On Tuesday, Federal Reserve Chairman Jerome Powell, in his opening remarks at a monetary policy conference in Chicago, raised concerns about the rising trade tensions in the U.S.,

> *?We do not know how or when these issues will be resolved.* ***As always, we will act as appropriate to sustain the expansion, with a strong labor market and inflation near our symmetric 2 percent objective.?***

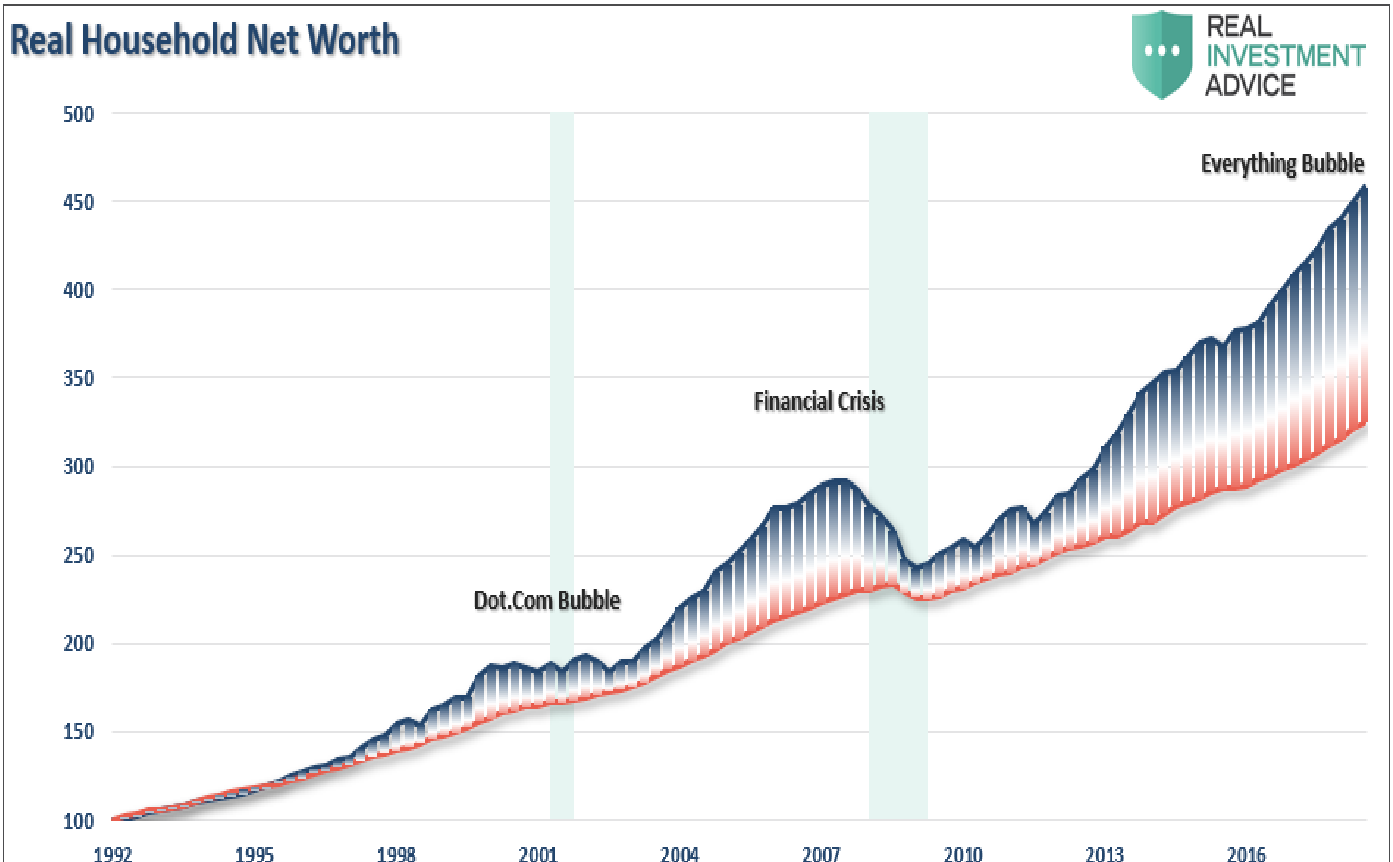
However, while there was nothing *"new"* in that comment it was his following statement that sent *"shorts"* scrambling to cover.

> *?In short, the proximity of interest rates to the ELB has become the preeminent monetary policy challenge of our time, tainting all manner of issues with ELB risk and imbuing many old challenges with greater significance.*•***?Perhaps it is time to retire the term ?unconventional? when referring to tools that were used in the crisis. We know that tools like these are likely to be needed in some form in future ELB spells, which we hope will be rare.?***

As Zerohedge noted:

> *"To translate that statement, not only is the Fed ready to cut rates, but it may take 'unconventional' tools during the next recession, i.e., NIRP and even more QE."*

This is a very interesting statement considering that these tools, which were indeed **unconventional *"emergency"* measures** at the time, have now become standard operating procedure for the Fed. Yet, these *"policy tools"* are still untested. Clearly, QE worked well in lifting asset prices, but not so much for the economy. In other words, QE was ultimately a massive *?wealth transfer?*•from the middle class to the rich which has created one of the greatest wealth gaps in the history of the U.S., not to mention an asset bubble of historic proportions.



However, they have yet to operate within the confines of an economic recession or a mean-reverting event in the financial markets. **In simpler terms, no one knows for certain whether the bubbles created by monetary policies are infinitely sustainable? Or, what the consequences will be if they aren't.**

The other concern with restarting monetary policy at this stage of the financial cycle is the backdrop is not conducive for *"emergency measures"* to be effective. As we wrote in ["QE, Then, Now, & Why It May Not Work:"]

> *"If the market fell into a recession tomorrow, the Fed would be starting with roughly a **$4 Trillion** balance sheet with interest rates 2% lower than they were in 2009. In other words, the ability of the Fed to ?bail out? the markets today, is much more limited than it was in 2008. But there is more to the story than just the Fed?s balance sheet and funds rate. The entire backdrop is completely reversed. The table below compares a variety of financial and economic factors from 2009 to present.*

	Then 1/1/2009	Now 1/1/2019	Change
Fed Funds	0.15%	2.40%	2.25%
10-Year Treasury	2.52%	2.68%	0.16%
Nominal GDP	-1.75%	5.34%	7.09%
Inflation Rate	-0.12%	1.52%	1.64%
Unemployment Rate	7.80%	4.00%	-3.80%
Jobless Claims (4-wk Avg.)	543500	229000	-314500
Shiller CAPE-10	19	28	9
Government Debt (Trillion)	$11.10	$22.00	$10.90
Private Non-Residential Fixed Inv.	-1.25%	8.61%	9.86%
Existing Home Sales	3820000	4370000	550,000
New Home Sales	336000	657000	321,000
Consumer Sentiment	61.2	91.2	30
NFIB Survey	83.9	101.2	17.3
PCE	-1.47%	3.98%	5.45%
Retail Sales	-11.48%	4.01%	15.49%
Leading Economic Indicators	76	111.3	35.3
Total Vehicle Sales (Million)	9.79	17.13	7.34
RIA Economic Composite	4.23	37.75	33.52

Fed Balance Sheet	$915 Billion	$4.115 Trillion	$3.2 Trillion

> ***"The critical point here is that QE and rate reductions have the MOST effect when the economy, markets, and investors have been 'blown out,' deviations from the 'norm' are negatively extended, confidence is hugely negative.*** *In other words, there is nowhere to go but up."*

The extremely negative environment that existed, particularly in the asset markets, provided a fertile starting point for monetary interventions. Today, as shown in the table above, the economic and fundamental backdrop could not be more diametrically opposed. This suggests that the Fed?s ability to stem the decline of the next recession, or offset a financial shock to the economy from falling asset prices, may be much more limited than the Fed, and most investors, currently believe. While Powell is hinting at QE4, it likely will only be employed when rate reductions aren?t enough. Such was noted in 2016 by David Reifschneider, deputy director of the division of research and statistics for the Federal Reserve Board in Washington, D.C., released a staff working paper entitled *?Gauging The Ability Of The FOMC To Respond To Future Recessions.?*•The conclusion was simply this:

> *?Simulations of the FRB/US model of a severe recession**suggest that large-scale asset purchases and forward guidance about the future path of the federal funds rate•should be able to provide enough additional accommodation**•to fully compensate for a more limited [ability] to cut short-term interest rates in most,**but probably not all, circumstances.?***

In effect, Powell has become aware he has become caught in a liquidity trap. Without continued "emergency measures" the markets, and subsequently economic growth, can not be sustained. This is where David compared three policy approaches to offset the next recession:

1. ***Fed funds goes into negative territory but there is no breakdown in the structure of economic relationships.***
2. ***Fed funds returns to zero and keeps it there long enough for unemployment to return to baseline.***
3. ***Fed funds returns to zero and the FOMC augments it with additional $2-4 Trillion of QE and forward guidance.•***

This is exactly the prescription that Jerome Powell laid out on Tuesday suggesting the Fed is already factoring in a scenario in **which a shock to the economy leads to additional QE of either $2 trillion, or in a worst case scenario, $4 trillion,**•effectively doubling the current size of the Fed?s balance sheet. This is also why 10-year Treasury rates are going to **ZERO.**

Why Rates Are Going To Zero

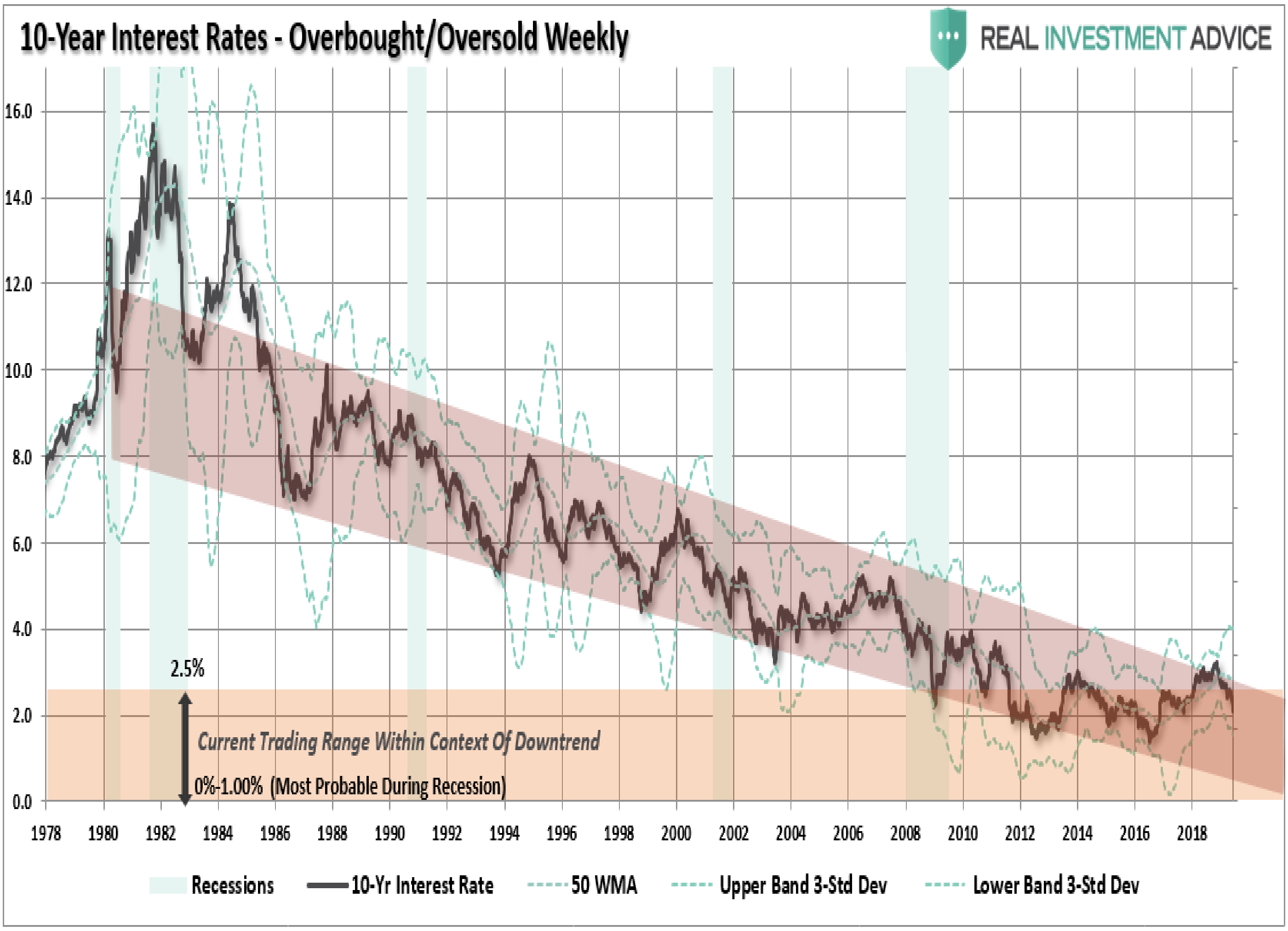
I have been discussing over the last couple of years why the death of the bond bull market has been greatly exaggerated. To wit: **(Also read: *The Bond Bull Market*)**

> *"There is an assumption that because interest rates are low, that the bond bull market has come to its inevitable conclusion. The problem with this assumption is three-fold:*
>
> 1. ***All interest rates are relative.** With more than $10-Trillion in debt globally sporting negative interest rates, the assumption that rates in the U.S. are about to spike higher is likely wrong. Higher yields in U.S. debt attracts flows of capital from countries with negative yields which push rates lower in the U.S. Given the current push by Central Banks globally to suppress interest rates to keep nascent economic growth going, an eventual zero-yield on U.S. debt is not unrealistic.*
> 2. ***The coming budget deficit balloon.** Given the lack of fiscal policy controls in Washington, and promises of continued largesse in the future, the budget deficit is*

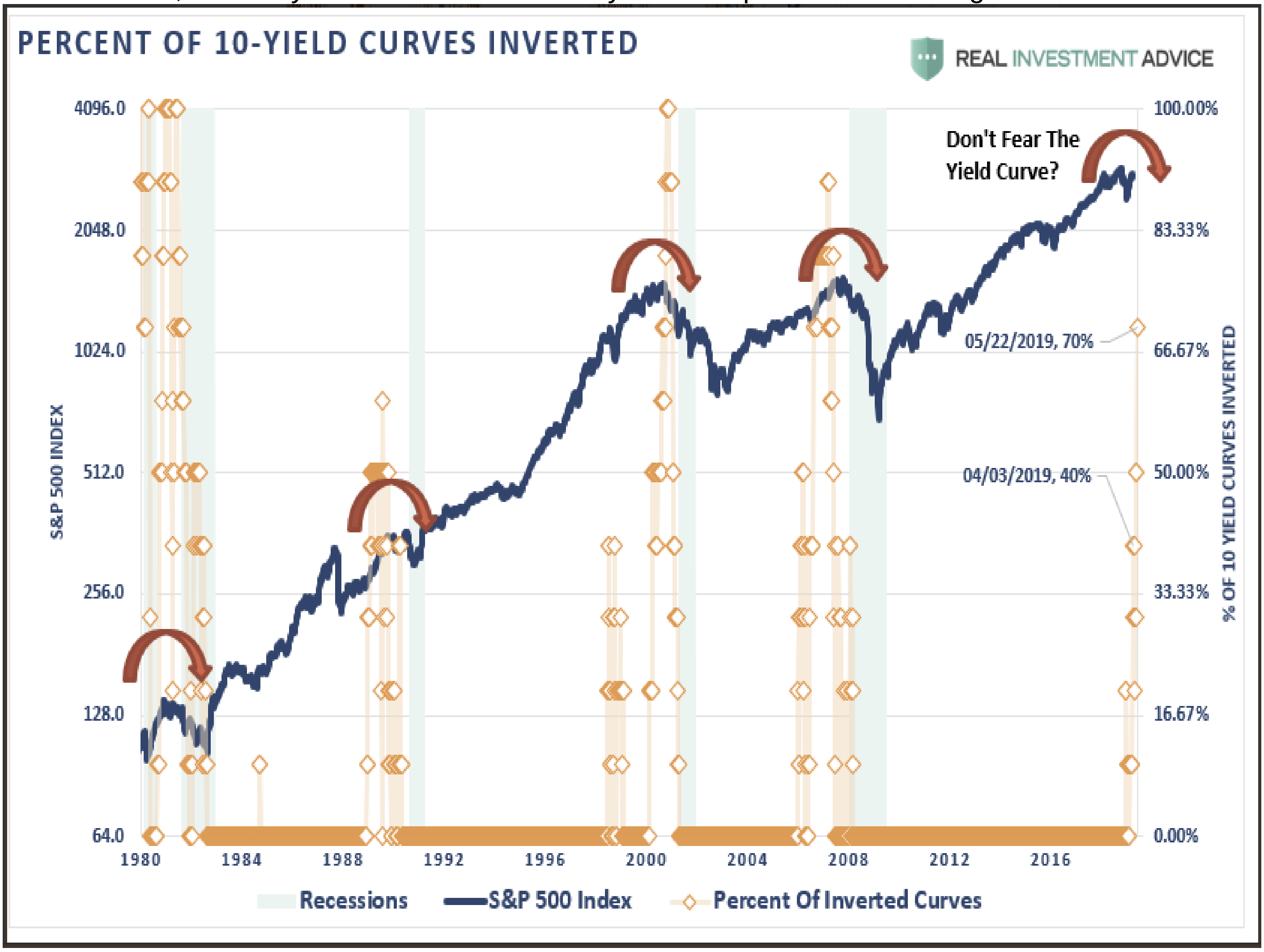
set to swell back to $1 Trillion or more in the coming years. This will require more government bond issuance to fund future expenditures which will be magnified during the next recessionary spat as tax revenue falls.

3. ***Central Banks will continue to be a buyer of bonds** to maintain the current status quo, but will become more aggressive buyers during the next recession. The next QE program by the Fed to offset the next economic recession will likely be $2-4 Trillion which will push the 10-year yield towards zero."*

It's item #3 that is most important. In "Debt & Deficits: A Slow Motion Train Wreck" I laid out the data constructs behind the points above. However, it was in April 2016, when I stated that with more government spending, a budget deficit heading towards $1 Trillion, and real economic growth running well below expectations, the demand for bonds would continue to grow. Even from a purely **technical perspective, the trend of interest rates suggested at that time a rate below one-percent was likely during the next economic recession.**



Outside of other events such as the S&L Crisis, Asian Contagion, Long-Term Capital Management, etc. which all drove money out of stocks and into bonds pushing rates lower, **recessionary environments are especially prone at suppressing rates further**. But, given the inflation of multiple asset bubbles, a credit-driven event that impacts the corporate bond market will drive rates to zero. Furthermore, given rates are already negative in many parts of the world, which will likely be even more negative during a global recessionary environment, zero yields will still remain more attractive to foreign investors. **This will be from both a potential capital appreciation perspective *(expectations of negative rates in the U.S.)* and the perceived safety and liquidity of the U.S. Treasury market.** Rates are ultimately directly impacted by the strength of economic growth and the demand for credit. **While short-term dynamics may move rates, ultimately the fundamentals combined with the demand for safety and liquidity will be the ultimate arbiter.** With the majority of yield curves that we track now inverted, many economic indicators flashing red, and financial markets dependent on *"Fed action"* rather than strong fundamentals, it is likely the bond market already knows a problem in brewing.



However, while I am fairly certain the?*facts?*•will play out as they have historically, rest assured that• **if the?*facts?*•do indeed change,** I will gladly change my view. **Currently, there is NO evidence that a change of facts has occurred.** Of course, we aren't the only ones expecting rates to go to zero. [As Bloomberg noted:]

> *"Billionaire Stan Druckenmiller said he could see the Fed funds rate going to zero in the next 18 months if the economy softens and that he recently piled into Treasuries as the U.S. trade war with China escalated. 'When the Trump tweet went out, I went from 93% invested to net flat, and bought a bunch of Treasuries,' Druckenmiller said Monday evening, referring to the May 5 tweet from President Donald Trump threatening an increase in tariffs on China. 'Not because I?m trying to make money, I just don?t want to play in this environment.'?*

It has taken a massive amount of interventions by Central Banks to keep economies afloat globally over the last decade and there is rising evidence that growth is beginning to decelerate. **While another $2-4 Trillion in QE might indeed be successful in further inflating the third bubble in asset prices since the turn of the century,** there is a finite ability to continue to pull forward future consumption to stimulate economic activity. **In other words, there are only so many autos, houses, etc., which can be purchased within a given cycle.**•There is evidence the cycle peak has been reached. If I am correct, and the effectiveness of rate reductions and QE are diminished due to the reasons detailed herein, the subsequent destruction to the?*wealth effect?*•will be far larger than currently imagined. **There is a limit to just how many bonds the Federal Reserve can buy and a deep recession will likely find the Fed powerless to offset much of the negative effects.**•If more ?QE? works, great. But as investors, with our retirement savings at risk, what if it doesn?t?