The King Report

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Why the Fed has no viable exit strategy

There are two parts to the Fed's exit strategy: normalize rates and shrink its balance sheet.

There has been copious analysis, including Fed comments, on normalizing rates. So we will spend only a few moments on it.

First, and numerous pundits have addressed this, the Fed knows that it must hike rates but it can't hike rates back to normal levels for the foreseeable future because the economy is too fragile.

Jeff Gundlach recently stated, "*If the Fed raises rates even moderately like to 1% or 2%, maybe the economy can't take it…*" http://www.cnbc.com/id/101984864

NZIRP is a tax on savings and interest income that is being used to keep government spending and debt from imploding; and secondly, to keep the big zombie banks afloat.

The CBO estimates that the US paid $233 billion on its outstanding debt of $17.45 trillion in FY 2013. This implies that the US paid a 1.33% rate on its aggregate debt.

Even if rates remain at current levels, the US interest expense is projected to double in 10 years.

The US interest expense could double or triple quickly with modest rate hikes. The consequences of higher interest rates are apparent even to Pollyannas.

The Fed also realizes that QE and NZIRP are concentrating income, fomenting unrealistic (if not bubbles) markets and destroying free markets.

So, the Fed will try to manage the higher interest rate conundrum by gradual rate hikes. But higher rates are not the only issue that is preventing the Fed from announcing an exit strategy.

The real exit strategy problem is the Fed has no convenient way to reduce its balance sheet.

When Congress asked Ben Bernanke if he was monetizing US debt with QE, Ben retorted that QE is not monetizing debt because it is temporary. Ben lied.

"*We're not going to monetize the debt*," Mr. Bernanke declared flatly… (Feb. 24, 2010)
http://www.washingtontimes.com/news/2010/feb/25/bernanke-delivers-warning-on-us-debt/?page=all

Feb 9, 2011 - *The Fed isn't monetizing the nation's debt because "**what we're doing here is a temporary measure, which will be reversed,**" Bernanke said…*
http://www.bloomberg.com/news/2011-02-10/bernanke-making-sure-fed-governors-remind-congress-deficit-bigger-than-qe2.html

Repos are temporary because there are natural offsetting positions that exit the Fed's balance sheet upon maturity.

The man that co-opted Milton Friedman's work to build a career fibbed or did not fully understand how central banking works. Outright Fed purchases have no natural offsetting positions. **QE generates permanent positions; there are no natural offsetting transactions.**

The academics at the Fed now realize that their $4.5 trillion balance sheet is permanent; and **there is probably only one politically charged way to reduce the Fed balance sheet.**

Fed officials have stated that they will continue to reinvest maturing securities even after rates are hiked. There is a good reason for this. The Fed doesn't know how to expunge cash from its balance sheet.

If the Fed allowed all balance sheet securities to mature, it would have $4.5 trillion in cash. If the Fed sold securities, it would still have all that cash.

Did Fed academics think that QE is like repos? It's not – there is no corresponding offset.

How can the Fed jettison all those bucks?

Each year, the Fed returns interest it receives on US debt holdings to the US Treasury. Ergo, the only avenue to remove the cash from the Fed's balance sheet is to give it to the US Treasury.

But this would present at least two enormous problems.

Politically, this would cause a DC imbroglio. Liberals would want to spend it; conservatives would want to pay down debt. This would generate political havoc and national divisiveness.

Remember the fight over how to spend the Stimulus Package? The American Recovery and Reinvestment Act of 2009 totaled $831B. Imagine that fight every year for the next five years, or a one-time WrestleMania to spend $4.5 trillion over five years.

If the Fed's cash is spent by the Treasury or the Treasury repurchases debt, the sudden injection of all that money into the system (domestic and global) could crush the dollar and ignite debilitating inflation. It could also provoke an economic-crushing interest rate spike.

Even though the Fed's portfolio will mature over several years, the above problems remain. Each year, a significant amount of cash must be expunged. Obviously the Fed cannot dump its $4.5 trillion portfolio in one or two years. But even a five-year expunging, which Yellen envisions ("***It could take until the end of the decade***."), will entail spending and absorbing about $1 trillion per year.

The longer the period of disgorgement, the higher the odds that the plan will be usurped by the normal vagaries of economics, exogenous shocks and politics – and we all know how putrid the Fed's forecasting has been.

Fed Sent $77.7 Billion in Profits to Treasury Last Year

The Federal Reserve sent about $77.7 billion in profits to the Treasury Department in 2013, the result of gains reaped from its unconventional efforts to spur economic growth.
In 2012, the Fed sent a record $88.4 billion to Treasury coffers.

The Fed is required to use its income to cover its operating expenses and send much of the rest to the Treasury's general fund, where it is used to pay government bills and benefits*. The payments to Treasury are called remittances. Fed Chairman Ben Bernanke has said that since 2009, the Fed has sent more than $350 billion to Treasury, about equivalent to the amount it had sent during the entire 18-year period before the crisis…*
http://blogs.wsj.com/economics/2014/01/10/fed-sent-77-7-billion-in-profits-to-treasury-last-year/

The fallacy of Fed 'profits' (and 'losses') February 20, 2013
But for Bob Eisenbeis, a former Atlanta Fed economist now at Cumberland Advisors, any discussion about Fed "profits" is inherently deceptive. He explains in a research note: ***That Fed remittances are considered profits is a total misrepresentation and a fiction****.* **The Fed is part of the government and is not a private-sector, profit-making entity.** *(The Federal Reserve Banks are quasi-public, but the Board of Governors is a government agency, and the system's debts are guaranteed by the government.)*

The Fed purchases Treasury debt from the public, paying for that debt with deposits it creates by a stroke of the pen. Looking at the Fed's portfolio of securities from the perspective of the nation's consolidated balance sheet, we see that one form of government debt (Treasury debt) is taken out of circulation and replaced with another form of government debt (Federal Reserve liabilities).

In effect, Treasury debt is taken out of circulation and is now owned by the government. It just happens to be the debt is on the books of the Fed and not the Treasury, but that is simply an accounting artifact and effectively the debt has been retired. *The Treasury pays the Fed interest, which is an intra-governmental transfer of funds. From the funds received from Treasury, the Fed extracts both its operating expenses and contributions to capital, makes the required 6% dividend payment to member banks, and remits the remainder back to the Treasury.*
http://blogs.reuters.com/macroscope/2013/02/20/the-fallacy-of-fed-profits-and-losses/

In other words, all the debt that the Fed has bought via QE is a monetization of debt.

Can the Fed return $4.5 trillion of securities (MBS will be replaced with Ts) to the US Treasury?

No – The Federal Reserve: *The Federal Reserve Act specifies that* ***the Federal Reserve may buy and sell Treasury securities only in the "open market."…***
http://www.federalreserve.gov/faqs/money_12851.htm

If the Fed returned Treasury securities to the Treasury, a much worse consequence could result.

Due to the Fed/Central Bank rig in the bond market, there is a well-documented shortage of prime (Treasury) collateral in the market.

If the Fed were to return $900B of prime collateral to the Treasury, the financial system would have a severe collateral shortage. This would cause a multiplier effect contraction of liquidity.

Treasury 10-Year Note Repo Shortage Risks Rise in Failed Trades (June 10, 2014)
Treasury 10-year notes are in such short supply in the ***$1.6 trillion-a-day market*** *for borrowing and lending securities that it may lead to a surge in failed trades.*
http://www.bloomberg.com/news/2014-06-10/treasury-10-year-shortage-risks-trading-fails-rise-nomura-says.html

*The Treasury also asked the dealers to explain the causes for an incre****ase recently in "fails-to-deliver" in the market for U.S. government debt****…* [July 18, 2104]
http://www.garp.org/risk-news-and-resources/risk-headlines/story.aspx?newsId=114718

Our friend Dr. Lacy H. Hunt, chief economist and EVP of Hoisington Investment Management and ex-Dallas Fed Senior Economist, notes that technically cash might be drained from the Fed's balance sheet by increasing cash in circulation. There is a constant need to increase currency in circulation but the natural demand is not nearly enough to absorb $900B/year.

According to the St. Louis Fed, currency in circulation is $1,292.467B as of 9/10/2014.
http://research.stlouisfed.org/fred2/series/WCURCIR/

Whether the Fed returns debt or cash to the Treasury, debt will have been turned into money – the definition of monetization of debt. This, of course, proves that Ben lied, repeatedly.

The Fed must resolve how to remove the cash and securities off its balance sheet, when legally they must give it to the US Treasury. At this time, there is no viable exit strategy to shrink the Fed's balance sheet.

If we were running the Fed's exit strategy, we'd buy gold, which is legal, with some of the cash. It could be handy when the inevitable rendezvous with unserviceable sovereign debt appears.

In Thursday's missive we showed that while homebuilder sentiment is at 2005 levels, actual sales and construction are a fraction of what occurred in 2005.

Yesterday, just one day after the exuberant homebuilder sentiment for August was posted, the Commerce Department reported that Housing Starts for new home construction fell 14.4% in August, to an annualized rate of 956,000 units, the biggest drop since April 2013. 1.073m was expected. Permits for new home construction declined 5.6% in August to an annualized rate of 998,000, 1.04m was expected.

European stocks surged during early European trading even though the widely-hyped ECB loan program had a very disappointing start. Perhaps the rally was related to Scotland.

E.C.B.'s Cheap Loans Are Met With Weak Demand From Banks
Banks borrowed less than expected from the European Central Bank on Thursday in a disappointing start for a program intended to encourage more lending to businesses and households, and pump money into the ailing eurozone economy.

The central bank said that it would allot nearly 83 billion euros, or about $107 billion, to 255 commercial banks next week… analysts said before the announcement that anything less than €100 billion would be a disappointment…

The demand for the cheap loans "is disappointing and will raise further doubts about the feasibility of the E.C.B.'s intention to increase its balance sheet by around €1 trillion," *Martin van Vliet, an analyst at the Dutch bank ING, said in a note to clients…* [Banks are reluctant to lend globally.]
http://www.nytimes.com/2014/09/19/business/international/weak-demand-from-banks-for-ecbs-program-of-cheap-loans.html?_r=0

ReutersBreakingviews @Breakingviews: *ECB's bazooka has turned into a pea-shooter. It had better now deliver on its promise to buy ABS*

The Fed and the Media by David R. Kotok, CEO Cumberland Advisors
There is a controversial issue regarding media coverage prior to the release of Fed minutes and policy statements. Prior to this last meeting and after the Hilsenrath column, there was an attribution in a widely followed morning newsletter that characterized Hilsenrath as a "Delphic Oracle." (For elder readers: is he the successor oracle to John Barry, or is he the designated leakee?) We find such characterizations troubling for several reasons.

If someone inside the Fed is whispering policy into a favored journalist's ear, based upon FOMC materials or discussions in advance of policy decisions, a possible violation of law and FOMC rules may rise to the level of criminality. However, if nothing is being whispered, the characterization that Hilsenrath has been a "receiver of information from highly placed and well-informed sources within the Fed" was inaccurate and the language used was very strong.

If Hilsenrath was simply expressing his personal view, then he has every right to do so; but the appearance that he may have access that violates rules (and influences markets) is dangerous. Either way, the discussion is distorting policy, increasing volatility, and therefore raising risk premia. Those are the exact outcomes that the Fed does not seek… http://www.ritholtz.com/blog/2014/09/the-fed-and-the-media/?utm_source=feedburner&utm_medium=feed&utm_campaign=Feed%3A+TheBigPicture+(The+Big+Picture)

U.S. Household Wealth Hits Fresh Record

Consumer Borrowing Climbs at Fastest Pace Since the First Quarter of 2008

Overall household borrowing rose at an annualized 3.6% pace in the second quarter, the fastest rate since the first quarter of 2008. Mortgage debt grew 0.4%, after two straight quarters of shrinking. Other types of consumer credit, including student loans, grew 8.1%, stronger than the previous quarter's 6.5% pace… http://online.wsj.com/articles/u-s-household-wealth-hits-fresh-record-1411056031

Total US household balance sheet as of June 30, 2104 shows a record 70.3% in financial assets.

Every time financial assets hit 70.3% of total, either housing values finally pick up and offset the disproportional increase in financial assets, or there has been a crash in financial asset values themselves… http://www.zerohedge.com/news/2014-09-18/household-net-worth-hits-record-815-trillion-q2-driven-stock-market-surge

History shows that at some point, financial assets must be converted into real assets – and vice versa.

The big money over time is made by transitioning from financial assets to real assets and by holding cash during the interlude. When an over-valued asset class collapses, most asset classes decline; cash is the refuge. (1973-1974, 1980-1982, 2000-2001, 2008)

Japan government cuts economic view, warns of stalling consumption

Japan's government cut its overall economic assessment for the first time in five months as private consumption is struggling to recover from the slump caused by April's sales tax hike.

The government on Friday ***cut its view on private consumption****, which accounts for about 60 percent of the economy, saying that consumer spending is seen pausing although a pick-up trend remains intact…*
http://www.reuters.com/article/2014/09/19/us-japan-economy-report-idUSKBN0HE02T20140919

The Nikkei is up 1.4% on the perception that the worsening economy means more QQE. Unbelievable!

Today is option and futures' expiration. There is usually significant buying on the NYSE open to replace expiring futures contracts. This is why stocks typically rally on the Thursday before expiry. After the morning rally, expiration day tends to become quiet until the last hour of trading. Then it's a crapshoot. A few manipulators usually dictate last-hour activity; and **today there is an S&P rebalancing. This makes late trading even more perilous…** SPZs are up 6.00 as we write for the expected MOO buying and because **early results show Scotland is solidly voting against independence.**

Only 36 percent of Americans can name the three branches of government

http://www.washingtonpost.com/blogs/govbeat/wp/2014/09/18/only-36-percent-of-americans-can-name-the-three-branches-of-government/

All the money that the US spends on education is doing what?