## SNL Blogs

SNL NASHVILLE NOTES

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# Nuclear escalation next for the Fed

By Jeff Davis

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Last Wednesday, the Federal Open Market Committee almost followed consensus, but made a subtle shift. As expected, the Fed will continue to purchase $40 billion of agency MBS each month. It also ended "Operation Twist," whereby short-duration Treasurys held on its balance sheet were sold to fund the purchase of longer-duration Treasurys in a sterilized move; rather, no more securities will be sold, though the Fed will continue to purchase $45 billion of longer-dated Treasurys as it monetizes (via the primary dealers) the federal government's deficit. Also, maturing securities will be reinvested.

As outlined in last week's pre-FOMC blog, I think one near-term outcome will be a propensity for credit spreads to tighten further as the Fed soaks up significant new fixed income supply. Treasurys and other fixed income investments may be overpriced; however, many investors have to invest in fixed income, and they are competing with a buyer that can create a liability to fund open-ended purchases.

Where the Fed did not follow script was by dropping its language that the highly accommodative policy would be maintained at least through mid-2015. Instead, the exceptionally low Fed Funds target (zero percent to 0.25% since late 2008) would be maintained as long as the unemployment rate remains above 6.5% and the expected inflation rate one-to-two years out does not exceed the FOMC's long-term 2.0% goal by more than 0.5% (i.e., 2.5%). What happens if inflation rises to 4%, but unemployment remains at 7%? Inflation targeting by an institution whose forecast record is no better than the Street's is a slippery slope. The policy seems to be to inflate away debt and fund a massive government deficit, while giving borrowers time to extend duration. I wonder if creditors get it.

**Factors affecting reserve balances**

| FRB assets and liabilities ($B) | Aug '07 | Aug '08 | Aug '09 | Aug '10 | Aug '11 | Dec '12 |
|---|---|---|---|---|---|---|
| Securities held outright | 790.76 | 479.29 | 1,354.00 | 2,054.00 | 2,649.00 | 2,618.00 |
| U.S. Treasuries | 790.76 | 479.29 | 704.00 | 777.00 | 1,639.00 | 1,656.00 |
| Agency debt | 0.00 | 0.00 | 107.00 | 159.00 | 112.00 | 79.00 |
| Agency MBS | 0.00 | 0.00 | 543.00 | 1,118.00 | 897.00 | 884.00 |
| Term auction credit | 0.00 | 150.00 | 234.00 | 0.00 | 0.00 | 0.00 |
| Term asset-backed facility | 0.00 | 0.00 | 30.00 | 40.00 | 12.00 | 2.00 |
| Commercial paper funding facility | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| AIG loan (ex-ML II & III) | 0.00 | 0.00 | 42.00 | 24.00 | 0.00 | 0.00 |
| Maiden Lane I, II and III | 0.00 | 29.11 | 62.00 | 67.33 | 52.00 | 1.00 |
| Central bank liquidity swaps | 0.00 | 62.00 | 77.00 | 0.06 | 0.00 | 12.00 |
| Gold stock | 11.04 | 11.04 | 11.04 | 11.04 | 11.00 | 11.00 |
| Special drawing rights | 2.20 | 2.20 | 5.20 | 5.20 | 5.00 | 5.00 |
| Other | 105.45 | 209.79 | 218.76 | 167.37 | 181.00 | 255.00 |
| **Total factors supplying credit** | **909.45** | **943.43** | **2,034.00** | **2,369.00** | **2,910.00** | **2,904.00** |
| Currency in circulation | 812.38 | 831.50 | 911.00 | 945.00 | 1,031.00 | 1,152.00 |
| Reverse repos | 33.34 | 43.79 | 68.00 | 62.00 | 70.00 | 95.00 |
| Deposits other than reserves | 11.72 | 12.36 | 280.00 | 235.00 | 114.00 | 63.00 |
| Reserve balances | 12.25 | 11.33 | 718.00 | 1,052.00 | 1,625.00 | 1,526.00 |
| Other liabilities & capital | 39.48 | 44.14 | 57.00 | 74.00 | 70.00 | 68.00 |
| **Total factors absorbing credit** | **909.16** | **943.11** | **2,034.00** | **2,369.00** | **2,910.00** | **2,904.00** |
| High-powered money * | 824.63 | 842.83 | 1,629.00 | 1,997.00 | 2,656.00 | 2,678.00 |

As of Dec. 9, 2012
* High-powered money is defined as the summation of currency in circulation and reserve balances.
Data based on Federal Reserve H.4 releases
FRB = Federal Reserve Bank
MBS = mortgage-backed securities
Sources: SNL Financial, federalreserve.gov

If the economy does not improve over the next year, not only will the Fed be on hold for years, but I think they will go for the nuclear option. The Fed is all-in at the high-stakes table, and they may have to up the ante to keep playing. The nuclear option entails charging banks to hold reserves at the Fed compared to presently paying 0.25% for reserves left at the Fed. The reserves, which are a Fed liability created when bonds are acquired from banks, are an asset of the member banks. If loan demand was stronger, the excess reserves would have been withdrawn and lent into the real economy where the multiplier effect of a fractional banking system would take hold. That has not happened. Consumers and businesses are intent for now to pay down debt. It is the age of deleveraging, according to Gary Shilling. Certainly the velocity of money (and the M2 Money Multiplier) has fallen as the Fed has created reserves.

According to the Fed's Dec. 12 H.8, loans held by domestic and foreign banks with U.S. offices have risen about 4% since year-end 2011 based upon the four-week moving average. Bank investors know that the limited growth is attributable to C&I (~11%) and 1-4 residential (~5%), while CRE and consumer loans are roughly unchanged, and revolving home equity is down about 6%. Of course, on-balance sheet loans only represent about 30% of credit. The shadow banking system is large, but it also is getting smaller. The Fed's Flow of Funds (Z.1) for the third quarter points to tepid credit expansion with the debt of domestic nonfinancial sectors expanding at a 2% annual rate (households -2%; business 4%; state/local government 0%; and Federal government 6%).

If Keynesians are concerned about aggregate demand, it is missing — though that can change in time. Bankers that I speak with point to tepid demand, though it is not clear how much pending changes in tax policy is weighing on loan demand. What really seems to be missing is confidence. My expectation is that if economic growth and employment do not pick up, then Wall Street will start to talk about the nuclear option next summer.

The Fed cannot create demand for goods and services. It only tinkers with demand at the margin by impacting borrowing costs and the value of financial assets. That said, the Fed can make it very painful for banks to hold reserves. It is my view that the Street has no concept of how far net interest margins will fall by mid-2014 given current Fed policy. The single most impactful action banks can take to improve profitability is to shift their earning asset mixes to (collectible) loans from bonds and liquid assets. I think there is a good chance the Fed will help the industry do so in 2014 if the economy does not improve by going nuclear. Reluctant borrowers may become enthusiastic borrowers if inflating assets can be financed with cheap debt.

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