Myrmikan Research

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Quoth the Fed: Nevermore

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Any lingering doubt that the Federal Reserve would never raise interest rates should have been erased last month after the worst payroll numbers in two years: the economy added 126,000 jobs, instead of the 245,000 forecasted by Wall Street. This data series is, in fact, mostly noise—the actual numbers tell us little—but the effect on policy is real.

Within days, Goldman Sachs released a report saying it "believe[s] that the right policy would be to put hikes on hold for now." What Goldman says, Goldman gets. Their suggestions for the timing of earlier QE rounds were followed precisely; they were able to dictate the exact amount of "flow" from the previous round of open-ended QE. One may dismiss an explicit conspiracy yet understand that the top economists at the Fed and the big banks all went to the same schools, read the same papers, frequent the same night-spots—groupthink dominates economic research and policy.

On cue, a few days later, Former vice chairman of the Federal Reserve Alan Blinder wrote in the Wall Street Journal:

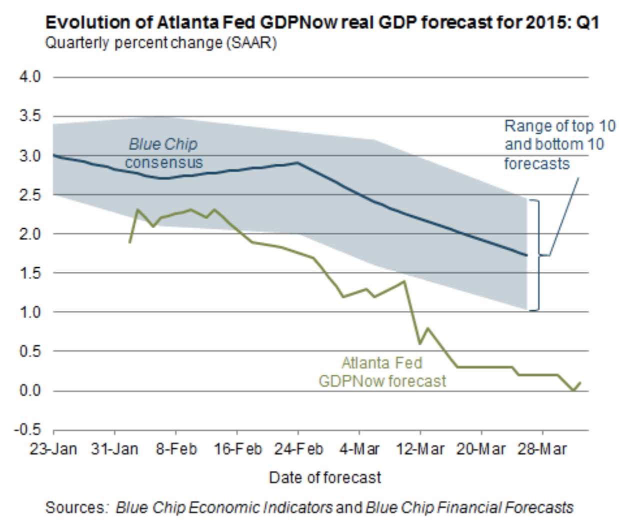
> The Fed wants to see . . . convincing evidence that inflation (which has been running below target) is heading back to 2% . . . And inflation is not forecast to reach 2% until 2017.

Current Atlanta Fed President Dennis Lockhart followed the lead: "Data available for the first quarter of this year have been notably weak," and "I expect it will take longer for direct, affirmative evidence to appear that would validate a decision to begin raising rates."

President of the Federal Reserve Bank of St. Louis James Bullard acknowledged "a risk of remaining at the zero lower bound too long is that a significant asset-market bubble will develop," but then opined that the Fed should cut rates if economy suffers shock after Fed liftoff. Minneapolis Fed president Narayana Kocherlakota went further: "[there is a] theoretical argument to be made for making asset purchases now if economy faltered."

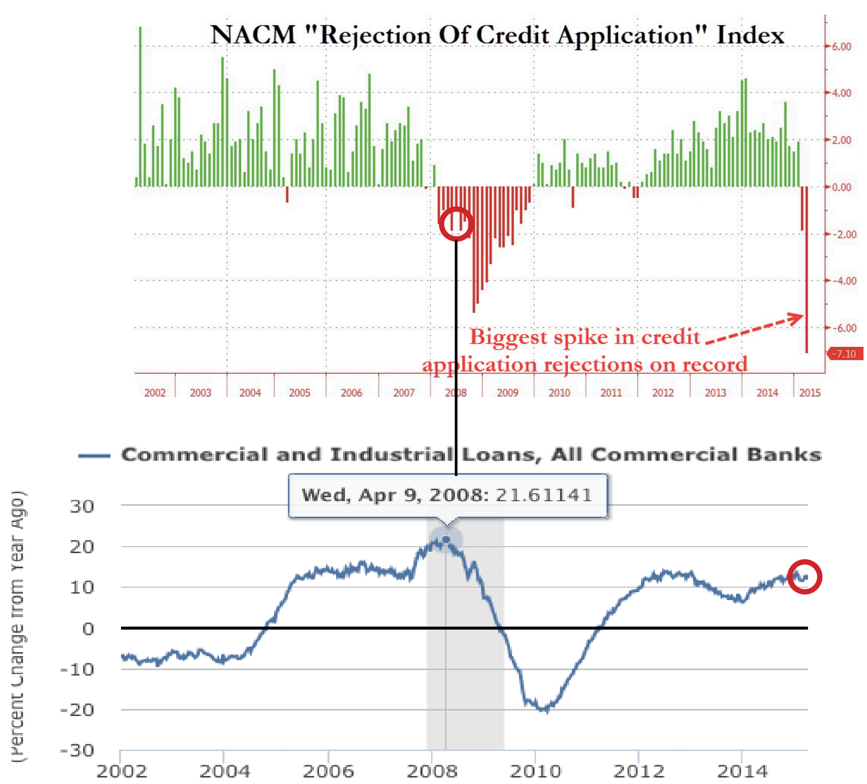
This is manna for speculators in conventional markets. The Fed is going to do more QE per Kocherlakota, or at least keep rates at zero for two more years per Blinder, or, if it does raise rates and markets fall, which of course they would, it will immediately lower them again. Assuming Fed omnipotence, what speculator wouldn't lever up and jump all in?

As long as the Fed is going to hold rates at zero, the data ceases to matter. Observe that the Federal Open Market Committee on March 18 projected economic growth of 2.5%, yet at the same moment, the Atlanta Fed's real-time GDP model, which historically has been quite accurate, was been forecasting 0.3% growth for Q1. It is unlikely that both are correct, but markets care not.



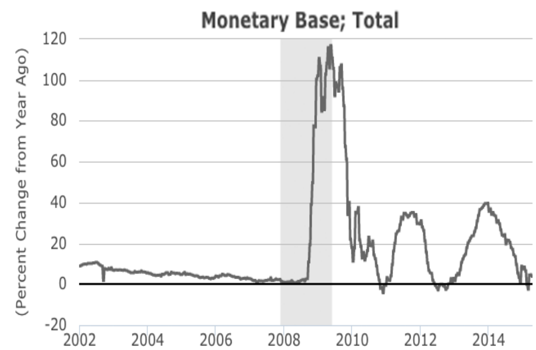
Something even more curious is happening in the credit markets. Banks are rejecting credit applications in record numbers. Banks normally want to lend as much as they can—it's how they make their money—except when they are worried about the solvency of the system. When they start rejecting credit applications en mass, credit contracts, which makes them even less likely to lend.

On the other hand, commercial and industrial loans are still growing at a robust 12% year-over-year. The previous time this anomaly occurred was in 2008. Banks began rejecting credit applications at the beginning of the year, but credit growth didn't peak, in percentage terms, until April. In fact, annual credit growth was still positive as late as April 2009!



This dichotomy is easily explained. Once upon a time, bank lending primarily financed individual commercial transactions. Over time, banks migrated toward lending against long-term assets. When a bank has lent a concern long-term capital, it is loath to let that firm expire, especially when only a incremental financing is required to tie it over. As a credit crunch looms, all the banks, at first, desperately try to keep their own clients afloat—for the bank's sake—while rejecting others. Only once the situation is hopeless do banks cut off existing credit lines and appeal to the state for aid.

As discussed in the previous update, there are roughly $100 trillion borrowed against nominal base money of $4 trillion. When the Fed stops printing money, where do the dollars come to make interest payments? When the next credit crunch arrives—and the behavior of the banks suggests it may be near—the Fed will have to print even more money to bail out the banks again.



The function of QE is to lower rates stimulate the economy, but if rates are already at zero, how can they go even lower? The Fed has been trawling the intellectual swamps for an answer, and out of the muck has come Citibank's Willem Buiter, who argues that the only thing that prevents central banks from setting interest rates below zero ("breaching the lower bound" they call it) is cash. If your bank tells you that is going to start deducting 5% from your checking account each year, there is a strong incentive to withdraw all your cash and put it in a lock-box. In a fractional reserve system, banks don't have much cash, so they would have liquidate their loans, which would prompt a run on the banks.

Fed Chair Janet Yellen thinks that rates can be a little bit negative because, as she recently pointed out: "cash is not a convenient store of value." One has to pay to have it stored somewhere and risks theft. But, there is a threshold of negative rates where this cost becomes palatable and prevents enlightened Fed policy.

Cash becomes subversive—as gold before it, cash must be suppressed. It is already happening. The handbook for the Federal Financial Institution Examination Council now requires banks to report customers withdrawing $5,000 of cash in aggregate. Consider that policy in conjunction with the police strategy called "Stop & Seize." It turns out the just having cash is suspicion enough to confiscated it. The Washington Post found:

- There have been 61,998 cash seizures made on highways and elsewhere since 9/11 without search warrants or indictments through the Equitable Sharing Program, totaling more than $2.5 billion.

- Only a sixth of the seizures were legally challenged, in part because of the costs of legal action against the government. But in 41 percent of cases

> — 4,455 — where there was a challenge, the government agreed to return money. The appeals process took more than a year in 40 percent of those cases and often required owners of the cash to sign agreements not to sue police over the seizures.

Buiter's theory is that, given the choice having the police take your money as they transport you to jail just for having it or losing your money to the bank, depositors will spend it instead and juice the economy. What he fails to consider is the effect on the capital structure of the economy.

Ben Bernanke, former Federal Reserve Chairman, and now senior advisor to the most levered hedge fund in the world, recently blogged:

> Paul Samuelson taught me in graduate school at MIT, if the real interest rate were expected to be negative indefinitely, almost any investment is profitable. For example, at a negative (or even zero) interest rate, it would pay to level the Rocky Mountains to save even the small amount of fuel expended by trains and cars that currently must climb steep grades.

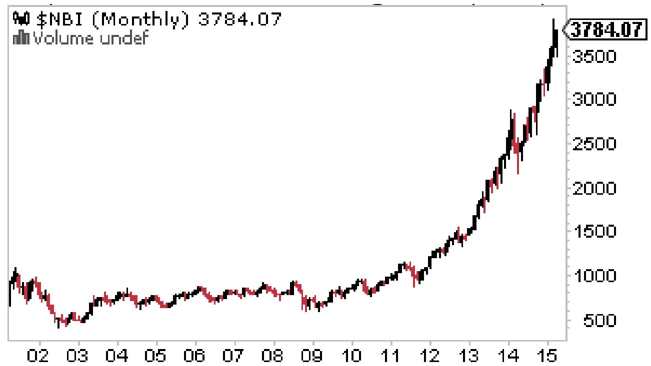
Samuelson was wrong: *real* interest rates can't ever be negative, even for a nanosecond. The very idea is an abomination. It would reverse time preference: one bird in the bush would be worth two in the hand. But, negative *monetary* rates can temporarily convince investors to fund the most extraordinary of things. Lord Macaulay gave a list of such enterprises during a previous credit bubble:

> The natural effect of this state of things was that a crowd of projectors, ingenious and absurd, honest and knavish, employed themselves in devising new schemes for the employment of redundant capital. It was about the year 1688 that the word stockjobber was first heard in London. . . . There was a Tapestry Company, which would soon furnish pretty hangings for all the parlours of the middle class, and for all the bedchambers of the higher. There was a Copper Company, which proposed to explore the mines of England, and held out a hope that they would prove not less valuable than those of Potosi. There was a Diving Company, which undertook to bring up precious effects from shipwrecked vessels, and which announced that it had laid in a stock of wonderful machines resembling complete suits of armour. In front of the helmet was a huge glass eye like that of a Cyclops; and out of the crest went a pipe through which the air was to be admitted. The whole process was exhibited on the Thames. Fine gentlemen and fine ladies were invited to the show, were hospitably regaled, and were delighted by seeing the divers in their panoply descend into the river and return laden with old iron and ship's tackle. . . .

Walter Bagehot recorded the objectives of some of the South Sea Bubble companies:

> Insurance of Losses by Servants—To make Salt Water Fresh—For building of Hospitals for Bastard Children—For building of Ships against Pirates—For making of Oil from Sun-flower Seeds—For improving of Malt Liquors . . . For importing a Number of large Jack Asses from Spain For trading in Human Hair—For fatting of Hogs—For a Wheel of Perpetual Motion.

NASDAQ Biotech Index

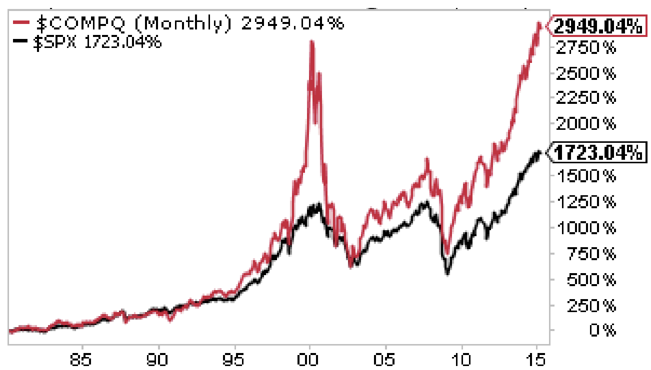


But none of these are more absurd than "the Company for Bodies of Perpetual Motion," otherwise known as the NASDAQ Biotechnology Index, chartered to pursue the immortality of billionaire baby boomers.

Let us consider the lifecycle of a biotech company: it spends cash every year with no income at all, until, hopefully, one day, a larger company buys it. In other words, there is a certainty of negative cash flows with a contingent bullet payment in the indefinitely distant future.

As rates go negative, the contingent future payment (the bird in the bush) overwhelms the current negative cash flows (the two birds in the hand). Valuations of such companies are aided the most when rates drop.

NASDAQ Composite vs. S&P 500



We see the same phenomenon comparing the NASDAQ Composite and the S&P 500. As rates go negative, the NASDAQ, comprised of growth companies with more distant cash flows, goes berserk and, therefore, attracts more capital.

This is why companies from GE to IBM to Carmax have formed internal banks to advance credit to their customers—they ship product today, but prefer to be paid in five years: pushing cash flow into the future makes sense in a negative interest rate environment. No one wants the bird today.

The bubble must burst. Effort expended on flattening the Rockies and developing bodies of perpetual motion is effort diverted from the satisfaction of present economic needs. Only ever greater monetary interventions may camouflage the distortions of capital structure. The scarcity of present goods will eventually force prices to reflect real conditions. This is the "financial crisis," and it will mean the more future, the more contingent, an asset, the greater will be its decline in value. Equities, those companies that purport to have infinite cash flows, will collapse.

Gold is a current asset, with no future cash flows—it is the financial opposite of biotech. This is why gold is the ultimate loser during the growth of a credit bubble, but a sure winner when it collapses. It is why gold mining companies will go from being worth next to nothing to something, a nearly infinite percentage increase.