

## Macro Keys

### This time really is different: Year-end won't matter to the Fed

#### Economics

#### Global

Global Macro Team

#### Markets need collateral, not cash

Pre-crisis the role of the Fed at the end of each year was to make sure market participants had enough liquidity over year-end, when financing pressures were at their height. To a lesser degree the Fed was also forced to play this role at each quarter-end.

In the post-crisis world, the Fed's role has reversed. The monetary expansion resulting from QE now means that, at year-end, market participants have cash, but not enough collateral (Figure 2, next page). This can clearly be seen by Fed activity at the end of 2013 and 2014 and, more recently, at the end of the third quarter. Why is this important?

#### Providing collateral = tightening of policy

The same mechanism the Fed is using to provide collateral to the market is the one they would use to create a floor for interest rates in the event of a rate hike. The policy for tightening rates and the demand for additional collateral over year-end are in sync – the Fed would want to conduct reverse repos (RRP) to drain cash to help create a floor under interest rates while the market would want to participate in the RRP program to obtain collateral, just as they have done at the end of the last few years.

As a consequence and, contrary to perception, year-end financing worries would highlight the need for a rate hike rather than the reverse. While this does not mean the Fed will hike rates if they do not believe conditions warrant a rate hike, it does suggest that they will not let year-end divert them from a move they feel is necessary.

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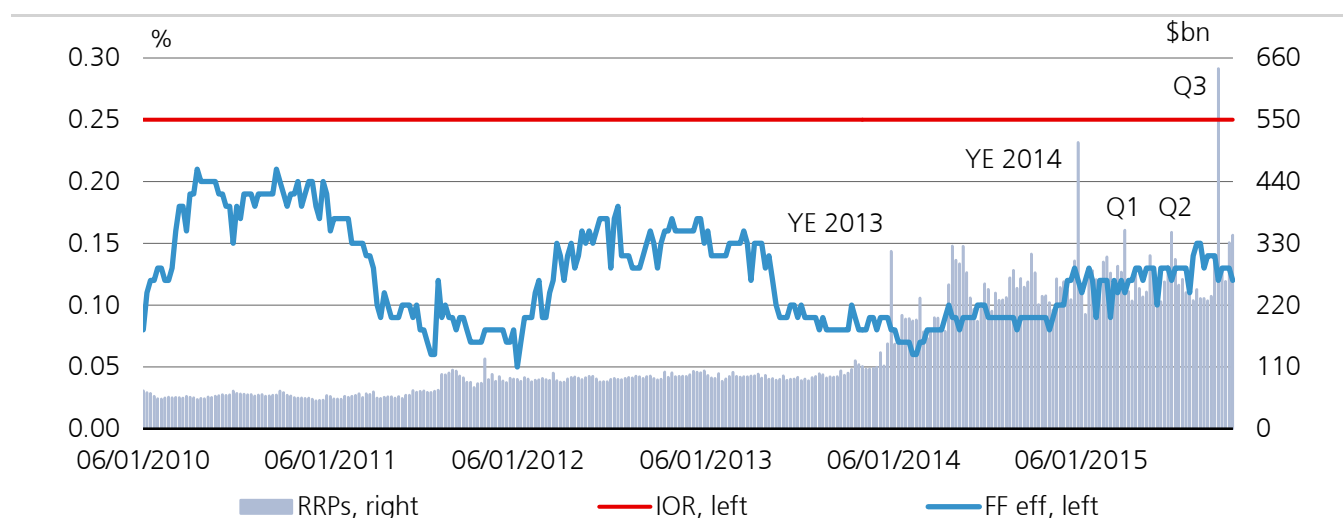
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**Figure 1: Historically, demand for cash increased at quarter- and year-ends. After the Fed's balance sheet expansion, the opposite is true: demand for collateral is increasing at quarter- and year-ends. If the Fed were to tighten policy, they would use the RRP program to lend securities and absorb cash, exactly the actions that market participants now prefer approaching year-end.**

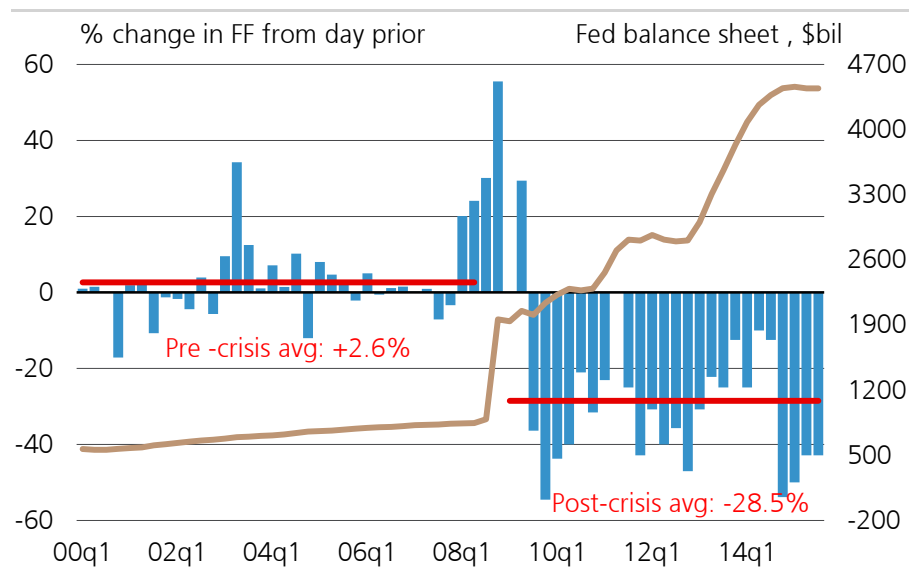


Source: Federal Reserve and UBS

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**Figure 2: Pre-crisis, overnight cash rates (Fed Funds) typically increased at quarter-end (as demand for cash rose). Post crisis, given the ample supply of cash from the Fed's expanded balance sheet, the opposite typically occurs.**

The chart below shows the change in the Fed funds effective rate at quarter-end, relative to the day prior.



Source: Bloomberg, Federal Reserve and UBS

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