AFTER QE2- EASY DOES IT? (THE MONEY JUNGLE, PART THREE)

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"A dollar bill always looks as big to me as a bedspread." Harry Luck, in the film "The Magnificent Seven" (John Sturges, director; 1960)

CONCLUSION

The current act of the Federal Reserve's money printing festival ends this month. Thus a big buyer of US Treasury securities substantially disappears. Suppose Senate, House, and White House performers do not enact a significant deficit cutting package. Assume no amazing economic growth magically eliminates much of the near term or long run shortfall. Will American individuals and institutions leap at the chance to boost their acquisitions of these low yielding bills, notes, and bonds? Absent "flight to quality" fears, probably not. The same is true of overseas players.

Judging from recent foreign buying patterns of US Treasury securities, it then will be difficult to attract sufficient foreign ownership to fill America's fiscal hole. In the absence of another round of quantitative easing, or unless the US (and worldwide) economy weakens substantially, US government interest rates will face pressure to rise.

MONETARY VIRTUE

Not only in its ardent pursuit of low rates, but also in its money printing exercises, the Fed reveals it's an institution of easing "virtue". So far, quantitative easing has offered a means of mitigating the US and worldwide economic disaster and helped to boost nominal GDP (and even real GDP) for a while. Moreover, money printing has bought time for US legislators to solve the (dare one say "our") gigantic federal deficit problem.

The Federal Reserve has gobbled up US Treasury securities. Most of the Treasuries owned are notes and bonds. The ravenous appetite commenced in spring 2009- holdings swelled from around $486bb in April to $766bb by late September that year. The feeding abated from then to end August 2010.

However, the second round of quantitative easing displays dramatic expansion of the Fed's outright Treasury holdings. From around $785bb in early September 2010, they've almost doubled to about $1.5 trillion (Fed release H.4.1, week ended 6/1/11). Based on the Congressional Budget Office's January 2011 estimate of fiscal year deficits, this $700 billion plus acquisition represents about half the 2011 fiscal year deficit of just under $1.5 trillion (2010's deficit was about $1.3tr, 2009's $1.4tr). Thus money printing has played a key role in covering America's federal deficit. The CBO's 2012 fiscal year deficit forecast is $1.1 trillion. http://www.cbo.gov/ftpdocs/120xx/doc12039/SummaryforWeb.pdf

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In the context of accommodative central bank behavior, let's not forget the $918 billion in mortgage-backed securities and the nearly $120bb in Federal agencies still held outright on the books. The Fed possessed no mortgage securities as 2009 began as the first round of quantitative easing arrived on scene. By June 2010, its hoard exceeded $1.1 trillion. The QE2 accumulation of Treasuries has more than compensated for the $200 billion decline since June 2010 in mortgage securities holdings. A footnote: the Fed held no agencies at all until the economic crisis accelerated in September 2008. The peak in their storehouse was about $169bb in April 2010.

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During QE2, the US monetary base has ballooned. From almost two trillion dollars in November 2010, it expanded to about $2.6tr on 6/1/11 (Fed's H.3; seasonally adjusted). The monetary base has tripled from the August 2008 take-off point of around $840bb.

MORE BALANCE SHEETS: FOREIGN DEALINGS IN US TREASURIES

Ownership of US Treasury bills, bonds, and notes by "major foreign holders" has remained about unchanged during the QE2 voyage. In March 2011 (the most recent month of data), foreigners (official and others, combined) held about $4.48 trillion; in October 2010, they had a stockpile of $4.37tr. The recent net acquisitions are only $106 billion over five months, or around $255 billion for a full year.

Mainland China grasps about 25.6 percent of the March total, but possesses less than it did in October 2010. Japan has 20.3pc of the March 2011 total. Although it added to its total in recent months, perhaps its quest to recover from the major earthquake of March 2011 will cut its net buying of Treasuries.

Foreign official holdings of around $3.2 trillion represent about 71 percent of the March 2011 grand total. However, since October 2010, net foreign official ownership has slipped by about $50 billion. Though this group bought about $95 billion in T-notes and bonds, they net sold about $115bb in T-bills. Bill interest rates around zero are not an attractive proposition.
http://www.treasury.gov/resource-center/data-chart-center/tic/Documents/mfh.txt

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Suppose one engages in an admittedly very rough estimate regarding financing sources for US fiscal years 2011 and 2012 based upon the CBO's deficit analysis. In regard to 2011's $1.5 trillion needs, add quantitative easing of around $750 billion (by end June 2011 or so) to net foreign buying of $250bb. That leaves about $500bb for American individuals, corporations, and money managers.

What about 2012's deficit of $1.1 trillion dollars (some may wonder if this figure is too low, particularly if the economy droops)? Anyway, suppose the Fed buys net zero Treasuries, and that net foreign buying totals $250 billion. That leaves $850bb for Americans to buy, an increase of about $350bb from the prior fiscal year rate. How eager will American households in particular be to contribute in this regard if their balance sheets (net worth) remain constrained and nominal yields on debt are low?

Even if America's deficit situation improves after 2012, what about the long run? Most wizards say enormous financing needs loom on the horizon under current entitlement and other programs.

Net foreign buying of US government debt is not guaranteed. Even in recent years, in a few months foreigners (officials and other foreigners combined) have been net sellers. For example, note July and August 2007, November 2008, and May 2009.

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As the relevant Treasury statistics ("Treasury International Capital System"/TIC) are only through March 2011, perhaps more current data will reduce debt financing worries. The next TIC release is 6/15/11.

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How high will American interest rates have to ascend to attract notable additional and sufficient American and foreign buying of Treasuries?

Or, suppose the Fed insists on keeping interest rates close to ground level. That risks further depreciation of the broad real trade weighted dollar, which collapsed to new all-time lows in April 2011 (1973-present).

EASY COME, EASY GO?

Associated with its quantitative easing and interest rate policies, the central bank sentinels have unleashed rhetoric concerning their talent in managing the process, particularly the unwinding. When if ever, and how fast, will it disgorge its vast supply of securities? **Thus Fed quantitative easing has a counterpart in qualitative easing**. Fed oratory indeed strives to inspire confidence in the Fed's monitoring skill, its determination to keep inflation expectations well-anchored, its trusty and ready-at-hand toolkit, and its ability to smoothly implement appropriate exit strategies.

The Fed undoubtedly promotes faith via its recent sunny real GDP projections for 2011 (3.2pc midpoint of central tendency), 2012 (3.8pc), and 2013 (3.9pc), right? It also probably takes comfort in the steep positive US yield curve (which it has played a crucial part in engineering) and the historical relationship between such steepness and recession. See the NY Fed's chart.
http://www.newyorkfed.org/research/capital_markets/Prob_Rec.pdf
The Fed gathers 6/21-22/11 and meets again 8/9/11.

Nevertheless, what if neither Americans nor foreigners supply sufficient cash to fill gaping federal deficits? Then round three of QE becomes more likely, especially if stock benchmarks like the S+P 500 head toward August 2010 lows alongside a weakening economy with still-high unemployment.