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FED SHADOW

"Some Time" A Great Notion

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A zero rate and a humongous Fed balance sheet -- good for now, but not forever.

Yesterday's [FOMC statement] was a clear signal from the Fed of its commitment to continuity in the federal government's program to do whatever it takes, no matter how long it takes, to stabilize the financial markets and the economy. Such signals -- especially ones as clear as this one -- are of urgent importance, because the governing dynamic of the present juncture is the transformation of the Treasury, the Fed and the FDIC from destroyers of capital to saviors of capital (see, among many on this theme, "Another Rescue, A New Rescue Ranger" November 24, 2008).

Update to strategic view

US BONDS: With the Fed promising to hold short rates near zero "for some time," the 2003 carry trade is back. While it's tempting to short long bonds at today's absurdly low yields, the cost of carry in the short is now too punishing to overcome.

GOLD, US DOLLAR: Gold and the dollar have been discounting the policy posture the Fed made explicit yesterday. With the news out, both may pause soon to consolidate their recent moves. In the intermediate- and long-term, we expect the Fed's continued ultra-easy posture to be bullish for gold and (barring an extreme response from other central banks) bearish for the dollar.

[see Investment Strategy Dashboard]

While the Fed's balance sheet has more than doubled in a matter of a few months to be now more than 20% the size of the aggregate balance sheet of the entire commercial banking system, the FOMC committed yesterday to "continue to consider ways of using its balance sheet to further support credit markets and economic activity," and to "sustain" it "at a high level." Hinting that its program to buy about 10% of outstanding publicly trade mortgages might grow even larger, and repeating the idea floated by Ben Bernanke in a speech several weeks ago that the Fed may buy long-term Treasury bonds, one has to wonder what other "ways" the Fed could possibly find, at this point, to "support credit markets." Over the last several weeks a number of clients have asked us whether, when and how the Fed might buy corporate debt, as a means of relieving refinancing pressure, bolstering the balance sheets of banks holding leveraged loans, and defusing risk in the credit default swap market. Such a thing would have been unthinkable just a year ago -- now, nothing can be ruled out.

There was nothing significant in yesterday's announced "rate cut" *per se*. In moving the funds target to a range of zero to 1/4% yesterday, the Fed outperformed our expectation for a 50 bp cut to a 1/2% target rate (see "1/2% Funds: History-Making, But Irrelevant" December 15,

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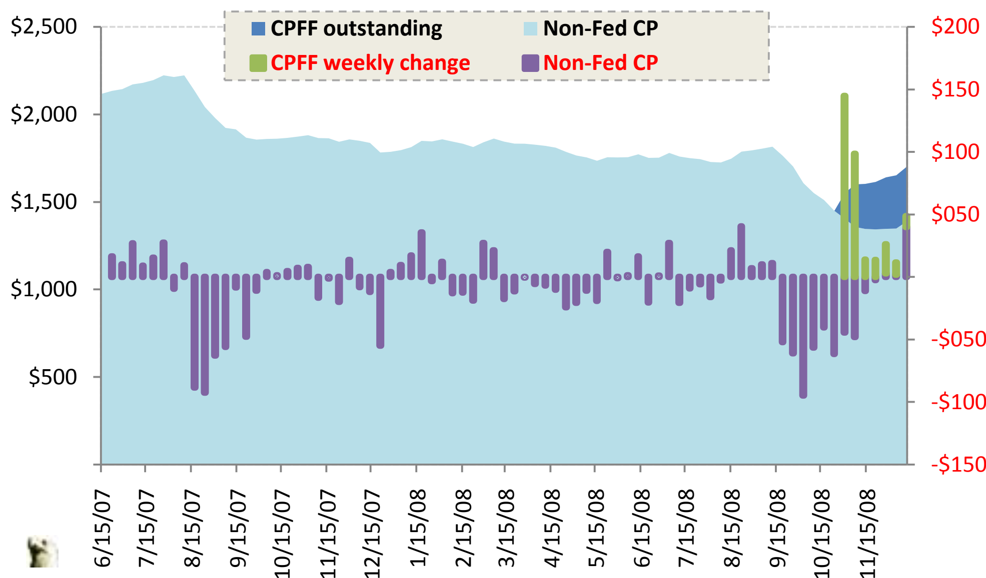
2008). But as funds have traded below target every single day since it was set at 1% on October 29 -- and in a range between zero and 1/4% on almost half those days -- the Fed's seemingly dramatic action is just a formalization of a long-standing reality. It is as though a marksman, unable to hit his target, instead of refining his aim moves the target to where his shots had been landing anyway -- and makes the bull's-eye bigger for good measure.

One potentially useful effect of a lower funds target is to reduce the rate of interest that the Fed itself pays on excess reserves left on its balance sheet by banks and other market participants. Pegged to the funds rate, at 1% this was by far the most attractive rate in the marketplace for riskless overnight money. So no surprise that over $700 billion is currently parked with the Fed, earning about $20 million a day, up from virtually nothing two months ago when paying interest on reserves began (see "Regime Change at the Fed" October 14, 2008). Initially, the Fed saw this as a way to fund its many new liquidity programs without running the inflation-risk of outright money creation. But now, the Fed has moved beyond just supplying liquidity to dysfunctional markets, and has begun to focus on counteracting strong forces of monetary deflation (see "Why Isn't Gold at $1500?" December 10, 2008) -- and in that context, the accumulation of excess reserves on its balance sheet can be interpreted as a self-made "liquidity trap." As quickly as the Fed prints money and drops it out of helicopters, that money just comes right back to the Fed in the form of reserves looking to earn an above-market interest rate. Yesterday's setting of the rate paid on excess reserves at 1/4%, the top of the new target range, significantly ameliorates that problem.

The most important thing the FOMC said about the funds rate yesterday was that "exceptionally low levels" would persist "for some time," just as it will "sustain" its enlarged balance sheet. This is the equivalent of the promise of a "considerable period" of low rates first made in the FOMC statement of August, 2003, after the funds rate had been set at what seemed then like an exceptionally low level of 1% at the previous meeting in June. The idea behind "some time" is no doubt the same as that behind "considerable period" -- that is, to lower rates at the long end of the Treasury curve via arbitrage by encouraging traders to execute "carry trades," borrowing at the funds rate and buying long-term bonds, under the assurance that their low borrowing cost will last long enough to permit them to earn out any potential capital loss in their longs. The same logic, in reverse, keeps shorts from attacking the long end of the curve by imposing a crushing cost of carry. As long as the Fed persists in promising stable near-zero short rates, the otherwise enormously tempting Treasury bond short we've been talking about has to be put on hold -- "for some time," as it were (see "Feeding Frenzy in Treasuries" December 2, 2008).



How long will "some time" prove to actually be? We don't know, but there's a good chance that the Fed will make it longer than it has to be. After the 2003 "considerable period" promise, the Fed was far too slow to raise rates as the economy strengthened, and the result was a housing and credit bubble. This time around, with so much pain having been taken in markets, it seems foolish to imagine that Fed might have to quickly reverse course. But there are some small and tentative bits of evidence that the Fed's liquidity facilities are beginning to work -- that is, some markets are beginning to develop a little bit of liquidity on their own, outside the Fed's assistance. Notably, last week was the first since the Fed set up the Commercial Paper Financing Facility that the natural market grew more than the CPFF. It was the biggest gain for the natural commercial paper market in 17 weeks.

What if small signs like that one start to multiply and to spread, even just a little? We wouldn't have to have an especially vibrant recovery to make the current funds rate far too low, and the Fed's balance sheet far too big. When that happens -- and it's only a question of when -- the Fed will likely be as tardy as it was after 2003. It will err on the side of caution, not daring to withdraw its liquidity facilities, raise mortgage rates, or drain money from the banking system until a sustainable recovery is absolutely assured. The Fed will know full well that to wait is to cause inflation -- but that will be seen as a small insurance premium balanced against the cataclysmic risks of systemic failure and monetary deflation. The dollar, now well off its recent highs, and gold, well off its recent lows, are hinting at that future now. The dollar, and the world's faith that its value will not be destroyed by inflation, is in the end the gating factor that limits the scope of the Fed's ability to keep expanding its balance sheet and to keep monetizing debt. We applaud the Fed's aggressive action now, but ultimately there is the risk that the boat coming to rescue us is the *Titanic*.

BOTTOM LINE: With the Fed promising to hold short rates near zero "for some time," the 2003 carry trade is back. While it's tempting to short long bonds at today's absurdly low yields, the cost of carry in the short is now too punishing to overcome. Gold and the dollar have been discounting the policy posture the Fed made explicit yesterday. With the news out, both may pause soon to consolidate their recent moves. In the intermediate- and long-term, we expect the Fed's continued ultra-easy posture to be bullish for gold and (barring an extreme response from other central banks) bearish for the dollar.