



The Fed Awakens

JOHN MAULDIN | December 16, 2015

I got the following from a friend at J.P. Morgan just a few minutes ago. You might have had something like it hit your inbox as well.

WASHINGTON – Federal Reserve officials said Wednesday they expect a more gradual pace of short-term interest rate increases in coming years than they did three months ago.

They also tweaked very modestly their views on the outlook for the economy, according to forecasts released after the conclusion of the Fed's two-day policy meeting. Officials made small changes in their views of future economic activity, and they still don't expect to achieve their 2% inflation rise target until 2018.

Clearly not a surprise and in line with what I've recently been saying. I think the Fed is going to be raising rates a lot more slowly than even they project. When you look at the "dots," the median projection for the Fed funds rate is 3.75% in the much longer run.

Side bet? I think we see 0% again before we see 2%. I'll take the overs on that bet, thank you very much. If you make the number 3%, I'll even give you odds.

Today's *Outside the Box* is from my friend [Danielle DiMartino Booth](#), who used to work at the Dallas Fed for Richard Fisher. She has gone out on her own and has begun to write occasional pieces that seem hit my inbox at least weekly. The cover a wide range of topics, but many of them deal with the Fed.

This morning she wrote:

What if it really is all about reinvestment and not one teensy quarter-point rate hike? Over the next three years, some \$1.1 trillion in Treasuries could roll off the Fed's balance sheet if reinvestments were to cease. Tack on the potential for mortgage backed securities (MBS) to prepay and/or mature and you're contemplating a figure that approaches \$2 trillion.

Make no mistake, shrinkage of the Fed's balance sheet to half its current size is much more feared by market participants than a slight tick-up in interest rates. Taking the step to not reinvest would increase the supply of Treasuries and MBS available to investors and reduce the Fed's support of the economy. The higher the supply on the market, the lower the price and hence, higher the yield, which moves opposite price.

I should note that she predicted the Fed would expand its overnight reverse repo program to the tune of \$2 trillion, and the Fed has done just that. That should be enough to cover most contingencies for the next few weeks; and, as Danielle explains, that move has a great deal more impact on the markets and your returns than an itchy-bitsy 25-basis-point increase in short-term rates.


Danielle weaves a story about what will really happen over the coming year, based on her knowledge of what Fed members are likely to do and what the markets may force them to do. If you are not much interested in Federal Reserve policy and how it is created, her writings might seem to take you deep into the weeds; but given the importance of Fed policy to the markets, maybe this one time you should pay attention to what goes on behind the curtain. I think this makes a great and timely *Outside the Box*.

My schedule is usually busy, but it has become hectic. I have over 120 people helping me as research associates for the book I'm writing, *Investing in an Age of Transformation*. I've outlined some 27 chapters, 24 of which have teams working on the research and writing. Each team needs its own regular 30- to 45-minute conference call. Plus, there are calls with individual researchers on some of the minutiae.

I am really impressed with the knowledge level and skill and enthusiasm this intrepid group of volunteers brings to the table. This is going to be so much more than the book I would have written all by my lonesome.

Have a great week. It seems that most of us in America (from the calls I've been making) have seen unseasonably warm weather so far this winter. I can't remember a December this nice in Texas. The long-range forecast says Christmas Day is going to be 72° and sunny. I was talking to friends in Detroit yesterday and they were marveling that there would be no snow for Christmas. Not that they were complaining. It's fabulous to be able to walk to local restaurants and entertainment venues in a light jacket in the middle of December. However, this being Texas, I know the weather can change on a dime, so we just enjoy the good times as they come along. Kind of like oil booms.

Your enjoying his month of global warming analyst,



John Mauldin, Editor
Outside the Box

The Fed Awakens

By Danielle DiMartino Booth

[Originally published on DiMartinoBooth.com](http://www.DiMartinoBooth.com)

What if Mario Draghi really did whip out a bazooka?

On December 3rd, the stock market pitched a fit reacting to what it perceived to be insufficient stimulus on the part of the [European Central Bank \(ECB\)](http://www.ecb.europa.eu). The market had wanted “Super Mario,” as investors have lovingly nick-named the ECB president, to take two measures.

The first would have expanded the quantitative easing (QE) program, increasing the amount of securities the ECB is committed to purchase. The second would have cut already negative deposit rates by -0.15%; Draghi only delivered -0.1% (negative rates penalize banks for holding excess cash at the EBC when they could lend it out to spur economic growth.)

Borrowing a page out of [New York Federal Reserve President Bill Dudley](#)'s battle plan, Draghi did manage to push through a much more forward-looking program – reinvestment of any proceeds that result from securities maturing on its balance sheet. Bratty fast-money, instant gratification investors dismissed the move.

Draghi, though, never looked more the cat that ate the canary than he did the next day in New York. He vociferously reiterated his commitment to do whatever it takes to get inflation to the ECB target, as long as that might take. If QE wars need be fought long into the future, reinvestment will strategically position Draghi on the central banking battlefield.

Back at home, many market watchers are scratching their heads as to why the Fed would be raising rates at this juncture. Financial conditions have tightened, not eased, since the Fed pushed the hold button at its September meeting. And yet, the markets and economist community remain unanimous that the Fed will pull the trigger.

What if it really is all about reinvestment and not one teensy quarter-point rate hike? Over the next three years, some \$1.1 trillion in Treasuries could roll off the Fed's balance sheet if reinvestments were to cease. Tack on the potential for mortgage backed securities (MBS) to prepay and/or mature and you're contemplating a figure that approaches \$2 trillion.

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"It seems to me you'd like to have a little room before you start ending the reinvestment... (which) is a tightening of monetary policy." So said Dudley on June 5th to a group of reporters. He went on to define how big the 'room' needs to be a *"reasonable level."*

"By how far that is – you know, if it's 1 percent or 1.5 percent – I haven't reached any definitive conclusion."

At the risk of allowing the appearance of decision-making to occur in unilateral fashion on Liberty Street, Fed Chair Janet Yellen made clear to reporters that the entire Federal Open Market Committee (FOMC) was tasked with determining the future size of the balance sheet.

In a June 17 Q&A session that followed the FOMC meeting, Yellen assured the public that, *"President Dudley was expressing his own personal point of view, but this is a matter that the committee has not yet decided and I cannot provide any further detail."*

But what if there's more than one way to skin the reinvestment cat?

The interest rate markets that determine the cost at which banks lend to one another is notoriously illiquid at the end of calendar quarters and years. The Fed knows this. That makes the insistence on raising interest rates this month all the more intriguing given the pressures emanating from the corporate bond market.

As watching-paint-dry boring as the mechanics surrounding the actual rate hike are, a rudimentary understanding is crucial to grasping the tumultuous nature of the deliberations among FOMC voting members. (That was a preamble to implore the reading of the next few paragraphs.)

The overnight fed funds rate market, which the Fed employed to embark on its last rate-hiking cycle, is a shadow of its former self in terms of trading volumes. We're talking about \$50 billion a day compared to today's theoretical \$2 trillion in institutional cash dehydrating on bank balance sheets parched for safe positive yields.

It's a complete unknown what portion of this \$2 trillion would rush off bank balance sheets into money market funds. That said, it's a slam-dunk assumption that the demand for higher yields is ubiquitous among those making south of nothing on their cash.

Planning for a complete unknown dictates that the Fed be flexible in trying to minimize overnight rate market upheaval. Funny thing – policymakers have a tool that can maximize a smooth transition called the reverse repurchase 'repo' (RRP) facility.

In the post-zero interest rate world, which celebrates its seven-year anniversary the day the Fed is expected to raise rates, repo markets determine overnight rates. Banks and other financial institutions swap collateral in the form of U.S. Treasuries, MBS and corporate debt to other investors for cash. In that these are overnight trades to facilitate the shortest-term funding needs, the bank buys back the securities the next day.

A bank in the above example that's selling securities overnight, with the understanding they'll buy them back the next day, is entering into the repurchase agreement. The party on the other side of the transaction, which buys the securities overnight agreeing to sell it back the next day, has entered into a reverse repurchase agreement.

Mitigating any disruptions in this market is key to a successful initial rise in interest rates. That's saying something when the size of the collateral market has already shrunk from \$10 trillion in 2007 to \$6 trillion today. A rate hike, in its simplest form, involves reducing the liquidity in the system from this \$6 trillion starting point. It follows that the Fed can use its RRP to absorb liquidity using money market funds as the conduit.

The problem is the RRP is currently capped at \$300 billion per day, a fraction of the potential demand for the discernible yield money market funds will presumably be able to offer in a positive rate environment.

Of course, the Fed could satisfy the need to provide the market with collateral by selling Treasuries, but again this shrinks the balance sheet.

What of the elegant solution cleverly proposed by Dudley, you ask? The answer: **Temporarily** lift the cap off the RRP to act in the markets' best interest. In the blink of an eye, the money market fund industry will be completely dependent upon the RRP as a one-stop shop for overnight collateral. In a world bereft of collateral sourcing to begin with, how could such a dependency imply anything "temporary"?

The short answer is it won't. The long-term devilishly detailed answer: Yes, the Fed uncapping the RRP would succeed in tightening financial conditions by absorbing monies from the money market funds that will be flooded with deposits. **But this maneuver will not release the collateral from the Fed's balance sheet. The size of the mammoth balance sheet would thus be largely held intact.**

Perhaps this is why we've been hearing dissentious grumblings from unusual suspects such as Fed Board governors Lael Brainard and Daniel Tarullo. Monetary policy is effectively being determined mechanistically at an illiquid time of the year notorious for mechanical dysfunction. Policymaking by proxy has to bristle even the loyalist of consensus builders.

Recall that there have been only four dissents on the part of Fed governors over the past 20 years (Federal Reserve district president dissents are relatively-speaking a common occurrence). If dissent weren't a clear and present danger, why would Yellen warn Congress she's prepared to push forward with a rate hike in spite of potential dissents? The chair could easily have been referring to mutinous governors.

Since the creation of the RRP, policymakers have gone to great pains to reassure the public they have the political will to shrink the facility when the time comes. That would be quite the acrobatic act if the money market fund industry becomes reliant on the RRP for daily functionality.

Conveniently, with markets pricing in all of two additional rate hikes in 2016, we'll never get to Dudley's 1 to 1.5-percent overnight rate that justifies shrinking the balance sheet.

Will policymakers have the luxury of time to raise interest rates enough to combat the next recession? Looking 12 months out, it's much more likely that the business cycle will have turned. As the Wall Street Journal has pointed out, at 78 months, the current expansion is longer than 29 of the 33 dating back to 1854.

There's no doubt the Fed's first rate hike in nearly a decade is an awakening. The open-ended question is the true motivating factor. Perhaps investors should cue off Draghi's recent success in securing ECB balance sheet reinvestment and connect the dots from there.

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