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FED SHADOW

Ben Boldly Goes

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Donald Luskin

It's official: the Fed is fighting deflation by monetizing debt.

With yesterday's FOMC announcement, the Fed has followed through dramatically on all our expectations to increase the scope of its already extremely large balance sheet (see "China Calling" March 17, 2009). After months of hinting, it released specific plans to buy $300 billion of Treasury securities. It will also buy an additional $750 billion of agency MBS, and an additional $100 billion of agency debt.

$300 billion is a small amount of money in the context of the enormous Treasury market, about a third of the new supply expected over the coming six months. But it is a large amount of money in the context of the Fed's balance sheet, approximately doubling the value of Treasuries already held that have not been lend under the Term Securities Lending Facility. On the other hand, $750 billion is a very substantial commitment to the agency MBS market -- in combination with the $500 billion already in the process of being acquired, the Fed will end up owning about one third of all the securities in this market. And as we noted Tuesday, the Fed's buying agency MBS is, in fact, an indirect way for it to buy Treasuries (again, see "China Calling"). Foreign central banks have been consistent sellers of agency securities for the last six months, ever since the crisis that put Fannie Mae and Freddie Mac into federal conservatorship, with the sales proceeds apparently flowing into Treasury purchases. If foreign central banks continue this substitution, then the Fed's bid in the agency market is effectively a bid in the Treasury market. It's a bid so large that, if necessary, it could take out the foreign central banks' agency positions entirely.

Update to strategic view
GOLD: Gold's steep uptrend from October was broken yesterday, as we expected -- until the FOMC announcement, after which it was immediately reinstated. It will still probably have to move to a more sustainable slope, but with the Fed's new commitment to fight deflation with enormous balance sheet commitments, our conviction is deeper than ever that inflationary consequences will ultimately ensue, and that gold will move to new all-time highs.
[see Investment Strategy Dashboard]

But by openly declaring its intention to buy Treasuries directly, the Fed is now on the record as having embarked upon outright debt monetization. The Fed is not worried at this moment about the potential inflation risk of this course of action -- quite the opposite. Talking about *deflation* without using the word itself, the statement said "the Committee sees some risk that inflation could persist for a time below rates that best foster economic growth and price stability in the longer term." The gold market got the message loud and clear: the Fed will risk inflation, indeed

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cause it, if that's what it takes to fight deflation. We said last week that gold was bound to break its steep uptrend from the October lows (see "Quantum of No Solace" March 10, 2009), and it had done just that yesterday until the FOMC statement was released -- within moments, it reversed from being *down* 2.4% on the day to trading as high as *up* 4.2%.

Gold may yet have to break that unsustainably steep uptrend, but it will eventually move to new highs as the inflationary consequences of the Fed's deflation-fighting stance play out. When the Fed no longer has to "promote economic recovery", "provide greater support to mortgage lending and housing markets" and "help improve conditions in private credit markets" -- all its goals as set out in yesterday's statement -- it will not likely shrink its balance sheet anywhere near as aggressively as it has expanded it. That will leave a great deal of money having been created, in a world that won't demand as much money as the world does now. That excess of money supply over money demand will, as always, lead to inflation.

But that's in the future. For now, there is deflation to fight and credit markets to support, and the Fed is doing generally the right thing -- and in a way that inspires confidence in a world desperately seeking confidence. For a Fed chairman who once confessed his entire prior experience making "major policy decisions" consisted of "whether to serve bagels or doughnuts" at faculty lunches, Ben Bernanke has emerged as the most effective, decisive and politics-free among the officials involved in addressing the credit crisis. The Fed's bold action yesterday, taken while the rest of Washington was busy consuming itself over bonuses paid to AIG executives -- rounding error in the grand scheme of the economics of bank rescues -- reinforces the sense that the Fed is a constructive fixed-point in a policy-making world that seems intentionally to be maintaining itself at the edge of chaos (see "Number of the Beast" March 18, 2009).

BOTTOM LINE: Gold's steep uptrend from October was broken yesterday, as we excepted -- until the FOMC announcement, after which it was immediately reinstated. It will still probably have to move to a more sustainable slope, but with the Fed's new commitment to fight deflation with enormous balance sheet commitments, our conviction is deeper than ever that inflationary consequences will ultimately ensue, and that gold will move to new all-time highs.