PALOS

Palos Weekly Commentary

Issue **No. 39** | **SEPTEMBER 26, 2019**

CONTENTS

Macro View

By Hubert Marleau

The September FOMC Delivered a Hawkish Decision: New Motto "Never Explain, never Apologize"

Submitted September 23, 2019

The Federal Reserve cut its benchmark interest rate by a quarter-percentage point for the second time in two months as it tries to protect the economy against trade-related uncertainty and slowing economic growth around the world. According to the OECD, intensifying trade conflicts are sending global growth to a mere 2.9% this year compared to a previous forecast of 3.2%.

The policy rate is now set in a range of 1.75 to 2.00 percent. While Chairman Jerome Powell left the door open for further cuts if the domestic economic conditions were to deteriorate, pledging that the Fed is data-dependent, not a single official sees the fed fund rate falling lower than 1.5 to 1.75 percent through the end of 2022. The so-called dot plot showed that the fed funds rate will remain unchanged through the rest of 2019 and 2020.

The markets have noticeably reduced the odds of another rate cut in October to 55% compared to 100% before the meeting because the message set the bar higher for further easing. In Greg Ip of the WSJ wrote that Chairman Powell refused to elaborate on what the Fed will do next, leaving less room for misinterpretation and forcing the market to think for itself. In the final analysis, Mr. Powell said: "We made one decision at the meeting." What else could he say. There is a split within the FOMC. The disagreement is unusual, making it difficult to predict which way the monetary stance is heading. In my view, what can be realistically and safely deduced is only one more rate cut of 25bps. Based on what we know about the economy today, we shall then soon have a policy rate that will be lower than the neutral rate and an upward sloping curve. That can only be good.

Macro View cont.

By Hubert Marleau

The Real Deal Is Quantitative Easing at Infinity in the U.S.

Submitted September 24, 2019

The Repo market is a poorly understood subject unless one is active in the money markets. Basically, it serves as the grease that keeps the money markets spinning. The Repo market is where banks rich in bonds but in need of ready money meet those with cash. It provides a place where assets can be deposited as security for a cash loan for a short period of time--usually overnight. These repurchase agreements-- where cash and collateral is swapped daily-- allows all kinds of banking transactions to take place in a smooth manner and within narrow interest rate boundaries dictated by the current federal funds rate. Because the Repo market is a vital corner of the money system and one of the world's most important rates, the Fed decided to enter the Repo market in 2013 to assure that the plumbing works well including the trading in the $16 trillion U.S. Treasury market, turning it into a huge pawn shop.

Last week, the interbank market was in chaos. The repo rates skyrocketed to 10% forcing the NY Fed to intervene with a series of repurchase operations to keep the federal funds rate within the prescribed range of 1.75% to 2.00%. While the episode is reminiscent of the severe seizure which occurred ten years ago, this time around the banking system did not suffer a 2008-style freeze-up. A decade ago, the issue was that banks lost trust in each other because the collateral of banks was not deemed worthy of consideration. What we had was an inverse bank run. Reason being, people were not taking their money out of the banks but unwilling to put any money in them.

What we had last week was a squeeze---too many bonds and not enough cash-- that brought about a supply-demand mismatch. I do not know all of the specifics that brought this about. Suffice it to say that it was essentially caused by structural and legacy problems that unfortunately collided with a confluence of events like corporate tax payments, margin calls on short oil positions and coupon settlements stemming from the bond rout.

Macro View cont.

By Hubert Marleau

Nevertheless, it is a warning sign that the Fed should not neglect and must address. The basic problem is the runoff of treasury bonds by the Fed, combined with the issuance of treasuries to finance the government deficit at a time when banks prefer to park their excess liquidity at the Fed with a competitive interest rate to meet the stricter capital requirements, stress tests and regulations whilst at the same time foreigners are accumulating dollar-denominated debt because rates are so low abroad.

In this connection, the Fed interjected with band-aids giving just enough liquidity to the system to prevent a repo-rate from blowing-up. What really mattered was the acknowledgement by Chairman Powell during a press conference following the FOMC meeting that he was taking the situation seriously. He admitted that the Fed underestimated the amount of reserves necessary for the banking system and that "we will need to resume the organic growth of the balance sheet earlier than we thought. That's always been a possibility and it certainly is now." I can't tell if the monetary authorities will expand the balance sheet by buying treasuries in the open market or by launching a standing repo facility. In any case, the Fed can handle the situation. It will be on a "QE-Lite" watch for an infinite amount of time to make sure that sudden cash shortages don't lead to broad turmoil.

Heisenberg reported that Mark Cabana of the BofA estimated "the Fed needs to purchase around $250 billion in assets in the secondary market in order to get back to an abundant reserve regime with a buffer. Going forward, the Fed would need to persist in outright purchases of around $150bn/year to maintain that level." For me, it sounds as though the Fed will address the lack of cash by announcing, at the October FOMC meeting or sooner, a promise of ad hoc liquidity injections in perpetuity or an inevitable balance sheet expansion at infinity.

Although Friday's overnight repurchase agreements marking the fourth-consecutive day of cash injections were oversubscribed, the money stress was abating because banks used lesser amounts of repos at lower funding rates than earlier in the week. So far, the Fed has introduced two measures to alleviate the jitters. The monetary authorities decreased the interest rate paid on excess liquidity left at the Fed, and the Open Market Trading Desk at the NY Fed will conduct a series of overnight and term repurchase agreement operations to help maintain the federal funds rate within the target range. It is, perhaps, a prelude to a forthcoming announcement of a permanent balance sheet expansion or standing facility. Expectations are high that the Fed will unveil a $500 billion standing credit line to the market participants at the next FOMC meeting on November 8 and possibly target the Repo rate to the Federal funds rate.

Macro View cont.

By Hubert Marleau

What Does It Mean to Have the Two Largest Central Banks in the World on Light Quantitative Easing (QE) for As Long as It Takes?

Submitted September 25, 2019

In sum, there is a shortage of cash and an excess of Treasuries; but banks are much safer than they were in 2008. As a matter of fact, the banks have a lot of liquidity, but have a tremendous amount of restraints on how to use it. Today, financial regulations designed to curb risk-taking compel banks to keep much larger amounts of reserves classified as high-quality assets on their balance sheet. That said, it did bring about a problem when the monetary authorities decided to unwind the Fed's quantitative easing program in 2017 as the net issuance of treasuries totaled $2.5 trillion in the last 24 months, gradually turning dealers at the Treasury auctions from lenders to borrowers. It led to a reduction in bank reserves and currency in circulation which has naturally increase as the economy expanded.

In the past two years, the U.S. monetary base decreased by about $600bn and bank reserves by almost $800bn because of a Fed-program of selling Treasuries in the secondary market called quantitative tightening. Given that the buyers of treasuries sold by the Fed were the banks, their holdings of treasuries more than doubled, causing a relative scarcity of cash. The long-term effect of this shift means that the Fed needs to find a way to keep the Repo market calm. There is only one way to deal with the imbalance: raise the monetary base by buying bonds in the open market. A technical fix is not a long-term solution; what is needed is a bond-buying operation that will increase the cash position of the banks and arrest deteriorating liquidity.

What we now have is assurance of low interest rates on the short end of the yield curve---given the recent rate cuts and QE-Lite in the US and Eurozone. The combination should help by keeping the yield curve flat or perhaps even aid in steepening it.

Macro View cont.

By Hubert Marleau

While I fully recognize that the predominant belief is that inflation is gone for good because of a popular narrative that supply-abundance and slow demand-growth is deeply entrenched, I anticipate that we shall eventually get a brand-new story about the economy. It will be one of moderate productivity gains and mild-inflation as opposed to what we have today--- secular stagnation. I cannot help but think that when the markets are positioned for the worst, forcing central banks to ease at a time when economic data shows less than full employment, productivity can only be the stimulus for current and future growth and inflation is bound to come back under the persistence of easy money. Thus, recession talks may prove to be an error.

History is clear that the stock market does well, and low bond yields are indefensible when an anticipated recession fails to occur. That is what we might get. It may not be exciting, but most high-frequency economic trackers are suggesting that real growth will be about 2.0% in Q3 and Cleveland Fed's NowInflation Casting model is predicting that core PCE will run at the annual rate of 2.1%. It's as if the traditional business cycle has left us for good---frequent and large swings have been replaced by a flat line of two for inflation-plus-two for growth.

Disclaimer:

PALOS

1 Place Ville Marie, Suite 1670
Montreal (QC) H3B 2B6, Canada

T. +1 (514) 397-0188
F. +1 (514) 397-0199

1 St. Clair Avenue East Suite 504
Toronto, Ontario M4T 2V7

T. +1 (647) 276-0110
F. +1 (647) 343-7772

www.palos.ca