With a Little Help from My Friends

By Vineer Bhansali| November 2, 2022

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I recently listened to the angst filled cover version of the Beatles classic "With A Little Help From My Friends", by bluesy crooner Joe Cocker. If you have not heard it recently, please quit reading right now and play it.

Here is how the chorus goes:

Oh, I get by with a little help from my friends
Mm, gonna try with a little help from my friends
Oh, I get … with a little help from my friends
Yes, I get by with a little help from my friends
With a little help from my friends

Having been in the markets for over 30 years, when I asked my own friends the question of whether the Fed's "losses" on its bond holdings and cash-flows matter, I thought I saw eyes roll, as in – "that's a stupid question". Of course, according to conventional wisdom, the Fed's losses don't matter, because the Fed can literally print more money whenever it wants. From a simple accounting perspective, all the Fed has to do is to create an IOU -- i.e., a "deferred asset" -- which it will pay back in the future. So, we are assured, don't worry about it.

To channel my inner Andy Grove, "only the paranoid survive". And in my case, this is by expecting the unexpected. This frequently starts by asking the question: what if the conventional wisdom is not entirely correct? What if, in the present case, the Fed's losses actually become a BIG political problem, if not a pure economic problem? In this world of a very politicized Fed, can political pushback become a problem for markets? And if so, what can investors do to position for it?

As we all know by now, the Fed printed trillions of dollars over the last few years to buy bonds and prop up the pandemic economy. But as they raise interest rates from close to 0% to almost 4% this week (with a 0.75% increase baked in) in the most rapid pace of tightening in decades, the bond market has had one of the worst selloffs in history. As a result, the bond holdings that the Fed currently owns have a "mark-to-market" loss of a few hundred billion dollars, and the Fed is paying more on its liabilities than it is earning on its bonds.

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How did we get here? The Fed, as I have said before, works for its not-so-little friends -- i.e., the commercial banks -- and ensures their profitability, directly or indirectly. This is by symbiotic design, since in the Fed's rhetoric, banks are central for policy transmission. No banks, no Fed. Period. Right now, as anyone with a basic savings account knows, the banks are paying close to nothing on deposits. But because the trillions of dollars of reserves the banks were given as part of the Fed money printing are earning a lot more on the interest on reserves (see here), the banks are arbitraging the public with the blessing of the Fed. On top of the $3 trillion or so in the bank reserve facility, another $2 trillion is in the bank reverse repo facility where the Fed pays interest to money market funds, and the money market funds also get paid hefty fees to recycle the money, thanks to the taxpayers' generosity.

In trader lingo, the Fed is in a public-financed negative carry trade where it is losing money to hold on to its bond assets which are also losing money as their prices fall – and as the Fed itself runs off its balance sheet or raises rates, it further impairs its own P&L. Onetime Fed hopeful and gold bug Judy Shelton wrote up the math here. The bottom line is the Fed will be running a negative cash-flow balance of tens of billions per year, which the taxpayer, via the Treasury, has to make up. And of course, if the Fed actually starts to sell off the bonds, as it might have to do with some of its mortgage bonds, it will "lock in" a loss.

As the Fed raises rates and slows the economy down, and possibly creates increases in unemployment and a recession, the need to pay the banks and money market funds and

foreign entities will require the Treasury to issue more bonds, for which eventually the US public is obviously responsible. And where does this money come from? From taxes, current and/or future. This is stuff of which political nightmares are made.

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Ever since I have been trading in the bond markets, it is well known that the Fed "leaks" controversial decisions to the press to help guide the markets. Market participants know who the Fed's mouthpiece in the press is at any given time. The reason is simple – by engineering a news article "trial balloon", the Fed can gauge the response of the markets without having to say anything themselves, especially during the self-imposed quiet period surrounding important FOMC meetings. A couple of days ago there was such an article in the Wall Street Journal by the current Fed proxy in the press (here). Anticipating congressional posturing, the article pre-empts the political impact of "losses": "*If the Fed runs sustained losses, it won't have to turn to Congress, hat in hand. Instead, it will simply create an IOU on its balance sheet called a deferred asset. When the Fed runs a surplus again in future years, it would first pay off the IOU before sending surpluses to the Treasury*".

The Fed's own analysis on the matter conveniently sweeps the concerns under the rug by acknowledging that while there will be a cash-flow loss, at some point in the future the liabilities will be paid off. They anticipate this return-to-profitability date to be in 2026, if the income from the assets it owns exceed the interest rates it has to pay. Note this forecast assumes the Fed will be successful in quashing inflation (fingers crossed), and short-term rates will eventually start to come back down below the yield on the Fed's assets (the yield is currently estimated to be around 2.3%). The inflation surge of 2022 was caused by easy monetary policy and helicopter drops of cash from the government, which consumers in turn used to go on a spending spree. What makes us think raising interest rates alone, accompanied with a small amount of asset runoff, can bring inflation down that much and

that quickly?

We do have to concede that the inability of the Fed to be "profitable", from a purely economics point of view, is irrelevant. It's not a company beholden to shareholders. The US can essentially print an infinite amount of dollars to pay its debt. In other words, the principal, in nominal terms, is not at risk. So I agree with the pundits – this is not an economics issue. But it will become a hot political issue. And because the Fed has lost a lot of credibility, I suspect politics will begin to play an important role in the perception of the Fed and hence its ability to make decisions, including making soft pivots, or the new "step-down" language to appease the political overlords.

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When push comes to shove, the Fed will buckle under political pressure. There are many ways this can happen. The Fed could simply decide to reduce the interest it is paying on the reserves and on the reverse repo facility. This is unlikely to happen while the Fed is tightening. Any reduction of the rate paid on the reserves would be considered by the market to be an "ease", which the Fed is probably not going to want to communicate. But if the Treasury bond market crashes further, the Fed might actually pivot to easier policy in the name of "financial instability concerns", and be able to reduce both interest rates and the interest rate paid on reserves.

The Fed could also reduce the size of the reserve facility; i.e., force the banks and money market funds to buy actual Treasuries and other bonds instead of paying them interest on reserves. It could achieve this by offering some of its own bonds for purchase. But in order to pull this off, the Fed would need to offer the banks a carrot as in a reward for taking the bonds off its own balance sheet. Part of the reason is that the traditional "friends", i.e. foreign central banks, are not buying too many Treasuries today, and might even be liquidating a few to generate much needed dollars, so no help from those friends. Indeed, if the Treasury

actually underwrites a backstop facility for buybacks, as was recently proposed, this would give the banks a reason to buy the bonds, come as this will with a money-back guarantee of sorts from their friends in high places. This could also be done in "tiers", as was done by the European Central Bank, where only a certain amount of assets would get the full interest on reserves. The limit could be linked to the banks passing some of the benefit through higher deposit rates to consumers. Honestly, I see the prospects of profit sharing with the public to be quite dim.

So we know the Fed is stuck. The current posture of running a negative cash-flow, negative carry trade on dissipating assets is a gamble. If the gamble does not pay off, there will be lots of political noise. You can count on it. And that noise will probably lead to a call for further supervision of the Fed. On balance, this will leave the Fed less flexibility to come to the rescue of risk markets the next time there is a stock market crash.

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Faced with these choices, the path of least resistance seems to be leading to a compromise. In that world, more debt is incurred by the Treasury and the Fed buys that debt to keep rates and the cost of financing low. This also means inflation remains sticky and high for a while. Japan has done this for decades now, and they still rank third in global GDP. So I would hunker down for a steady state of inflation of 3%-4% for the next few years, and with a little help from some friends in DC, the Fed will be able to change its inflation goals. In a world where a political compromise is inevitable, the short end of the Treasury yield curve, in particular inflation-linked bonds, are to me the obvious places to invest while we wait for the dust to settle.

And with a little more help from our bank friends, we might even earn a few cents on that long-suffering savings account while we wait.

Important Disclosures

Vineer Bhansali, Ph.D. is the Founder and Chief Investment Officer of LongTail Alpha, LLC, an SEC-registered investment adviser and a CFTC-registered CTA and CPO. Any opinions or views expressed by Dr. Bhansali are solely those of Dr. Bhansali and do not necessarily reflect the opinions or views of LongTail Alpha, LLC or any of its affiliates (collectively, “LongTail Alpha”), or any other associated persons of LongTail Alpha. You should not treat any opinion expressed by Dr. Bhansali as investment advice or as a recommendation to make an investment in any particular investment strategy or investment product. Dr. Bhansali’s opinions and commentaries are based upon information he considers credible, but which may not constitute research by LongTail Alpha. Dr. Bhansali does not warrant the completeness or accuracy of the information upon which his opinions or commentaries are based.

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