

August 2, 2013

"Fed policy has had a distorting effect on capital allocations decisions of all kinds at virtually every level of the economy. It is a very large and dull hammer for markets."

-RICK REIDER, Manager of \$760 billion in fixed income assets at BlackRock.

Too much cheesecake? *EVA* readers might find this surprising, but I actually do a fair amount of soul-searching about the individuals I take to task in these pages. Very long-time subscribers might recall I was fairly merciless about Alan Greenspan aiding and abetting the housing bubble on his watch. Lately, one of my regular punching bags, mostly because he refuses to take the Everclear-infused punch bowl away from the party, has been Ben Bernanke.

During my recent introspections on the latter, it has occurred to me that perhaps I have been a bit too hard on the Benster. Reinforcing that feeling was a sneaking suspicion that the turmoil he caused in May and June with this taper-talk might have been a classic case of being dumb like a fox. My logic was that his cryptic comments about cutting back on QEternity, which caused a global unwind of the increasingly dangerous "carry trade", could have been a brilliant ploy to let some helium out of the balloon before it became a modern day equivalent of the Hindenburg.

Based on a research piece by Deutsche Bank (DB), it appears as though this is exactly what happened, whether or not it truly was Mr. Bernanke's intended goal.

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As a brief refresher on the "carry trade", so often criticized in past *EVA*s, this is where institutional investors borrow short-term, often at multiples of their capital base, in order to buy longer-term securities, usually of the yield variety. With short-term interest rates anchored at zero for years by the Fed, this has been a license to print money almost as freely as our dear central bank.

Unfortunately, long-lasting episodes of past carry trades have always ended in tears, often accompanied by plenty of wailing and gnashing of teeth (and, of course, in our wonderfully litigious society, copious amounts of suing.) The fact that this most recent carry-trade era has lasted such a long time has made it even more lethal in its systemic implications. While that might seem like merely an opinion, and I guess it is, it's one that's fairly hard to dispute given the utter chaos around the globe that was triggered by a few opaque comments from Mr. Bernanke.

Yet, several weeks ago, it did appear that Mr. Bernanke might take some short-term pain in order to normalize the cost of money and avoid a much more incendiary situation down the road. However, as interest rates nearly doubled almost overnight, Gentle Ben quickly turned tail, showing all the courage of the Italian infantry at Stalingrad.

In fact, his brief attempt at playing semi-tough encouraged none other than our senior partner, Charles Gave, with 40 years of battle-scarred investment experience, to pen a piece which lauded the newly aggressive approach of the Fed Chairman titled: "Volcker's Return." Unfortunately, his subsequent Congressional testimony evoked memories of Groucho Marx's classic line: "Those are my principles and if you don't like them...well, I have others." This caused Charles to disgustedly note, in a subsequent essay, that Mr. Bernanke had the fortitude of a cheesecake.

Bubble Blinders. The first notable implosion of a significant carry trade was in 1998 when Long Term Capital Management (LTCM) went kaput and overnight morphed into Long Term Capital Punishment for both its investors and, more problematically, the wider financial system. This spectacular flame-out happened despite (or because of?) an investment team brimming with Nobel Prize winners. While fast action by the Fed and several major banks (all of whom had a vested interest in preserving the status quo) prevented that debacle from going viral, unlike the Lehman failure ten years later, it nevertheless set off a pernicious chain of events. (Notably Lehman had famously declined to pony up when the LTCM hat was passed around.)

The LTCM situation, combined with the mostly forgotten but extremely intense "Asian Crisis", led the Fed to feel compelled to cut interest rates despite an economy that was roaring along in the late '90s. This poured more fuel on an already blazing tech sector—the last thing it needed. Once tech stocks tanked, the Fed, after having belatedly reversed course by tightening in the summer of 1999, began to slice rates again, this time frantically and repeatedly. It left its key overnight lending rate at a level below inflation until June of 2004, when a national housing mania was already in full swing.

Besides keeping the cost of money too low far too long, the Fed also allowed (many would go as far as to say 'encouraged') the spread of an epidemic of reckless home lending programs. To make matters even worse, both Mr. Greenspan and Mr. Bernanke, who succeeded him in 2006, emphatically denied there was such a thing as a housing or credit bubble. Yet, any high school econ student reviewing the chart below would have easily concluded that starting in 1987, when Mr. Greenspan took the helm at the Fed, debt had truly gone ballistic, a trend Mr. Bernanke did nothing to arrest, with much of this flowing into residential real estate.

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One of my new favorite editorialists is influential Democrat and publisher of the *US News and World Report* (not to mention CEO of mega-REIT, Boston Properties), Mort Zuckerman. In a *Wall Street Journal*

Op-Ed piece from last Friday, titled "Mistreating Ben Bernanke, the Man Who Saved the Economy", Mr. Zuckerman clearly took dead aim at folks like me who have bestowed epithets such as 'Bubble Ben' on the Fed Chairman (though it does have a nice ring to it, doesn't it?)

Frankly, Mr. Zuckerman makes a persuasive case that Ben Bernanke, with his intense studies of the Fed's mistakes in the early stages of the Great Depression, was the perfect person to save us from a repeat. His frenetic and highly creative responses during the utter chaos of the serial collapses of Lehman, AIG, Fannie, and Freddie deserve serious commendation, which I offered at the time. (However, as noted back then, he whiffed on stabilizing the credit markets before they fell by 40% on investment grade corporate bonds and by 80% on AAA rated mortgage debt.)

Yet, the Zuckerman editorial completely overlooks the fact that Mr. Bernanke has to share blame with his predecessor for the housing and credit manias. Our current Fed chairman repeatedly stated that housing was not a bubble. And when what looked an awful lot like the Goodyear blimp to many folks, including this author, began to deflate, he assured the world the impact of its crash-landing would be "contained".

What really seemed to get Mr. Zuckerman's fur up was President Obama's "mean-spirited dismissal of perhaps the greatest central banker in American history" (pardon me, if I wince a bit on that last part.) For those who missed this, the President appeared to accept the in-absentia resignation of Mr. Bernanke on the Charlie Rose show, causing a firestorm of criticism over its lack of decorum.

This does confirm a long-standing *EVA* prediction that Mr. Bernanke is smart enough not to want to deal with the repercussions of cleaning up QEs gone wild (Mr. Obama stated that he "stayed a lot longer than he wanted or he was supposed to".) Now the question is, who will replace him and, more importantly, what does it mean for the financial markets?

QE cubed? Just a week or two ago, the betting line had Janet Yellen as the overwhelming favorite to succeed Mr. Bernanke. Despite my innate contrarianism, I agreed with this group-think. Lately, however, former Obama administration treasury secretary Larry Summers appears as if he's sprinted into a dead heat with Ms. Yellen. (Recent reports of intense antipathy toward Summers from a vocal block of Democratic senators is a rising threat to his nomination, despite his cozy relationship with the Obama administration.)

There are those, including some of the deep thinkers at GaveKal, who feel it doesn't matter who takes the reins next at the Fed—essentially, that they are all cheesecakes. They could be right but the most interesting comment I came across recently was this Larry Summers' quote from a conference in April: "QE in my view is less efficacious for the real economy than most people suppose." Judging by the below charts, illustrating the erosion in the US economy's growth rate and the stagnation in after-tax household incomes over the last dozen years, methinks Mr. Summers is onto something.

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It's becoming my belief that the increasingly vivid failure of the current QE program to lift the economy to its former 3% growth rate means that it won't continue in its present form. Should Janet Yellen be appointed (and approved), she may well decide to double or triple the pace (though I still believe there's more than a trivial chance even *she* reverses course).

The market would most probably view such an all-in commitment to QE with great enthusiasm—initially. A 20% type hockey stick move would not be out of the question. The risk, of course, is that the stage would then be set for a true crash given how pricey stocks would be at that point (some 40% above their post-WWII average based on the Shiller P/E) and how obvious the threat of the Fed's ultimate exit would loom.

If Larry Summers becomes the new Fed head, the odds of a wind down of QE in early 2014 go up materially. (There's also the chance Bernanke decides to start the taper process before he leaves and, while I have my doubts about that, it's possible the recent string of better than expected economic data may embolden Mr. ~~Cheesecake~~ Bernanke.) If so, and stocks are still hovering around their highs, the correction is likely to be swift and steep, but a lot less traumatic than the eventual reality-collision under the upside blow-off scenario.

If you're wondering why the \$2 plus trillion the Fed has already printed has been, at best, ineffective for the economy, and, at worst, counter-productive, consider that amorphous entity which attracted so much unwanted press during the credit cataclysm: the shadow banking

system. As you can see below, despite all the criticism and scrutiny it attracted immediately after the Great Panic of 2008, it never contracted much and is now actually somewhat larger than it was prior to the crash.

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Yet, despite its resilience, the nearly \$70 trillion that resides in this vast network is slowly being asphyxiated...

Fading shadows. For better or worse, the shadow banking system (SBS) remains vital to economic and financial activity, especially given the ongoing decline in the circulatory speed of money (aka, monetary velocity). According to the Financial Times, the SBS provides some 80% of all lending in the US; therefore, this is far from just the province of hedge funds and leveraged speculators; in fact, money funds are considered part of the SBS.

Unknown to most regular folks, and even to many investment professionals, is the essential role "repos" play in this ecosystem. "Repos" is short for repurchase agreements and these are one of the key funding mechanisms for the SBS. Repos are short-term loans, usually just overnight, and, here's the crucial, part: they are collateralized with US treasuries.

Moreover, because of the allegedly riskless nature of the government IOUs that are put up, they can be "re-hypothecated", which means re-lent. Thus, in effect, money is multiplied similar to how it is supposed to work in the fractional reserve banking system where \$1 of capital can translate into \$10 of credit. Instead of the old 10 :1 ratio for traditional banks, the current multiplier for repos is only around 3 times. Yet, during an era of falling money velocity, this is an important offset, especially given that there is supposedly \$4 trillion in repos outstanding. But this is where the Fed's relentless hovering up of treasuries securities is at direct cross-purposes with its objective of stoking the economy.

As the Fed adds around \$40 billion each month (along with another \$45 billion of federally-backed mortgages) to its existing \$2 trillion stash of government securities, it is starving the SBS of the oxygen it needs to live, much less grow. The Fed is effectively taking the collateral out of circulation and locking it up on its own balance sheet where it lays dormant. Meanwhile, the money it injects into the traditional banking system to fund its securities purchases is also largely inert.

If you think I'm making too big a deal out of this, consider the following excerpt from a recent International Monetary Fund (IMF) study: "...at this rate, the Fed could silo over \$1 trillion additional of good collateral in 2013...This is likely to have first-order implications for collateral

velocity and global demand/supply of collateral."

Compounding this problem globally is that China is cracking down on its own runaway shadow banking system. While the US version has actually been shrinking (the brilliant Andy Kessler, the source of much of this data, estimates it is half its pre-crisis size), China's nontraditional banking apparatus has more than picked up the slack—at least until lately, when Chinese authorities became alarmed over its vertiginous expansion.

In Europe, of course, there are serious problems as well. Institutions that have relied on government debt from countries such as Italy to collateralize their repos are becoming increasingly nervous that, given serial ratings downgrades, Italian sovereign bonds will no longer qualify. Thus, there is a serious risk of an acute shortage of high grade collateral in Europe as well (of course, the way eurocrats have bent the rules in recent years, they may well decide junk bonds are good enough).

This is not to say the squeeze play on the shadow banking system is the only negative, or even the biggest, of the Fed's multi-trillion dollar money fabrication. The July 30th edition of the *Wall Street Journal* ran an editorial by Stanford professor Ronald McKinnon titled "The Near-Zero Interest Rate Trap." It highlighted how ultra short-term interest rates have disincentivized lenders, like money funds, from extending credit to all but the safest borrowers. This is a point the King of Bonds, Bill Gross, has made repeatedly and it's a profound example of one of the unintended negative consequence of the Fed's Big Print.

The final point I'd like to make before signing off until next week, is that yet another QE backfire is the reality that interest rates have risen during the Fed's printing extravaganzas. Even Mr. Bernanke's repeated assurances, and those of his cronies, that the Fed is still the Big Easy have not prevented 10-year T-note yields from rising back up to their recent highs of 2.7% (vs 2.1% in December 2008) before any QEs were launched!)

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(Interestingly, Operation Twist, which didn't involve money printing, but rather the sale of shorter term government securities to buy longer term issues, actually did drive rates down; this is represented by the white-shaded area on the above chart between QE2 and QE3.)

So think about this for a moment. All of these outright binge-printing episodes raised rates rather than lowered them. They also clobbered money velocity and now appear to be doing serious harm to the shadow banking system, further inhibiting money multiplication (heck, even money *addition* would help right now!)

That's why I'm not conceding that the next Fed chairperson, no matter who it is, will continue in this epic but futile exercise in string-pushing. They may decide that to truly get rates down, especially after the run-up seen recently, the correct course of action would be to send QE3 to the bottom of the sea where it belongs.

Given that, since the financial crisis, there has been an 85% correlation between the expansion of the Fed's balance sheet and the stock market's advance, investors might want to consider that possibility before they dive further into increasingly dangerous waters.

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