

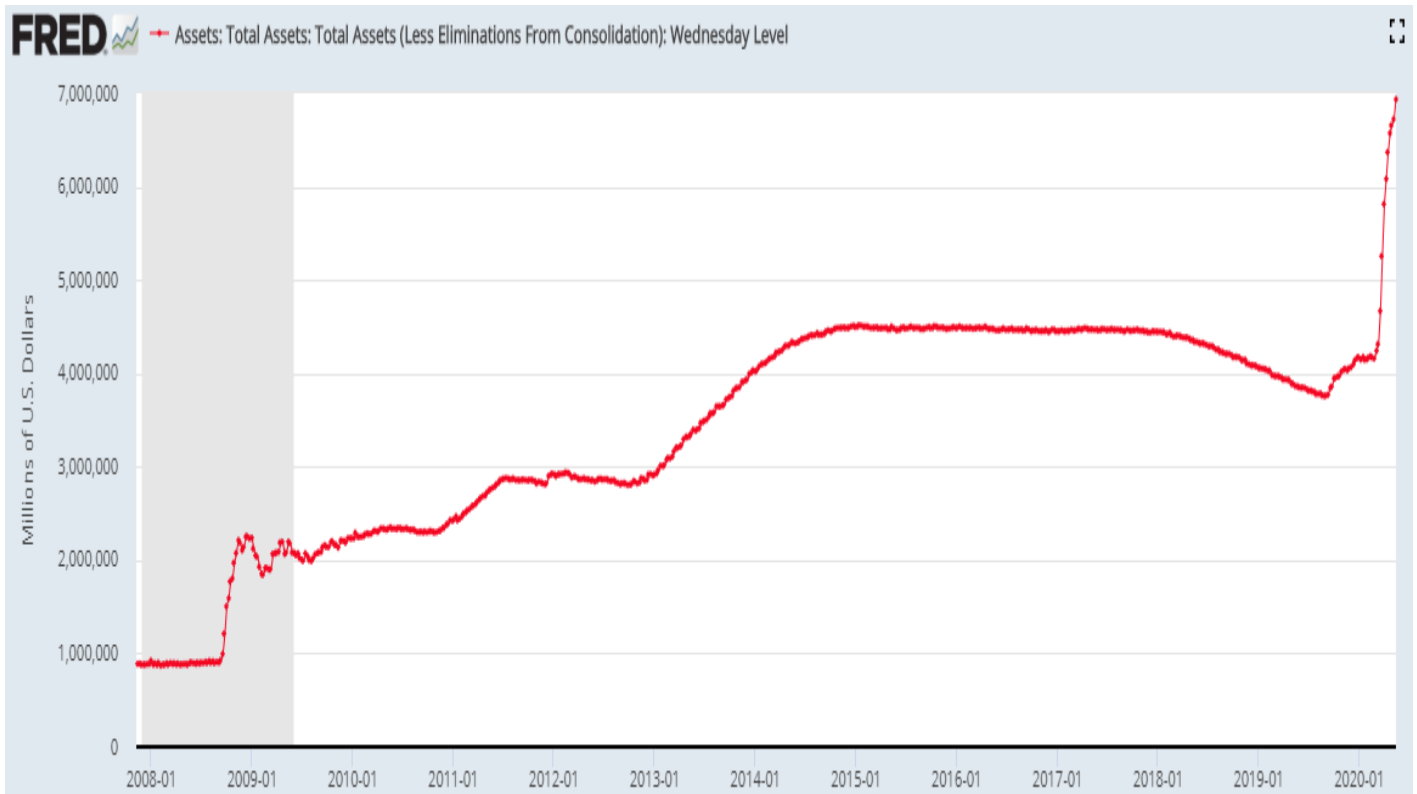
The Fed Enters Monetary Light Speed

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Ben Kenobi: How long before you make the jump to lightspeed? Han Solo: It'll take a few moments to get the coordinates from the navicomputer. Luke Skywalker: Are you kidding??! At the rate they're gaining? Han Solo: Traveling through hyperspace ain't like dusting crops, boy! ? Star Wars, Episode IV

Light Speed


In the early Star Wars movies, Han Solo was the captain of the rusting Millennium Falcon spaceship. When making a daring escape, Solo would command the ship to jump to light speed. The surrounding stars would blur in streaks as they left their pursuers in stardust and suddenly ended up somewhere across the galaxy far, far away. On April 9, 2020, the Fed made the jump to light speed with their announcements of even more remarkable stimulus packages. The new operations were in addition to the myriad of operations in March and prior months. To define monetary light speed, the Fed's balance sheet rose from \$3.76 trillion at the end of August 2019 to \$4.16 trillion at the end of February 2020 ? a change of \$400 billion. As of May 13, 2020 it was at \$6.93 trillion. A shocking increase of \$2.77 trillion in ten weeks, dwarfing anything seen during the financial crisis.



Having promised to purchase Treasuries, mortgages, and municipal bonds, in whatever amount necessary, they set off on a new path. Now they can buy investment grade corporate securities, high yield bonds (junk), and even certain Collateralized Loan Obligations (CLOs - the securitized form of high-risk leveraged loans). These operations will take place through the newly formed Secondary Market Corporate Credit Facility (SMCCF). Per the Federal Reserve Act, the Fed can only purchase or lend against securities that have a government guarantee. So how can they purchase non-government guaranteed securities?

SPV Back Door

The simple answer is the Treasury is enabling the Fed to side-step the law, or to be more accurate, break the law. As the Fed's accomplice, the Treasury Department provides \$75 billion of initial funding from the Exchange Stabilization Fund. The funds are deposited into a special purpose vehicle (SPV), and specifically aimed to purchase secondary market corporate bonds. Technically, the Treasury, not the Fed, is buying those securities on behalf of taxpayers. Enter the co-conspirator. The Fed, acting as an intermediary and employing asset manager BlackRock, intends to leverage that amount ten times. This allows the Fed to buy an additional \$675 billion in securities and select Exchange Traded Funds (ETFs).



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Calling Out the Fed

As John Hussman described on April 20, 2020, Congress never granted that authority (the leverage) to the Fed, making such a maneuver illegal. *?? additional purchases to ?leverage? that funding are neither secured by non-financial collateral, nor have security sufficient to protect taxpayers from losses. They are illegal, both under Section 13(3) of the Federal Reserve Act, and under Section 4003(c)(3)(B) of the CARES act, which ?for the avoidance of doubt? specifically invokes 13(3) ?requirements relating to loan collateralization, taxpayer protection, and borrower solvency.? Given the leverage and speculative nature of the securities the Fed is acquiring in the SMCCF (SPV) scheme, a 10% drop or more in the value of the SPV assets would result in immediate insolvency and losses to taxpayers. In simple terms:*

- The Treasury Department funds the SMCCF SPV with \$75 billion (a legal action)
- The Fed acting as the intermediary of the SPV, stated they may leverage those funds 10 times (an illegal action)
- If at any point up to the \$750 billion of investments made through the SPV, the value of held assets drops by more than the initial \$75 billion funded by the Treasury, the loss is in breach of what Congress authorized.
- The assets the Fed will buy do not meet the stated requirement of sufficient security intended *?for the avoidance of doubt?* about the potential for loss (to the taxpayer). It is an illegal structure.

If the economy and markets regroup, borrowing and consumption patterns return to pre-virus outbreak levels, and investors shed all fears of another leg down in markets, then maybe we can sound the all-clear.

Economic Reality

However, even Pollyanna would not subscribe to such an optimistic path. **Unemployment in April**

was **14.8%**, consumer spending, industrial production, and confidence are plummeting. Every industry and many individuals have their hands out for taxpayer-sponsored relief (bailout). **GDP is expected to drop by 12-15% in the second quarter and that may be optimistic. In a May 17th 60 Minutes interview, Fed Chairman Jerome Powell said it could be down as much as 30%.** Making matters worse, the economic carnage affects all industries and is global in nature. As if depression-like economic data were not enough, there is not yet a therapy or vaccine for the Coronavirus. Although there is little doubt one will be forthcoming, the timing is uncertain and appears to be, at best, months out in the future. The probability of corporate losses on the Treasury's balance sheet amounting to over \$75 billion is not at all unrealistic. Plus, there is the continuing uncertainty in the economic outlook despite hopes for the economy to reopen gradually. Current valuations of the bonds in the Fed's SPV do not adjust for the risk of a global economic outlook that is more constrained and restricted than at any time since the great depression. Again, from John Hussman: *"As a result, the newly created SMCCF is either a Ponzi scheme at public expense (if the Fed plans to allow portfolio losses to exceed 10%) or a 1987-style portfolio insurance scheme (if the Fed plans to liquidate securities into a falling market in order to cap its losses at 10%)."* Pick your poison.

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Fed Independence

The SPV scheme applies to several non-traditional [lending facilities](#) also used in the 2008 financial crisis and many [new facilities](#). The collaboration merges the Fed and the Treasury into one organization. This plan follows a recommended script published as an [Op-Ed by former Fed Governor Kevin Warsh](#) in the Wall Street Journal on March 15, 2020.

Winners and Losers

The SPV scheme was used on a limited basis with much higher quality assets during the financial crisis but was quickly unwound as the economy recovered. Given the expansion of powers this time, we should assume these actions could reduce Jay Powell's authority over monetary policy. Essentially he is indirectly ceding control of our "independent" central bank to the Treasury Department. **The risk is that the executive branch may end up with dominant influence over certain important operations at the Fed.** What this means is that the line between monetary and fiscal policy is even further blurred given the exposure taxpayers unknowingly assume for losses on risky SPV holdings. Corporate executives reaped unwarranted multi-million-dollar rewards for short-term-oriented, profit-maximizing behavior over the past ten years. However, once again, the taxpayers, most of whom did not benefit from irresponsible corporate and fiscal actions are on the hook. The SPV structure allows the Fed and Treasury to nationalize major segments of the financial markets. With that, the credibility of pricing signals is lost. The capital markets are not only crucial for raising capital but equally important in the way they offer traffic signals to businesses and individuals concerning true economic conditions. Without these signals, capital allocation becomes distorted, and productivity growth flounders. Based on observations over the past ten years, it is safe to say we are well past that point. **If Jay Powell and Steve Mnuchin were legislated to assume personal risk in their scheme, would they be willing to accept it? No. Certainly, they would not accept it.**

Summary

It is shameful to watch the blatant abuse of power where Constitutional order requires the Fed and other government officials to abide by proper laws intended to restrict such behavior. As recently as January's impeachment hearings, both sides of Congress were well-versed in quoting from the Constitution. Today, however, the laws of those guiding documents are largely ignored. By most accounts, it seems very likely that the Fed will, sooner or later, buy equities in the ultimate act of expediency. Buying high yield bonds is but one very short step away from the next level down in the risk continuum ? stocks. With the Fed now engaged in light speed monetary policies, our future is likely to include:

- Zero bound and potentially negative interest rates
- A lower natural economic growth rate
- An even larger wealth inequality gap
- Loss of Fed independence from the Executive branch of government
- Price *instability* (deflation then inflation)
- Significant and damaging volatility
- Nationalized financial markets
- Irrelevant market signals

The Fed does not have the benefit of Star Wars technology or Hollywood special effects to avoid fostering ever new mutant forms of moral hazard. Quite the opposite, in fact. Their monetary ?navicomputer? does not protect against the economic equivalent of slamming into a stray asteroid or planet. Indeed, it seems more likely to steer the country into such a disaster. Every crisis provides the latitude for an ever-greater power grab without regard for constitutional authority. The virus is inconvenient, but the policy actions taken with no regard of forethought are quite another matter. No, the Fed is not ?dusting crops? at this stage.