

Is the Fed Deliberately Behind the Curve?

Chair Warsh Lets Markets Do the Tightening

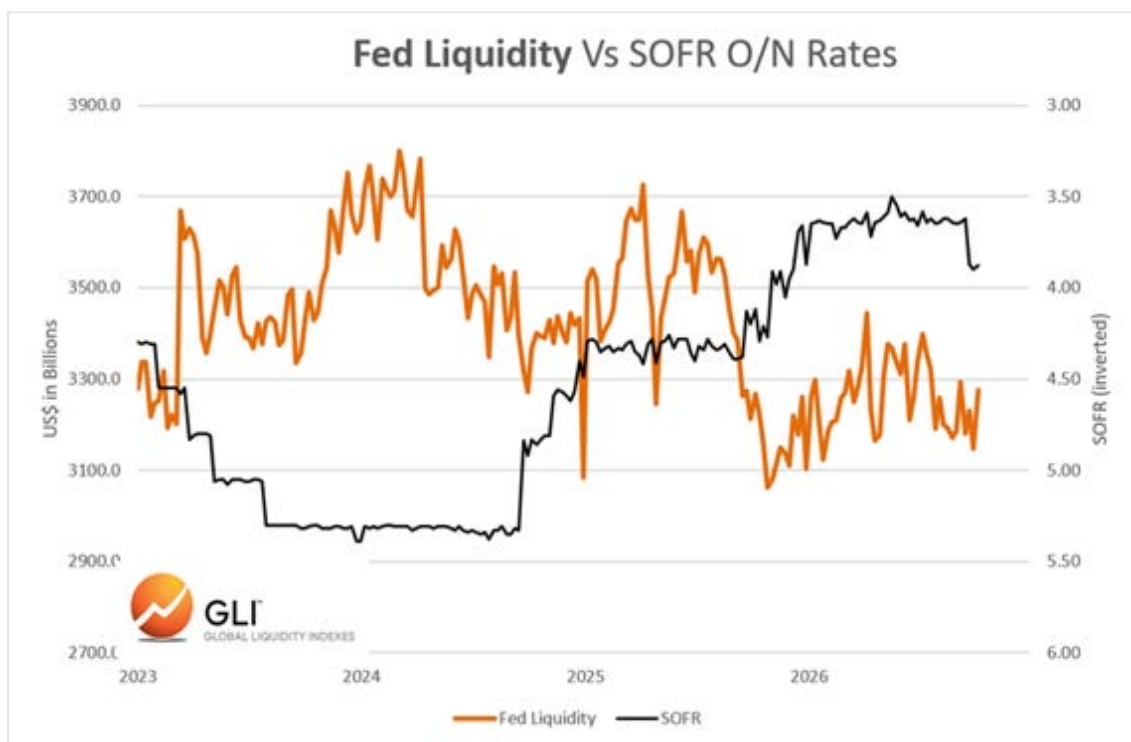
Recent weekly moves in Federal Reserve liquidity raise a basic but important question: how much monetary tightening is actually reaching the financial system? Fed funds alone do not measure the pace of US monetary tightening. Rather collateral conditions, bond volatility, the dollar and yield-curve signals are better policy indicators.

The investment twist is that this may not just be a bond story: if markets, not the Fed, are doing the tightening, Bitcoin may ultimately behave less like a speculative investment and more like an ultra-long-duration asset.

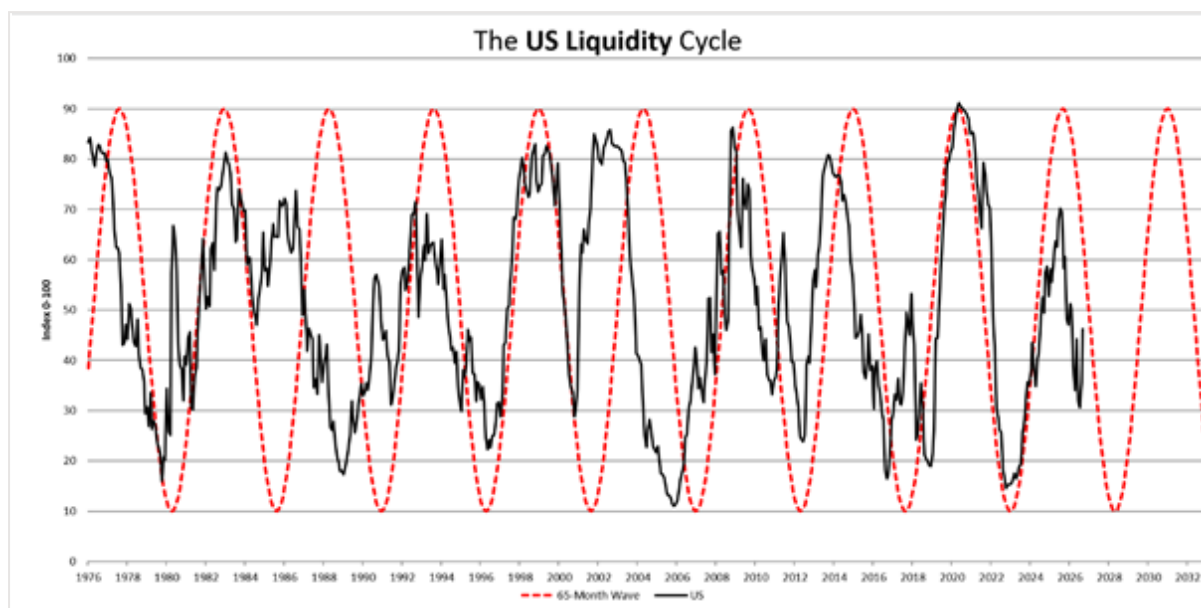
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Half Speed Ahead!

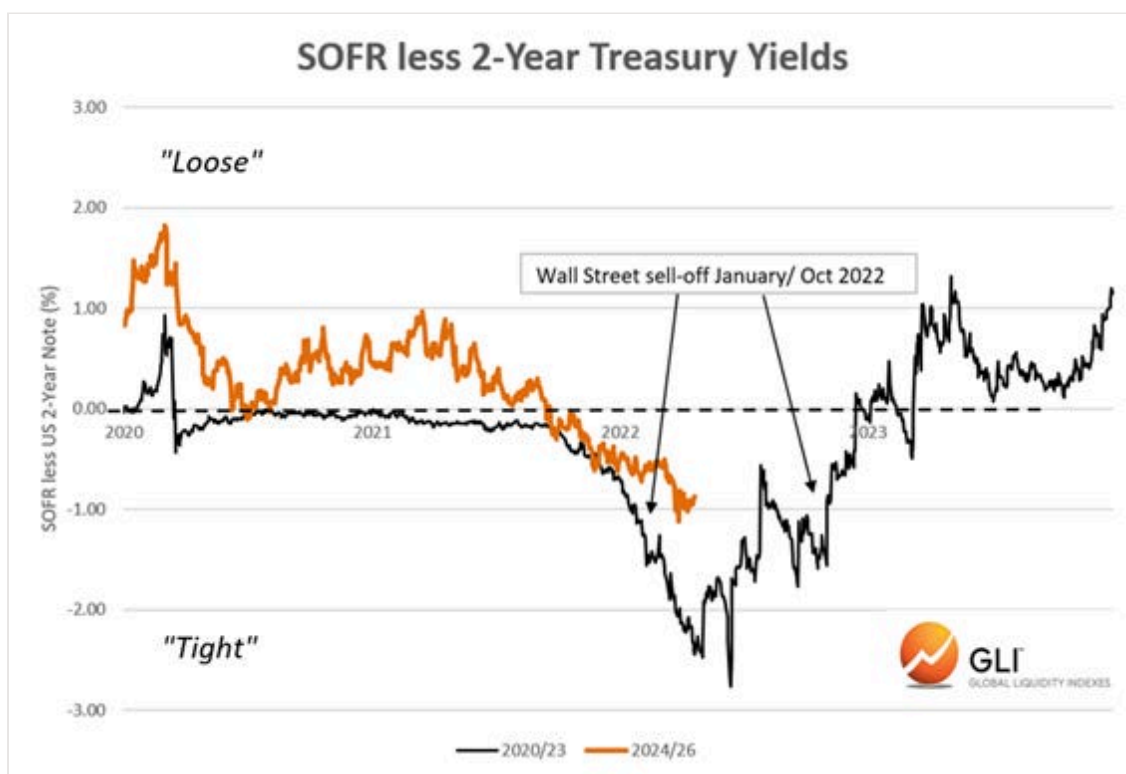
Investors usually treat a higher Fed funds rate as synonymous with tighter policy. Yet in a debt-saturated economy, higher rates also raise Treasury interest payments to the private sector. These larger income transfers to households, businesses and financial institutions partly offset the intended contractionary effect. More importantly, the link between Fed funds and money-market liquidity is weak, as the following chart shows:



A fuller guide to conditions comes from our **US Liquidity Index** (range 0-100), shown in the next chart. The index captures Fed interventions, private-sector liquidity provision and cross-border inflows. It has clearly peaked and turned lower, signalling slower momentum in US liquidity expansion. Even so, the recent flip-flop is not unprecedented, but it raises doubts about the true pace of tightening.



The continued narrowing of the spread between SOFR repo rates and two-year Treasury yields reinforces the point. The Federal Reserve remains deliberately behind the curve, especially by comparison with the more aggressive tightening of 2021-22. The quantity and circulation of collateral, rather than the level of Fed funds alone, now appear to dominate liquidity conditions. **In short, markets are doing much of the tightening for the Fed — probably as Chair Warsh would prefer. This reduces the odds of Fed ‘errors’ and may mean a shallower cycle.**



Main Points

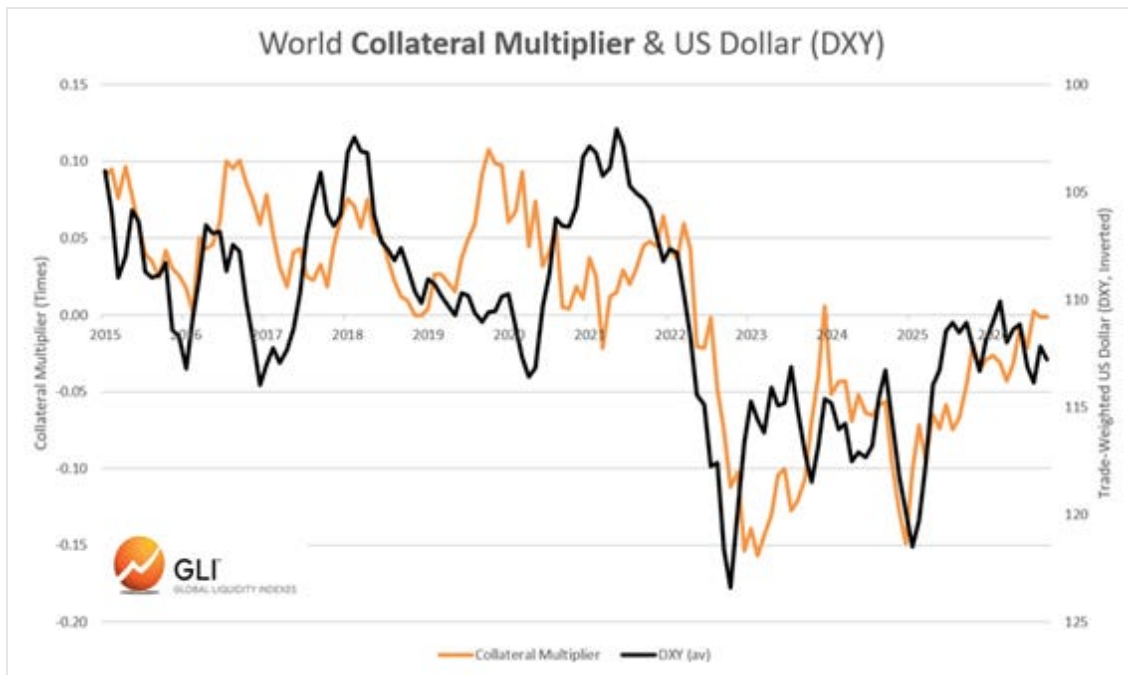
- The **US Liquidity index** has peaked and turned lower, but limited SOFR stress suggests recent policy rate increases have not sharply reduced money-market liquidity
- Collateral availability and reuse matter more than the 'price' of reserves: a **MOVE Index** above around 85 reduces the collateral multiplier, while a jump above 135 signals recession risk
- With the MOVE near 105, Global Liquidity is expected to slow but without triggering a recession, while a yield peak and reversal could support Bitcoin, whose estimated **empirical duration** is a high 22.4 years

The Collateral Connection

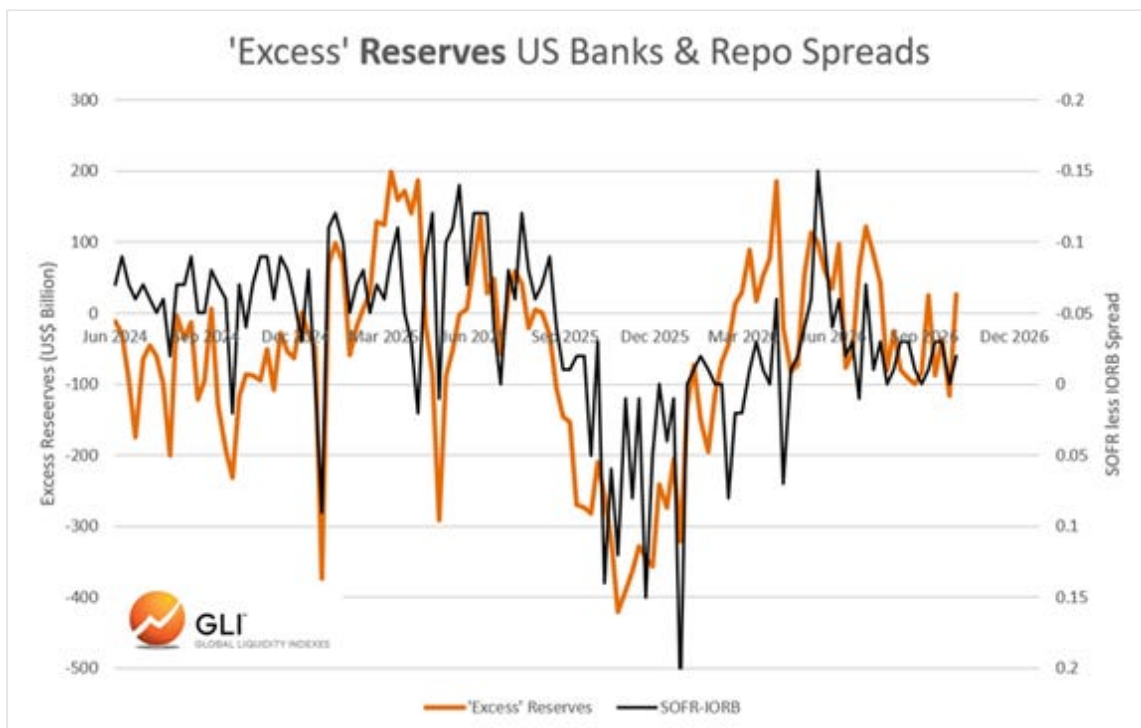
Modern markets are driven less by the price of bank reserves than by the availability and re-use of collateral. In this system, the Federal Reserve and the Treasury jointly influence both base liquidity and the *collateral multiplier*. By affecting Treasury-market volatility, captured by the MOVE Index, policymakers influence how intensively collateral can be leveraged and rehypothecated. High volatility reduces collateral efficiency; stable markets expand the effective supply of liquidity. The next chart illustrates why MOVE now matters more to liquidity conditions than changes in Fed funds alone.



The US dollar adds another constraint, as the next chart shows. FX swaps and Eurodollars provide access to collateralised cross-border funding, but that funding becomes less attractive as the dollar strengthens. This helps explain the similar, but inverse, co-movement between the trade-weighted US dollar (DXY) and changes in the collateral multiplier.



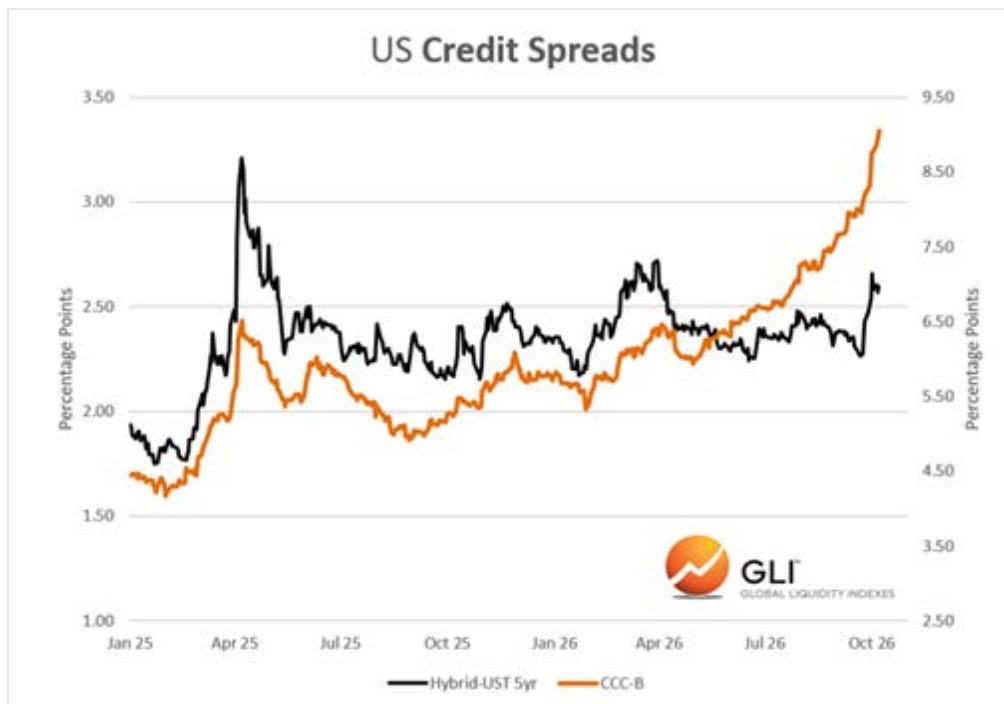
In theory, higher Fed funds rates should curb leverage and credit demand. In practice, collateral supply and collateral usability appear to matter more. **Despite recent rate increases, US money-market liquidity has barely deteriorated** and funding stress remains limited, as the behaviour of SOFR spreads in the following chart shows.



MOVE Over Fed funds

Even if the Fed is tip-toeing, the flatter US yield curve and wider credit spreads still point to tighter financial conditions. But this tightening appears to reflect robust private-sector credit demand and economic resilience more than a deliberate withdrawal of liquidity by the Federal Reserve. The private sector is competing more

aggressively for available funding, but **policymakers are not materially shrinking its supply**. This is a sharp contrast with the pre-2008/09 regime, when policymakers assumed money-market liquidity would look after itself — and therefore could be safely ignored.

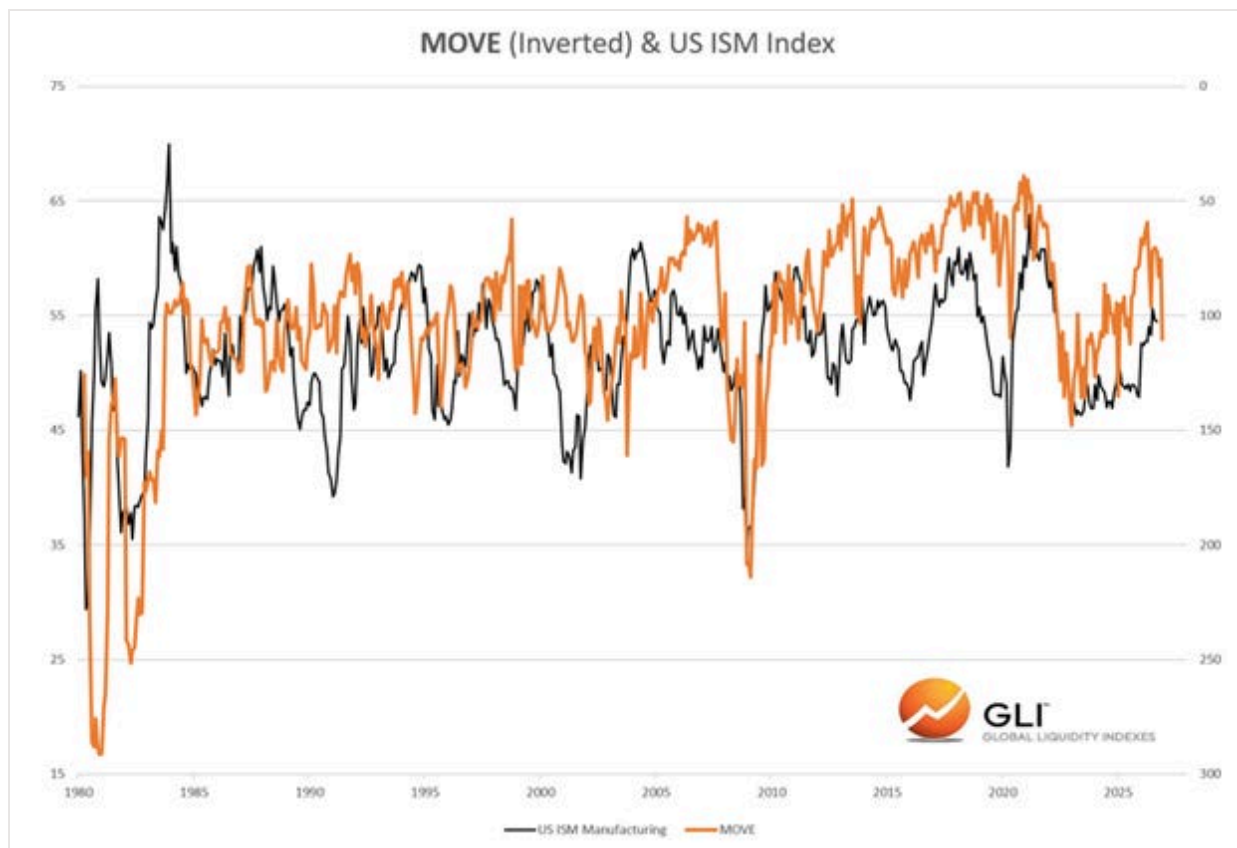


How should we judge policy from here? MOVE, the US dollar, credit spreads and the slope of the yield curve are all crucial signals. Of these, changes in the MOVE Index appear the most prescient, leading both recessions and recoveries. The message is simple: low bond volatility matters.

This is why Treasury Secretary Bessent is focused on mechanisms to cap bond volatility. In our view, the Treasury 'buyback' programme is aimed less at yields directly and more at lowering the MOVE index. It is plainly too small in size to move yields by itself. But by removing stale 'off-the-run' Treasuries, the Treasury improves market liquidity. At the same time, shifting the US debt maturity profile towards bills and away from coupons further reduces potential bond volatility.

Investment Implications

According to our analysis, a MOVE index above roughly 85 tends to trigger a fall in the collateral multiplier, while a jump above 135 warns of recession. Using these benchmarks, Global Liquidity is likely to slow further and the economy is likely to decelerate, but recession should be avoided if the MOVE remains close to current levels, around 105.



While neither the Fed nor the Treasury can control it directly, the MOVE index has become a better policy signal than Fed funds. It allows markets to dictate the pace of monetary tightening and, potentially, gives the FOMC scope to deliver fewer rate hikes.

If bond markets are setting the effective policy direction, we need to watch them even more closely. We suspect the US Treasury curve will continue to flatten, consistent with the slowing pace of Global Liquidity. In that sense, this cycle looks remarkably orthodox from a fixed-income perspective.

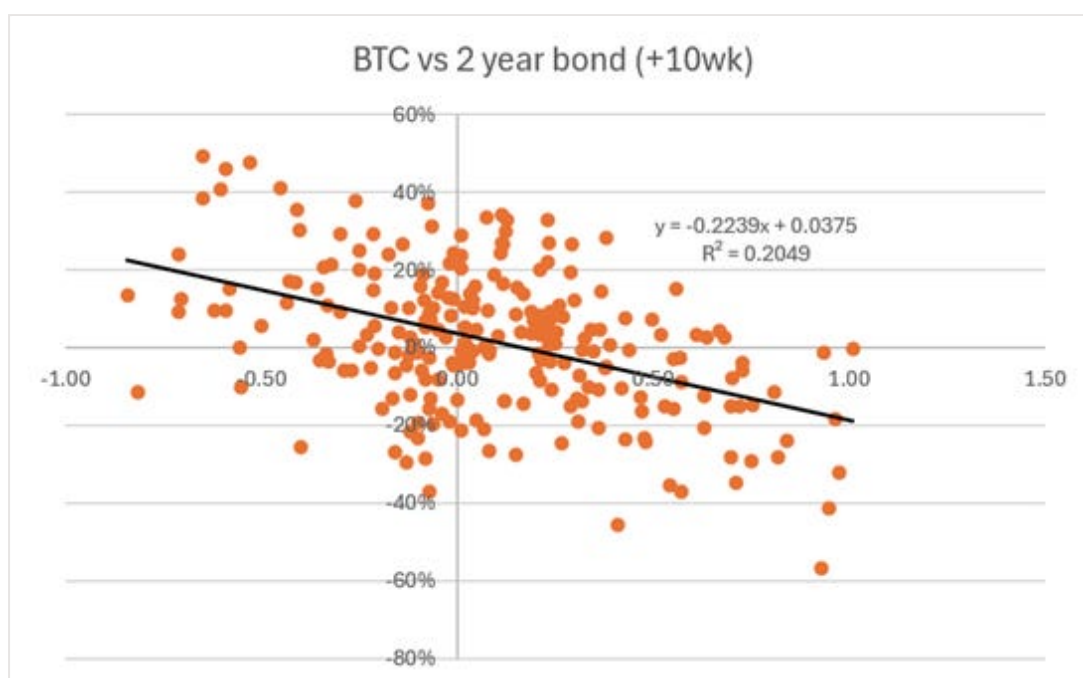
We are currently in a *Speculation* bearish-flattening regime. Next comes *Turbulence*. That is typically bad for risk assets, but yield curves often then move into a bullish flattening, with long-dated yields falling faster than short-dated yields.

Ignore the headlines that persistently argue against bond duration. **This may finally be the moment to reconsider bonds and begin to think about adding interest rate sensitivity.** One key question is how crypto performs if stocks sell off as growth slows, while bonds rally.

Although we do not have enough history to test the relationship robustly, the scatterplot below offers some hope that Bitcoin, at least, may stabilise. Ideally, we would need to see the Global Liquidity cycle turn higher. But if yields fall, BTC could benefit.

The chart shows the six-week log change in BTC against the equivalent change in the US two-year note yield, lagged by ten weeks. Rises (falls) in yields are associated with weaker (stronger) BTC\$ prices. The statistics look decent and they suggest that BTC has an *empirical duration* of 22.4 years. For comparison, gold is currently around six years and equities close to three years. Empirical duration is not actual duration, but it is

a useful guide to interest-rate sensitivity. **If the economy is slowing into 2027, Bitcoin deserves a place on the watch list.**



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