Richard Bernstein Advisors

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Quick Insights

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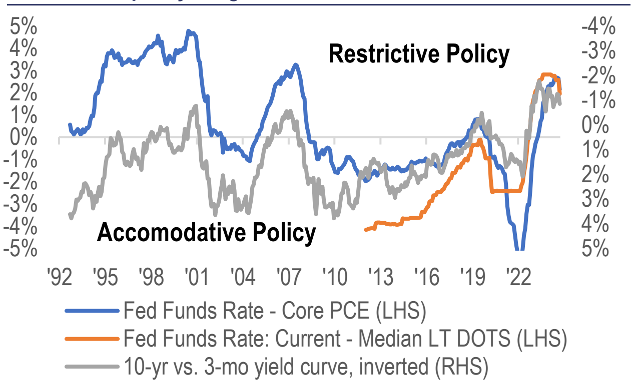
Navigating the tight policy, loose liquidity paradox

Tight Fed policy doesn't always equate to tight liquidity

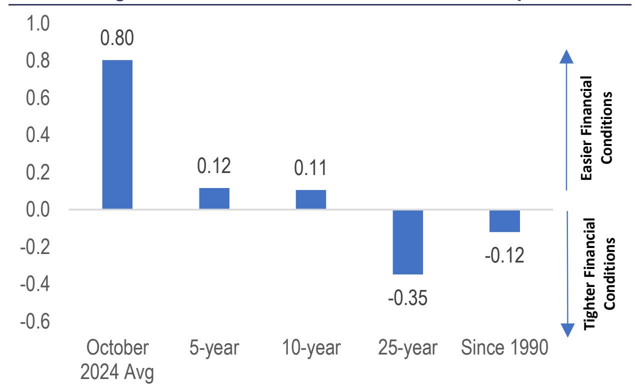
The Federal Reserve's dual mandate is to maintain stable inflation and maximize employment. With inflation having fallen significantly and the post-pandemic extreme labor market tightness having subsided, the Fed believes its policies are now too restrictive, hence the aggressive start to its easing cycle. While the Fed's policy stance appears tight on a variety of metrics (Chart 1), liquidity conditions tell a different story. The Fed manages liquidity through its policy tools, but it's crucial to remember that the Fed is just one source of liquidity among several. The Fed acts like a coxswain on a rowing team, steering the liquidity boat, but the rowers (factors like capital markets, fiscal policy, banks and foreign capital) aren't always in sync. Despite the Fed's efforts to tighten liquidity over the past year, other forces have moved in the opposite direction, keeping financial conditions relatively loose. Even banks, which have been tightening lending standards, have slowed their pace of tightening over the past year, contributing to an environment of easy liquidity compared to historical norms (Chart 2).

Chart 1: Fed policy is tight based on most metrics



Source: Richard Bernstein Advisors LLC, Bloomberg, Federal Reserve Board

Chart 2: Avg US Financial Conditions Index over select periods

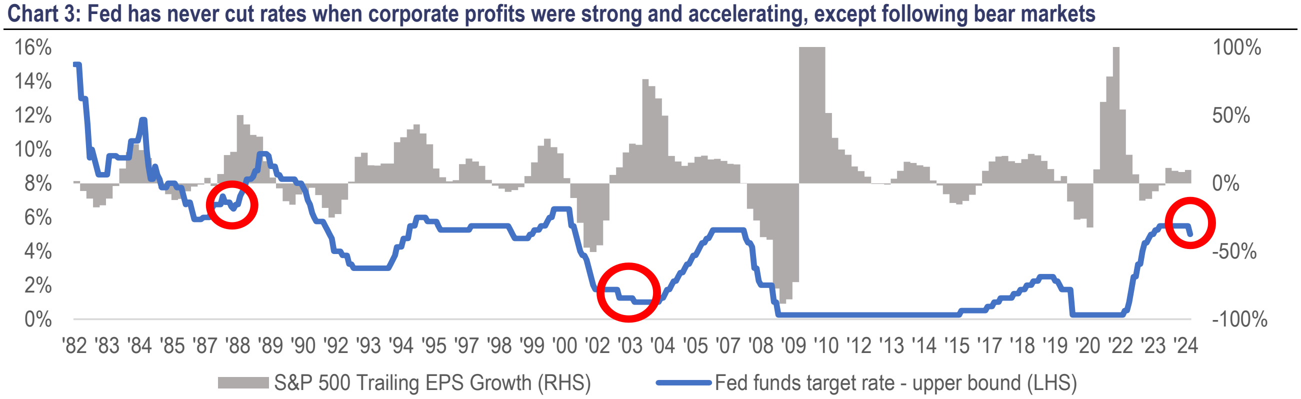


Source: Richard Bernstein Advisors LLC, Bloomberg US Financial Conditions Index

Could the Fed be adding fuel to the fire?

This is the first time in history that the Fed has ever cut interest rates when corporate profits were strong (currently ~10% y/y) and accelerating, except in the wake of the 1987 and 2002 bear markets (Chart 3). Easing into an economy with ample liquidity and accelerating corporate profits could reignite inflationary pressures, particularly when key components such as food, health care, education and autos are already stabilizing or accelerating. Persistently higher inflation could eventually force the Fed into another round of tightening, potentially choking off growth. But in the meantime, faster nominal growth could benefit certain segments of the market, including US small caps, deep cyclical sectors (such as industrials, energy, and materials), and non-China emerging markets, all of which appear to be in the early stages of earnings recoveries.

Chart 3: Fed has never cut rates when corporate profits were strong and accelerating, except following bear markets



Source: Richard Bernstein Advisors LLC, Bloomberg, S&P

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