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Julius Caesar, John Allison and the Federal Reserve

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The Federal Open Market Committee will meet on Tuesday and Wednesday. I do not think anyone involved in the capital markets envies the high-stakes game the Fed finds itself in; however, the Fed contributed to its current predicament by cutting rates to 1.0% in mid-2003 and then raising rates too slowly as the housing market was clearly overheating to the detriment of the banking system that it regulates. Now, most central banks are in a race to cheapen their currencies relative to other currencies and to finance government deficits that the market would only finance at much higher rates. We seem to be somewhere between testing theories of how to deal with liquidity traps and central banking policy in Latin America during the 1970s. Deflation meets inflation.

Factors affecting reserve balances

FRB assets and liabilities ($B)	Aug-07	Aug-08	Aug-09	Aug-10	Aug-11	Dec-12
Securities held outright	791	479	1,354	2,054	2,649	2,618
U.S. Treasuries	791	479	704	777	1,639	1,656
Agency debt	0	0	107	159	112	79
Agency MBS	0	0	543	1,118	897	884
Term auction credit	0	150	234	0	0	0
Term asset-backed facility	0	0	30	40	12	2
Commercial paper funding facility	0	0	0	0	0	0
AIG loan (ex-ML II & III)	0	0	42	24	0	0
Maiden Lane I, II and III	0	29	62	67	52	1
Central bank liquidity swaps	0	62	77	0	0	12
Gold stock	11	11	11	11	11	11
Standard drawing rights	2	2	5	5	5	5
Other	105	210	219	167	181	255
Factors supplying credit ($B)	**909**	**943**	**2,034**	**2,369**	**2,910**	**2,904**
Currency in circulation*	812	831	911	945	1,031	1,152
Reverse repos	33	44	68	62	70	95
Deposits other than reserves	12	12	280	235	114	63
Reserve balances*	12	11	718	1,052	1,625	1,526
Other liabilities and capital	39	44	57	74	70	68
Total factors absorbing credit ($B)	**909**	**943**	**2,034**	**2,369**	**2,910**	**2,904**
* Reserves + currency = high-powered money	825	843	1,629	1,997	2,656	2,678

Data as of Dec. 9, 2012.
Source: Federal Reserve's H.4.1 (FRB = Federal Reserve Bank)

It is hard to see how this will not end very badly in time. Every policy has a cost. No doubt the Fed views its current path as having fewer long-run costs than benefits. Perhaps it is unfair of me to paraphrase Julius Caesar, who said men will believe what they wish.

This week's Fed meeting probably will not produce any surprises, but if consensus is right, the Fed will make a commitment to being all-in at the high-stakes table. The Fed is expected to affirm its commitment to maintain exceptionally low rates (i.e., 0-0.25% target Fed funds) at least through mid-2015. In addition, the Fed is expected to continue to buy $40 billion of agency MBS each month. The additional poker chips will be the outright purchase of Treasurys. Presently, the Fed is selling short-dated Treasurys and buying long-term Treasurys to extend the duration of its portfolio and to push long rates lower. It is a sterilized repositioning.

Some might call resumption of unsterilized government debt purchases to be monetization undertaken to finance the Federal deficit even though the primary dealers stand between the Fed and Treasury. I am sure the Fed will explain the move in the context of ensuring that mortgage rates remain very low so that housing can continue to heal. Likewise, it will ensure that marginal corporate borrowers will continue to have access to cheap capital. The 2012-2013 "debt wall" of maturing CRE and high-yield loans and debt that investors worried about in 2009 has been refinanced the past two years into the next decade.

There is a Never-Never Land aspect to it all. The Fed is creating reserves to purchase bonds from the primary dealers who are obligated to bid Treasury's auction. Also, Congress and the administration have been able to avoid making hard decisions to the extent the Fed has been a large buyer of Treasurys. Why do so if the Fed does the heavy lifting? Bond vigilantes are a concept; the Fed owns the market and has a balance sheet to prove it.

If consensus is right, the Fed will absorb about $1.0 trillion of debt issuance in 2013. JPMorgan is projecting the Fed will absorb about $1.0 trillion of $1.1

trillion of U.S.-denominated debt issuance in 2013 that has a maturity of more than one year. Excluding agency MBS and Treasurys, JPMorgan is projecting a slight reduction in debt issuance to $303 billion in 2013 from $317 billion in 2012. Unless asset flows from equities to fixed income reverse, the result may be further tightening in credit spreads for technical (flow) reasons even though the fundamentals may argue credit is richly priced.

Where would pricing of Treasurys and therefore other assets be if the Fed did not absorb the supply? The answer is obvious, but it has big implications for the economy. Free markets allocate capital based upon risk-adjusted expected returns. With the Treasury market distorted, pricing for all other assets are distorted. As such, distortions will develop in the real economy in time. Perhaps one distortion we see today is the flood of capital —foreign and domestic — into U.S. farmland as a store of value.

For banks, there are three implications that I see. One is that net interest margins will be much lower by mid-2014 than the Street can envision. The second is that credit quality will be in good shape as many marginal credits — excluding perhaps high loan-to-value HELOC — will continue to benefit from liquidity that tips refinancing capital in their favor. Also, banks will find no shortage of good bids from distressed debt investors. As for bank stocks, I still do not think the Street has its mind wrapped around how low NIMs will be by mid-2014, and branch closures are not going to offset that much of the coming revenue loss. All of which brings me to my third implication. Declining consensus for bank stocks may not matter that much because the valuations are modest; however, it also implies the upside is not there either.

The big unknown is the Fed's exit strategy to shrink its balance sheet to the pre-crisis level of about $900 billion of assets. Absent a booming economy in which the federal government is running a multiyear surplus, it is hard to envision the Fed selling more than a few bonds at the margin. Further, the current $3 trillion asset balance sheet supported by $55 billion of capital (about $400 billion with the gold marked-to-market) will approximate $4 trillion by year-end 2013 and $5 trillion by year-end 2014 if the current and expected policies continue. Rising rates beyond periodic token increases would obliterate the Fed's capital, the federal government's finances and long-duration assets that are priced based upon low rates.

To the extent there was a real deflation risk, the Fed conquered it with the steps it took in late 2008 and 2009 to inject massive liquidity into the system. Now it toys with inflation, contained or otherwise, absent a cataclysmic economic or geopolitical event. Private credit formation remains negligible while the reserves sit on the Fed's balance sheet, but that can change in time. The Fed is telegraphing to borrowers to refinance and extend duration. Barry Sternlicht, CEO of Starwood Property Trust Inc., has gotten the message. He told Bloomberg Radio last week that now is the best time to invest in commercial real estate since he got started in the early 1990s when the RTC was unloading bank properties. Sternlicht noted that nowhere could investors generate a high-single-digit to low-double-digit ROE than in CRE today. The math is straightforward: Moderate leverage and modest borrowing costs below 4% to finance CRE property that entails a 6% cap rate. He noted that the debt on a recent Atlanta shopping center his fund acquired was a potential asset. It is a 10-year assumable loan. The targeted holding period for the property is just five years.

Maybe I am too pessimistic on how all of this plays out versus taking losses and forcing Washington to properly finance what it chooses to fund; however, there is too much of a something-for-nothing aspect to it all beyond the punishment that savers, pension funds and life insurance companies are taking. Borrowing essentially costs nothing because the Federal Reserve with encouragement from Washington says so. BB&T Corp.'s ex-CEO John Allison earlier this year told *Investor's Business Daily* in an interview that bad decisions are typically made by intelligent people who ignore the facts and what they know to be the truth, especially if there are no short-term consequences.

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