FALL 2019 :
QE OR NOT QE ...

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WHERE DOES THE FED STAND 2 MONTHS AFTER THE EXPLOSION OF THE REPO RATES?

QE OR NOT QE IS INDEED THE QUESTION….
OR IS IT ??

Long time readers and followers know quite well that one of our main point of interest in the financial markets is liquidity. And especially the very important issue of the liquidity provided to the financial systems by the Central Banks. I have written at length on these subjects in various articles:

https://www.seven-cm.com/assets/files/pdf/University/Zombie_ApocalypseVF.pdf

Or as recently as mid-October after the Repo rates September spikes :

https://www.seven-cm.com/news/2019/oct/September2019-From-RepoToQE-vf.pdf

And even in an older one (2018)

https://www.seven-cm.com/assets/files/pdf/University/SEVEN-CM-Le-probleme-de-la-liquidite-part-2.pdf

Many of you probably remember the following chart, which is one of my favorite as well. It shows the growth of the total assets of the 4 main Central Banks in the world, compared to the evolution of the All Countries World Index.

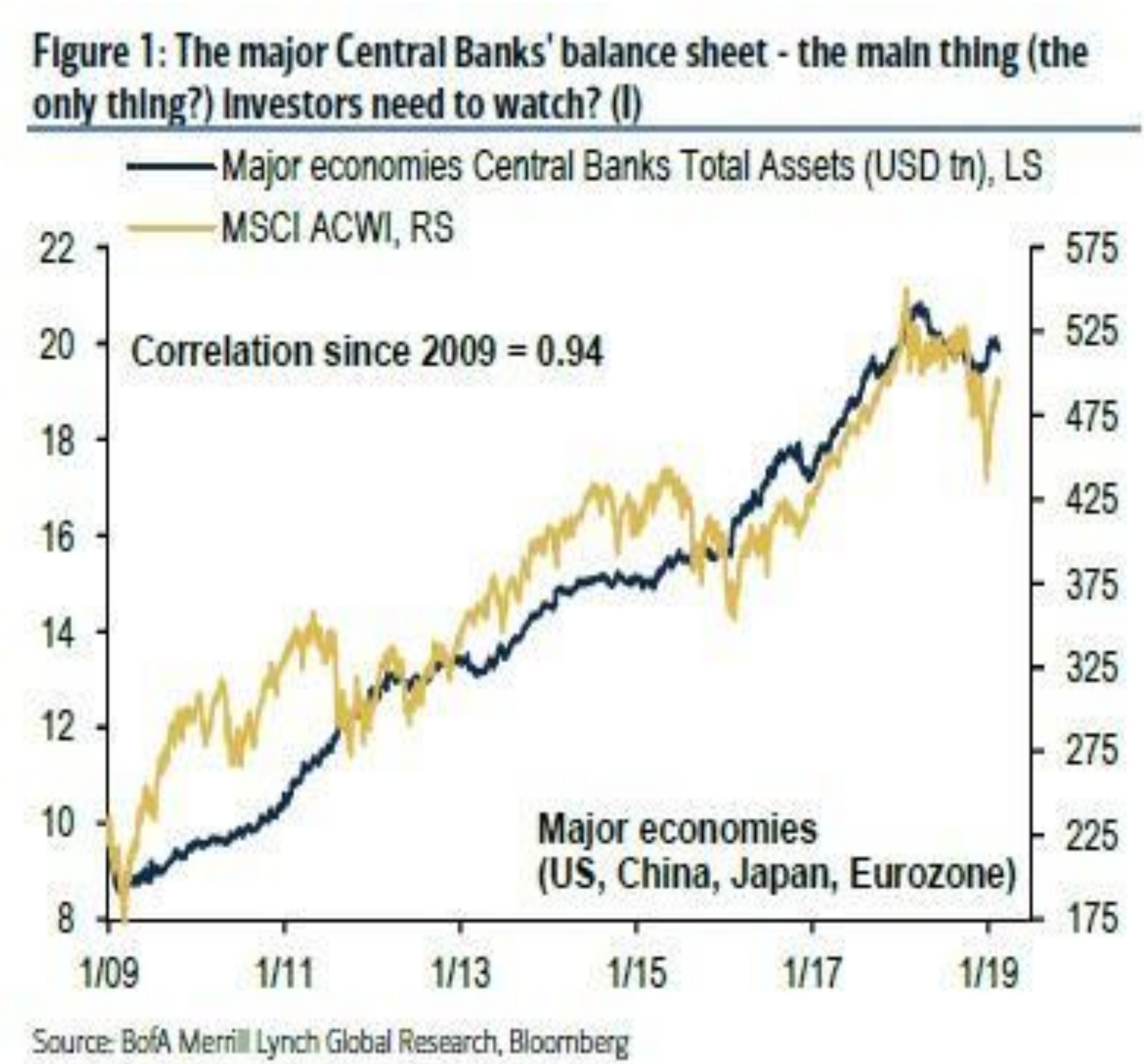

Chart 1 :source : BoA ML

Most people haven't followed the interbank/repo liquidity issue which appeared on September the 16th, and aren't familiar with it, nor should they be expected to be. However, like a few others financial analysts or advisors, like more and more insiders actually, we consider it to have been the biggest financial event of the year, even though it's not really on the front page of financial media. As Lyn Alden, a prominent US Financial blog, writes: « It quietly represents the complete pivot of this entire decade of U.S. Federal Reserve monetary policy ».

Investors the world around shouldn't have to pay attention to global macro issues when it comes to their portfolios. And especially to something as specific and technical as the US Repo market! But unfortunately, all these global macro issues involving central banks, government deficits, liquidity levels, and so forth, are currently some of the main ingredients dictating stock and bond market direction everywhere.

A brief reminder of what happened

Since the end of the 50's and the Vietnam war in the 1960's, the US Government had to rely on foreign central banks and other foreign institutions (banks or Insurance companies) buying their ever growing debt. For decades, it used to be Europe and Japan buying most of it, and then with the rise of China in the early 2000s, China became the biggest buyer.

But in late 2014, foreigners mostly stopped buying U.S. Treasuries for the first time in several decades. Some, like the Russian Federation even sold the most part of their Treasuries holdings (2018). So, for the past five years, U.S. institutions such as banks, pension funds, and corporations had to absorb over $3 trillion in new U.S. debt without foreign buyers helping to take some of the load, at the same time that U.S. deficits were expanding due to tax cuts that were not offset by decreases in spending. Obviously, the rather weird idea to trigger a trade war with the Ex biggest capital provider (China) didn't help to solve the problem either.

This whole system functionned pretty well until the 16th of September 2019, when many balance sheets of the main domestic financial institutions appeared to be rather full of Treasuries already and without enough cash in reserve to buy more…. So, the U.S. Federal Reserve had to step in and start borrowing those treasuries from large banks in exchange for cash, which had run their cash levels down to regulatory lower limits in order to buy treasuries.

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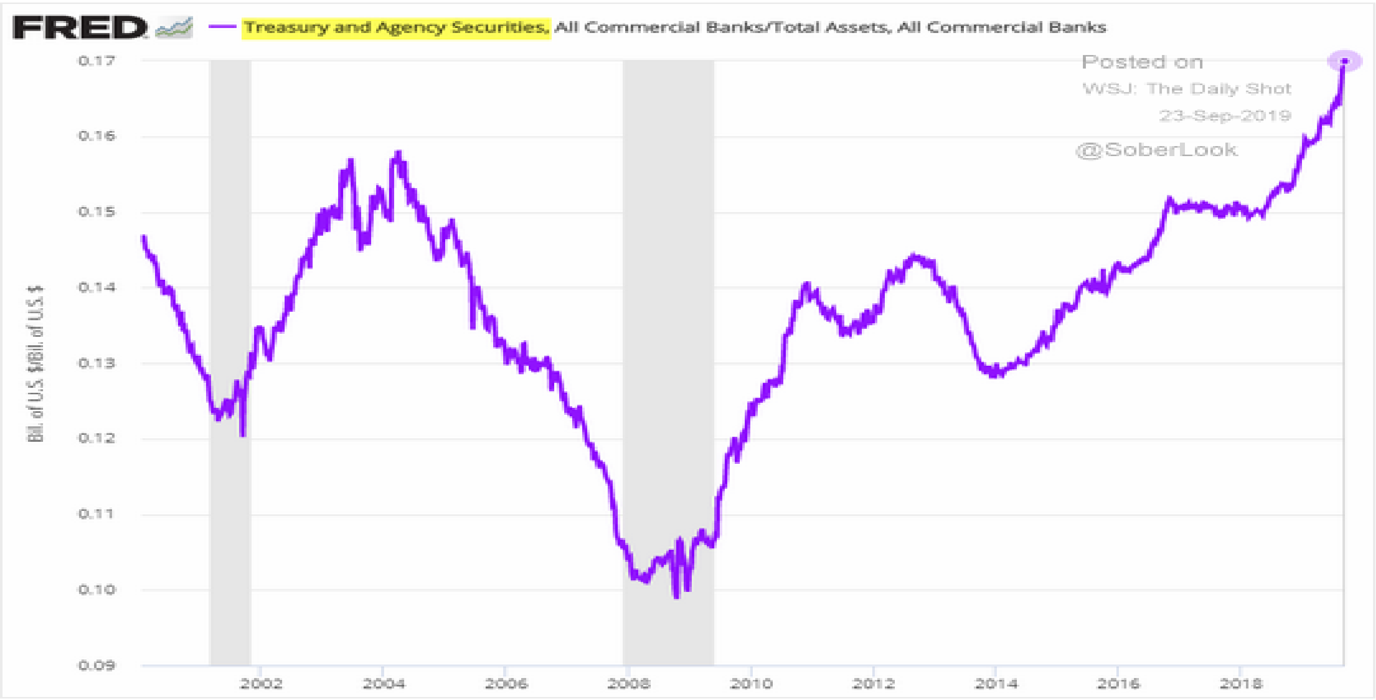
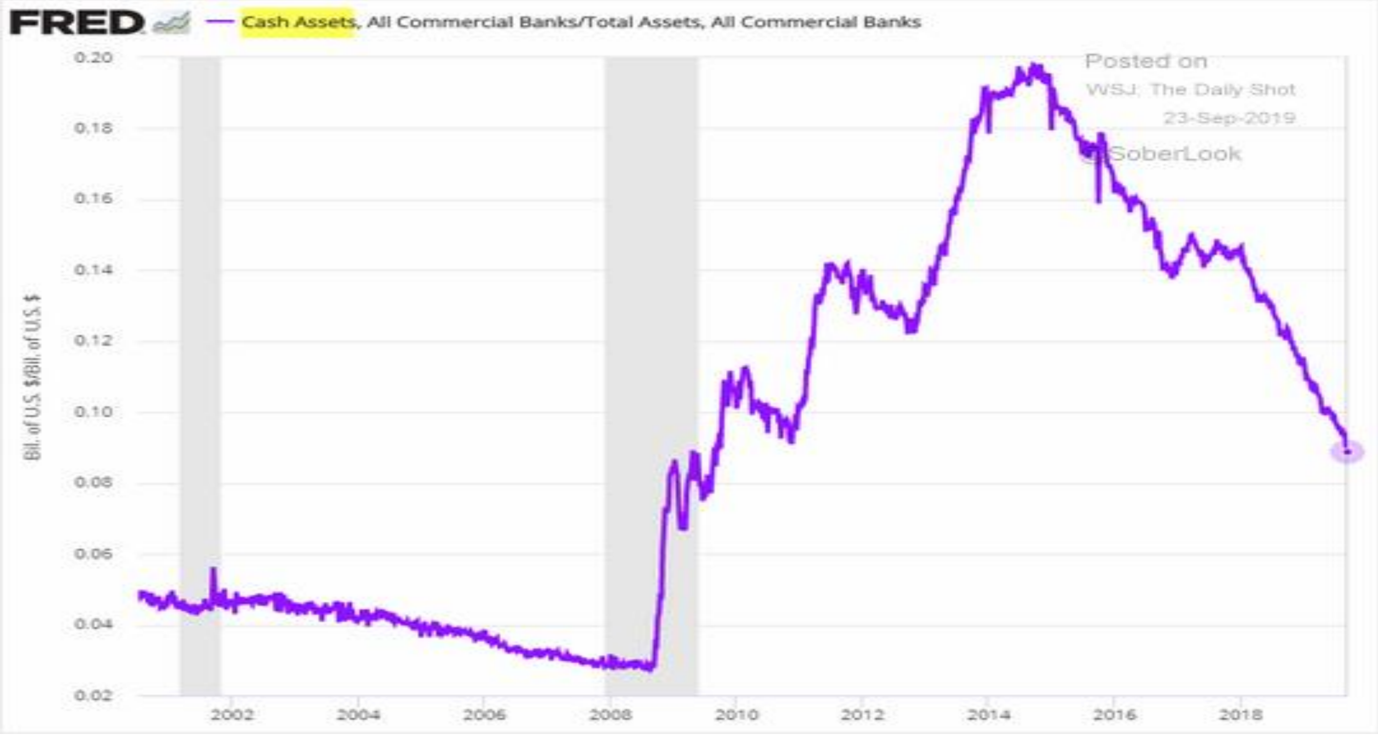
The two following charts will give you a clearer idea of the rythm of increase of US-Treasuries on US Financial institutions balance sheets, compared to the rather steep decrease of their available cash…..





Charts 2 & 3: source FED of St Louis

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Yes, of course these overnight and two weeks (14 days) Repo Operations succeeded! And the FED managed to take back control of these rates. But by that time, end of September, many analysts and markets professionals were already convinced that the FED would shift from temporary open market operations "TOMO" to permanent open market operations "POMO" and finally to permanent organic balance sheet expansion (i.e Quantitative Easing ….). And effectively on October 8th, the Fed indeed announced they would begin expanding their balance sheet by buying $60 billion in Treasury bills per month starting on October 15th and extending until at least mid-2020.

The first consequences

- The first consequence of the set of measures taken by the FED was the normalization of the spread between the REPO rate and the Fed Funds rate.

- The second consequence, judging by the Bond markets and especially the Equities markets reactions, is that from now on, every investor should follow closely the expansion of the FED balance sheet, and the expansion of the other Central Banks balance sheets as well. Whether you believe Chairman Powell when he says that THIS IS NOT QE is irrelevant, what actually matters is the overall level of liquidity provided by the Central Banks.

- And finally, last but not least, the third consequence is : the FED has been creating new money to buy U.S. debt from the large banks, meaning that U.S. government deficits are being monetized by money creation, even though the USA are NOT yet in a recession.

As Ms Lyn Alden writes : « This is a complete pivot in U.S. monetary policy ».

On the next page, you will see a St Louis FED graph showing in details how the FED balance sheet evolved during the last 5 years. And the historic pivotal point appears very clearly…..

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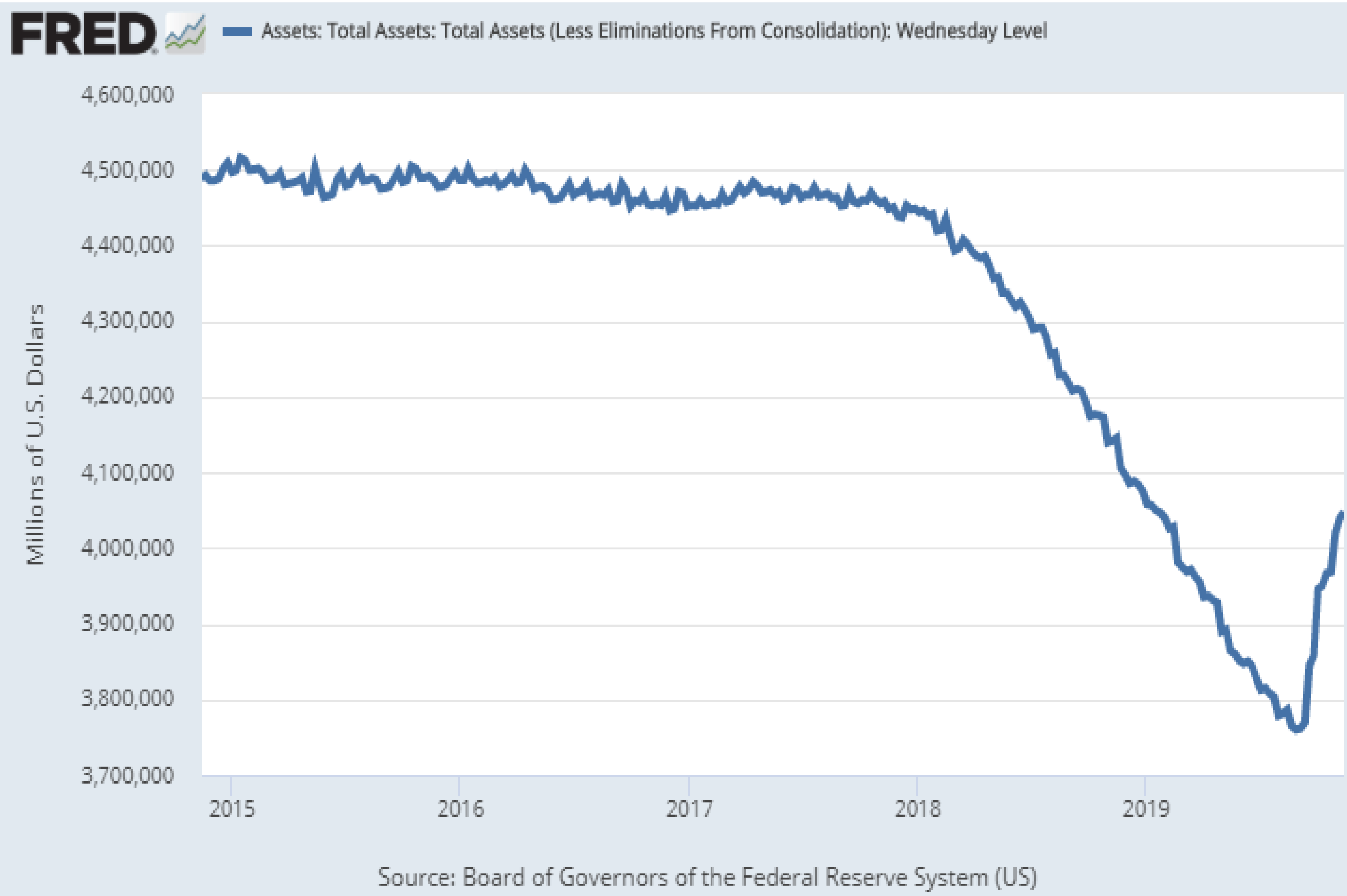

Chart 4 : source : Fed of St Louis

In the past nine weeks since the repo lending rate spiked up, the Federal Reserve has increased its balance sheet by $277 billion, mostly by buying US T-bills. In the past four weeks alone, it has been about $80 billion, which if sustained would be just over a $1 trillion annualized rate.

And, if the United States has a recession, tax revenues would likely fall substantially, deficits would rise accordingly, and this monetization rate would accelerate quickly.

To Monetize or Not to Monetize, That is the (Real) Question

When Fed Chairman Ben Bernanke performed Quantitative Easing (QE) from 2008 to 2014 during and after the financial crisis (where the Fed created new money and used it to buy U.S. government treasuries and mortgage-backed securities),

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he defended it in speeches as **not** monetizing debt due to the fact that it was temporary and would be unwound.

The Fed would eventually sell the debt it bought, rather than keep holding it and buying more, it was claimed.

And in the following paper: https://www.stlouisfed.org/publications/central-banker/spring-2013/is-the-fed-monetizing-government-debt , the St. Louis Fed featured arguments that QE was not debt monetization because the Fed balance sheet would return to normal. Their president at that time, James Bullard said: "The (FOMC) has often stated its intention to return the Fed balance sheet to normal, pre-crisis levels over time. Once that occurs, the Treasury will be left with just as much debt held by the public as before the Fed took any of these actions.« A very nice and carefully thought return to the starting line…. But as many have found out, none of that happened, so it should be clear now that the Fed has been using money creation as a permanent source of financing for government spending.

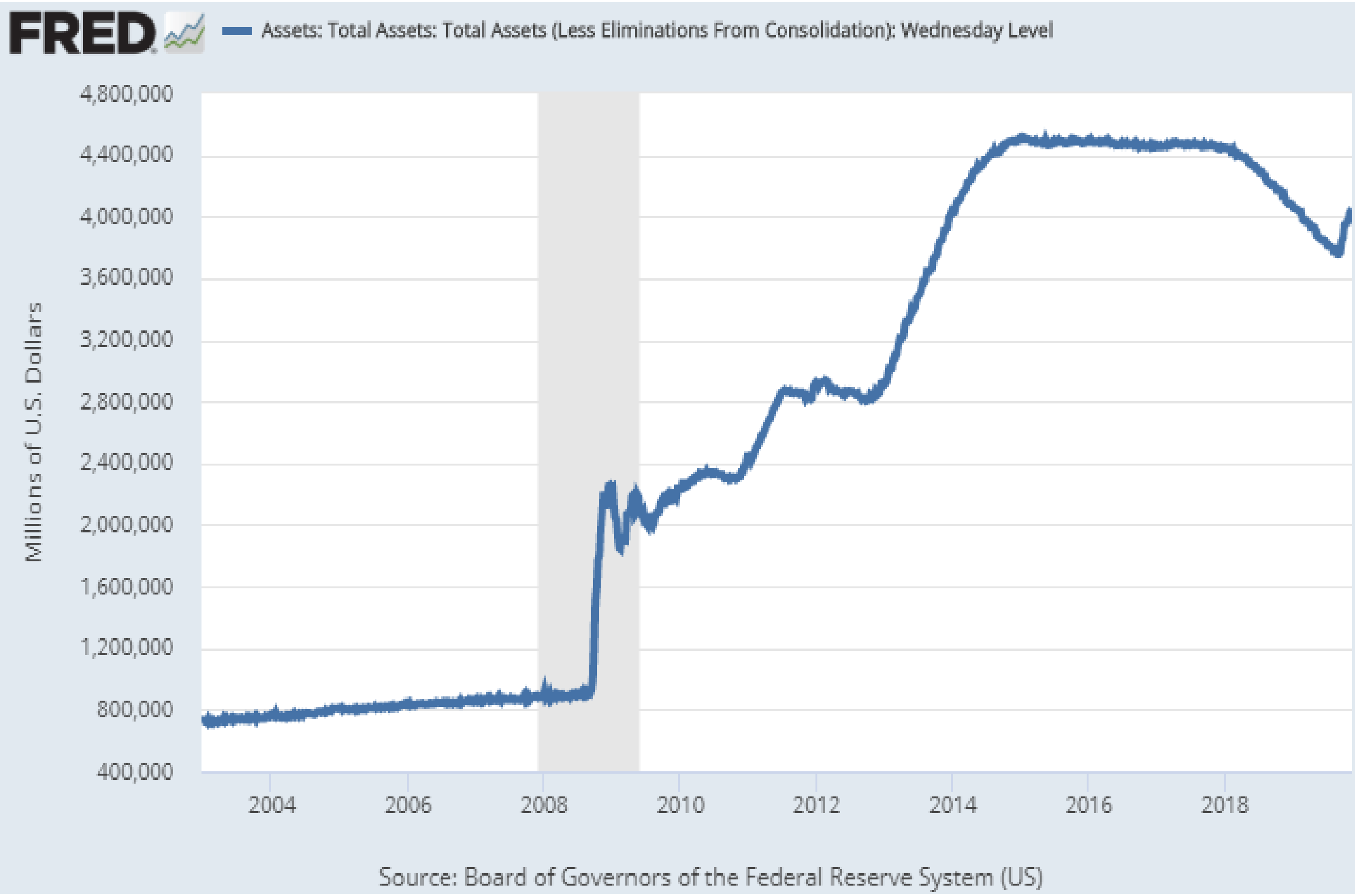

Chart 5 : source: fed of St Louis

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Here is how to read this chart: during that 2008-2014 period, the Federal Reserve balance sheet increased from $900 billion to $4.5 trillion due to three rounds of quantitative easing. Over half consisted of treasuries.

By 2014, the Fed indeed stopped buying treasuries and other assets, and held its balance sheet flat at $4.5 trillion for several years. And then at the end of 2017, the Fed began a nearly two-year process of gradually selling off their treasuries and shrinking their balance sheet. They said this would happen on autopilot and that it would be like watching paint dry. It eventually got to under $3.8 trillion after a very gradual pace of selling.

However, two months ago in September, the U.S. repo market exploded. It seems that domestic private balance sheets (banks, pensions, corporations, etc.) couldn't absorb any more U.S. debt with $1 trillion per year in new debt supply. The Fed started lending money to them and temporarily taking Treasuries for a day or up to two weeks at a time, and then within a month (by mid-October), the Fed announced that they would just start buying $60 billion worth of U.S. government debt per month in addition to continuing their short-term lending operations. Here are Ms Lyn Alden's conclusions on the subject:

« This marks the end of balance sheet shrinking. Within nine weeks from mid-September, the balance sheet increased by $277 billion, and went back over $4 trillion and growing, which is four times higher than pre-crisis levels. By mid-2020, we will likely be at new highs for balance sheet size. The treasury purchases throughout this past decade ended up being permanent, and it was indeed debt monetization, meaning that currency was created to buy government debt. »

Some practical implications

First and foremost, the obvious one: IT'S A BRAND NEW SOURCE OF LIQUIDITY! Or at the very least the relentless shrinking of the liquidity pool has been stopped. And if you go back to chart 1 page 2, it's obvious that during the last decade, there has been significant correlation between global stock market performance and liquidity levels.

Then, this recent and massive liquidity injection of $277 Bn contributed to halt the USD progression against most part of the other currencies. It actually started to address a very serious issue (especially for Emerging Markets) the USD Liquidity shortage.

The Dollar Index (DXY) topped in early October and has been quietly consolidating since. However the current level of ~$80 Bn/month liquidity injection is not designed to seriously weaken the dollar, Indeed, at the opposite of the former QE rounds, the current pace is not aggressive enough to increase the cash reserves held by US banks. Actually it seems to be barely enough to prevent these cash reserves to DECLINE any further. As Ms Lyn Alden puts it nicely: “Treasuries are flowing from the government into the large banks, and then out to the Fed. »

Finally, it belongs to everyone to make sure that the conclusions we have to draw from these episodes won’t be far too influenced and biased by extreme opininons, here are two Different examples on the causes of the Repo market breaking:

- Several analysts have suggested that this repo issue was due to one or a few acutely insolvent banks (either in the US or Europe). Clearly, two months after the beginning of the affair, nothing has happened on the Commercial Banks front. So it’s clearly not the case!
- During the first stages of the repo crisis, many prominent financial media reporters tried to make us believe that all this was due to a seasonnality issue, an unfortunate conjunction of adverse factors, or any TECHNICALITY they could think of…. NOPE! This had been simmering for 5 years. And the FED actions clearly represent a major turn in the way the monetary policy is run, AND WILL CONTINUE TO BE RUN in the years ahead!

Once again, when you just do not have enough buyers left to buy your Gargantuan debt, if the last thing you want are interest rates on the rise, your ever growing budget deficits have to be monetized by new capital creation…..

Before we come to the conclusion, we would like to share with you the chart (next page) which will show you what was probably a real aggravating factor to the crisis.

It clearly shows that when the reserves held by foreign Central Banks at the FED shrink, the financial markets have got nothing good to expect…..
And unfortunately, that was the case in 2019.

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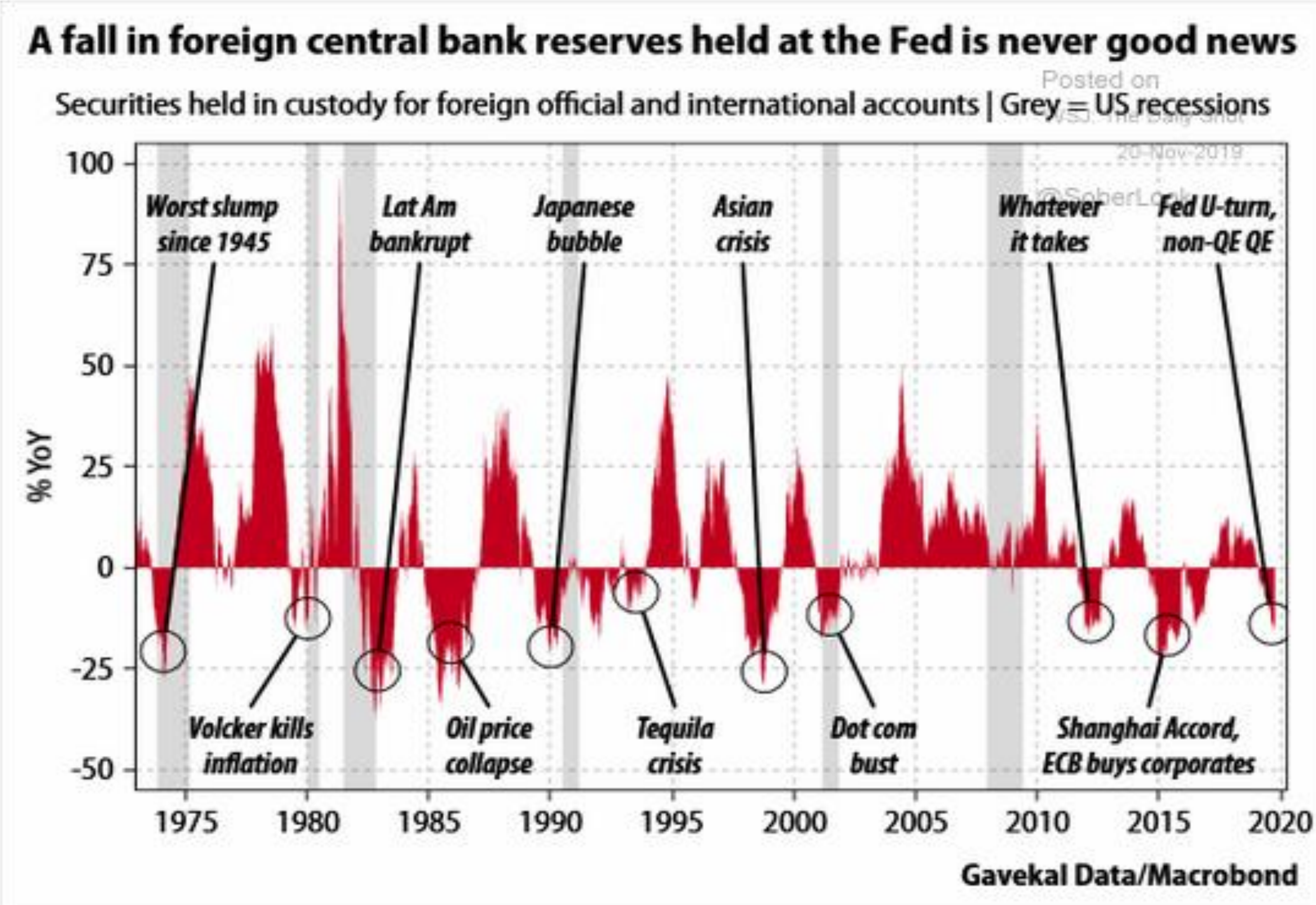

Chart 6: source: Gavekal

Conclusion

There is no doubt in our minds that the FED pivot in the 2nd half of Sept is by far the most important financial decision of the year! And by a distance! Much more fundamental than the January pivot to stop the hiking cycle or the last tweak of the ECB rates and the resuming of the QE program engineered by M. M. Draghi!

This decision validates the theory that the FED balance sheet will NEVER go back to its pre-crisis levels. And therefore that a good chunk of the US Federal debt has already been monetized by the FED! Whether you still consider that the last sets of FED measures do NOT constitute QE is actually irrelevant! What is important now is that you realize that the great Monetization phase has started. A good understanding of the financial events in the years to come will actually depend on that.

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