Beware the QE Trojan Horse  
October 15, 2019  
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“What’s in a name? That which we call a rose,

By any other name would smell as sweet.”

Juliet Capulet in Romeo and Juliet by William Shakespeare

The turmoil from the mid-September crisis in the repo funding market has not subsided. Indeed, some are calling for aggressive policy actions to prevent a recurrence. Regardless of what those policies are called, they are nothing more than thinly disguised quantitative easing (QE).

The mid-September repo crisis continues to weigh on market participants. The Federal Reserve quickly addressed soaring overnight funding costs through a special repo financing facility not used since the great financial crisis (GFC). The re-introduction of repo facilities has, thus far, resolved the matter. It remains interesting that so many articles are being written about the problem, including my own.

The on-going concern stems from the fact that the world’s most powerful central bank briefly lost control over the one rate they must control.

The Fed’s measures to calm funding markets, although superficially effective, may not address bigger underlying issues. Indeed, the on-going media attention to such a banal and technical topic is indicative of deeper problems. The Fed has applied a tourniquet and gauze to a serious wound, but permanent medical attention is still desperately needed.

The Fed is in a difficult position. As I discussed in Understanding the Great Repo Fiasco, they are using temporary tools that require daily and increasingly larger efforts to assuage the problem. Taking more drastic and permanent steps requires aggressive easing of monetary policy at a time when the U.S. economy is relatively strong and stable. Such policy is not warranted and could incite the most underrated of all threats, inflationary pressures.

Hamstrung
The Fed is hamstrung by an economy that has benefited from low interest rates and stimulative fiscal policy and is the strongest in the developed world. By all appearances, the U.S. is also running at full employment. At the same time, a hostile president is sniping at the Fed governors to ease policy dramatically. The Federal Reserve board has rarely seen as much internal dissension as recently observed. The current fundamental and political environment is challenging, to be kind.

Two main alternatives to resolve the funding issue are:

1. More aggressive interest rate cuts to steepen the yield curve and relieve the banks of the negative carry in holding Treasury notes and bonds; and

2. Re-initiating QE by having the Fed buy Treasury and mortgage-backed securities from primary dealers to re-liquefy the system.

The only real “permanent” solution is the second option, re-expanding the Fed balance sheet through QE. The Fed constrained since there is no fundamental justification (remember “we are data-dependent”) for such an action. Further, Powell, when asked, said they would not take monetary policy actions to address the short-term temporary spike in funding needs. Whether Powell likes it or not, not taking such an action might force the need to take that very same action, and it may come too late.

Advice from those who caused the problem

There was an article recently written by a former Fed official now employed by a major hedge fund manager.

Brian Sack is a director of global economics at the D.E. Shaw Group, a hedge fund conglomerate with over $40 billion under management. Prior to joining D.E. Shaw, Sack was head of the New York Federal Reserve Markets Group and manager of the system open market account (SOMA) for the federal open market committee (FOMC). He also served as a special advisor on monetary policy to President Obama while at the New York Fed.

Sack, along with Joseph Gagnon, another ex-Fed employee and currently a senior fellow at the Peterson Institute for International Economics, argued that the Fed should first promptly establish a standing fixed-rate repo facility and, second, “aim for a higher level of reserves.” Although Sack and Gagnon did not concede that reserves are “low,” they argued that whatever the minimum level of reserves may be in the banking system, the Fed should “steer well clear of it.” Their recommendation is for the Fed to increase the level of reserves by $250 billion over the next two quarters. Furthermore, they argued for continued expansion of the Fed balance sheet as needed thereafter.

What they recommend is monetary policy slavery. No matter what language they use to rationalize and justify such solutions, it is pure pragmatism and expediency. It may solve short-term funding issues for the time being, but it will leave the U.S. economy and its citizens further enslaved to the consequences of runaway debt and the monetary policies designed to support it.

If it walks and quacks like a duck …
Sack and Gagnon did not give their recommendation a sophisticated name, but neither did they call it “QE.” Simply put, their recommendation is in fact a resumption of QE regardless of what name it is given.

To them it smells as sweet as QE, but the spin of some other name and rationale may be more palatable to the public. By not calling it QE, it may allow the Fed more leeway to do QE without being in a recession or bringing rates to near zero in attempts to avoid becoming a political lightning rod.

The media appears to be helping with what increasingly looks like a sleight of hand. Joe Weisenthal from Bloomberg proposed the following on Twitter:

To help you form your own opinion, let’s look at some facts about QE and balance sheet increases prior to the QE era. From January 2003 to December 2007, the Fed’s balance sheet steadily increased by $150 billion, or about $30 billion a year. The proposal from Sack and Gagnon calls for a $250 billion increase over six months. QE1 lasted six months and increased the Fed’s balance sheet by $265 billion.

This proposal is a mirror image of QE.

Summary

The challenge is that those former Fed officials do not realize that the policies they helped create and implement were a big contributor to the financial crisis a decade ago. The problems the financial system is now enduring are a result of the policies they implemented to address the crisis.
Their proposed solutions, regardless of what they call them, are another round of imprudent policies to address problems caused by the responses to the GFC.

Michael Lebowitz is the founding partner of 720 Global and partner with Real Investment Advice. We assist our clients in differentiating themselves from the crowd with a focus on value, performance and a clear, lucid assessment of global market and economic dynamics. For more information about our upcoming subscription service RIA Pro, please contact us at 301.466.1204 or email mplebow@720global.com.