a couple of months. Thereafter, dollar liquidity shrinks and the USD resumes trending higher.** We estimate that the net effect of the US Treasury injecting dollars into the system, coupled with the continuation of the run-off from the Fed shrinking its balance sheet over the next three to six months, will be equivalent to +/-USD200bn in additional liquidity in the US economy. However, this will likely be a temporary boost to $-Liquidity, as the US Treasury would have to rebuild its TGA balance and, as a result, would have to drain dollars from the US banking system after a while. This is the same process that took place at the beginning of 2018, exacerbating the global dollar shortage and tightening financial conditions, leading to a stronger USD. This process will drain dollars from the financial system and, coupled with the continuation of the Fed's QT programme, lead to the second stage of the risk-off phase that started in 2018.
- **Scenario 2: US Treasury injects dollars, the Fed stops "QT"; US $-Liquidity improves significantly; USD weakens.** We that with the injection of dollars into the US banking system by the US Treasury and if the Fed stops its QT programme, the financial system will have ample dollars, of +/-USD380bn. As a result, the USD would weaken, leading to easier financial conditions that would support riskier assets.

Chart 3: The US debt ceiling is also likely to be a ceiling for the USD for now

We expect $-Liquidity conditions to improve as the USD weakens 3-4%; this bodes well for SA/EMs, but is unlikely to be sustainable.



Source: DataStream , Nedbank CIB

- There is an inverse relationship between the change in excess $-Liquidity and the USD. When excess $-Liquidity in the US growing, the USD remains relatively week. When excess $-Liquidity in the US is shrinking, the USD is relatively strong. **In fact, excess US $-Liquidity leads the USD by approximately three months (Chart 3).** It is evident that it is the "quantum of money" rather than the "price of money" that has driven the USD (and other assets), especially recently.
- **Investment implications:** In our base case (Scenario 1), we expect the USD to weaken close to 90 index points (DXY) or **EUR/USD 1.14-1.16**, which translates into a stronger rand and bond yields (10yr) of **R13.50-R13.80 and 9.00-9.20%**, respectively, over the three- to six-month horizon. However, into Q2/Q3 2019, we expect the tide of excess $-Liquidity to recede and **rand and bond yields to be much weaker**.

Key forecasts and target values

	Target values (period end)				Broad trading range	
	3m	6m	12m	Year-end	High	Low
Fed funds	2.50	2.75	3.00	3.00	2.50	3.00
US 10-year bond yield	2.80	3.00	2.80	2.80	2.30	3.20
Repo rate	6.75	6.75	7.00	7.00	6.75	7.00
SA 10-year bond yield	9.20	9.60	9.40	9.40	8.60	9.70
R208 (%)	7.00	7.10	7.20	7.20	6.90	7.40
R186 (%)	8.90	9.30	9.10	9.10	8.30	9.40
R2048 (%)	10.00	10.20	10.30	10.30	9.50	10.50
EURUSD	1.16	1.12	1.14	1.14	1.16	1.12
USDZAR	13.50	14.40	14.10	14.10	14.40	13.50
EURZAR	15.66	16.19	16.00	16.00	16.19	15.66
GBPZAR	17.60	18.10	17.90	17.90	18.10	17.60
AUDZAR	9.80	10.20	10.00	10.00	10.20	9.80
Δ Global $-Liquidity	↔ to ↑	↔ to ↓	↓	↓	-	-

Nedbank CIB Market Research/Nedbank Group Economics

	1Q19	2Q19	3Q19	4Q19	2019 Ave	2020 Ave
SA headline CPI	5.00	4.90	5.30	5.40	5.30	5.20
SA core inflation	4.40	4.50	4.50	4.60	4.50	4.50
SA GDP	1.60	1.70	2.10	2.30	1.60	2.00
Current account as % of GDP					-3,3	-3,6

South African Reserve Bank

	1Q19	2Q19	3Q19	4Q19	2019 Ave	2020 Ave
SA headline CPI	4.60	4.70	4.80	4.80	4.80	5.30
SA core inflation	4.80	5.00	5.10	5.30	5.00	5.10
SA GDP	-	-	-	-	1.70	2.00
Current account as % of GDP	-	-	-	-	- 3.70	- 4.10

National Treasury

	1Q19	2Q19	3Q19	4Q19	2019 Ave	2020 Ave
SA headline CPI	-	-	-	-	5.60	5.40
SA core inflation	-	-	-	-	-	-
SA GDP	-	-	-	-	0.70	1.70
Current account as % of GDP	-	-	-	-	-3,2	-3,7

Source: Nedbank CIB Markets Research, Nedbank Group Economics, SARB, NT

All numbers in % unless otherwise indicated

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