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Something to Think About

OAKWORTH CAPITAL BANK

COMMON CENTS

This week, the Federal Reserve announced it would continue with its $85 billion/month bond buying program, and the markets were positively giddy. Hooray! The Fed is going to flood the banking system with even more money that will slosh about in "cash assets" on bank balance sheets.

Never mind banks haven't lent out all but a few pennies of the first $3 trillion or so the Fed has created out of thin air over the last several years. What harm will another $85 billion, or so, for the next several months do? My thoughts exactly. Frankly, there is little reason NOT to keep dumping brand new cash on the economy, because it isn't going anywhere.

Banks aren't lending it out, or even really investing it. Instead, it sits in "cash" at the Federal Reserve earning up to 0.25%. Now, when I mean sitting in cash, I mean sitting in cash. In Dec 2007, commercial banks in the United States had an estimated $293.5 billion in "cash assets" according to the Fed's H.8 report. They had over $2.378 trillion during August 2013.

Obviously, that is an increase of over $2 trillion, actually $2.085.2 trillion, which is a lot of money. Over that same time frame, the Fed's balance sheet has grown from $877.148 billion, as of the last weekly reading in December 2007 (H.4.1 report), to $3.061 trillion as of the end of August 2013. That is an increase of $2.184 trillion.

Doing some quick ciphering, I can conclude most of the Fed's "new money," with which it increased its assets, and doing a whole bunch of nothing. In fact, less than $100 billion of that $2.184 trillion is doing something other than the financial equivalent of gathering dust.

What's more, the Fed has added $1.269 trillion in US Treasury securities to its balance sheet, taking the total to $2.024 trillion. This is more than the sum total of the entire commercial banking system in the United States, which owned $1.7823 trillion in US Treasury AND Agency debt as of last month.

Meanwhile, foreigners have increased their holdings of US Treasury securities from $2.353 trillion to $5.590 trillion over this same time frame. *This is an increase of $3.237 trillion. For fun, the Chinese have upped their holdings $800 billion, and the Japanese some $550 billion.*

So, what does this mean? If foreigners own $5.590 trillion in US Treasury debt, and the Federal Reserve owns another $2.024 trillion, combined they own $7.614 trillion. Since there was $11.586 trillion in publicly traded, marketable US Treasury debt at the end of August 2013, this means the US private sector is financing less than 35% of the Treasuries accumulated public debt.

I guess US investors aren't stupid enough to buy in at these yields, huh?

Inside this issue:

Grab a brew. Don't cost nothing'.

Bluto

Something to Think About Cont.

But what should be done about it? This is the road to ruin, is it not? Well, unless you can figure out a way to pay for everything the public wants while keeping interest rates low, I hate to tell you, you best just enjoy the ride. This train has left the station, and it isn't coming back for a while.

So, you have two options: 1) freak out, or; 2) relax.

Here is what I wrote about the subject for the Montgomery Advertiser, which will appear this Sunday:

This past Wednesday, the Fed announced it would continue buying $85 billion in bonds each month. The markets rallied like gangbusters on the news. However, how much longer can the Fed keep it up?

What is the matter? Is the free beer not cold enough for you? Is there not enough swag in your goodie bag? Does your in-laws' place at the beach have only four bedrooms as opposed to five? Why do you have to be a hater?

In all seriousness, I would have thought the shenanigans would have ended by now, but the fun continues. Frankly, it would be laughable if it weren't so, um, laughable.

I liken the whole situation to the following: imagine you know someone that really loves ice cream. This person can really knock it back, eating the stuff from the time they wake up until the time they go to bed. Not surprisingly, your buddy has put on a few pounds over the last several years. So many, in fact, he has developed a raging case of Type 2 diabetes, and a whole host of other medical problems.

However, the local dairy has gotten kind of used to your buddy loading up the truck. In fact, it depends on it, and continues to deliver umpteen gallons of the flavor of the day straight to his door. For a while, he put it in the freezer in his basement, but then he ran out of space. Now, the stuff just melts on the stoop. Even so, he loves talking to the delivery man when he comes each day, because he still can't squeeze through the door.

That is kind of what is going on with monetary policy. We truly don't need the extra liquidity in the economy. Currently, the cash assets in the banking system are beyond absurd. Put another way, all the money the Fed has created with these bond purchases is gathering dust at, you guessed it, the Federal Reserve. Banks haven't lent it out, and are making a whopping 0.25% on it, or less.

Further, the Fed has been buying up, again, US Treasury securities. When have we ever really needed extra liquidity in the US Treasury market? Heck, most people in the investment industry would consider short-term US Treasury Bills and Notes to be cash or near cash.

So, if the economy isn't using the money, and the US Treasury market doesn't need the backstop, why in the world is the Fed doing this? I quit understanding the actual, economic necessity for this some time ago. At some point, arguably when the Fed started buying US Treasuries in its quantitative easing programs, the Fed crossed an invisible line.

Instead of simply providing liquidity to the US economy through the banking system, it became a primary financing vehicle for the US Treasury, which has been bleeding money for years. What's the harm? The Treasury can borrow below a true private market rate; the money sloshes about at the Federal Reserve, and there isn't any real inflation to speak of. What is not to like? What flavor ice cream do you want?

Something to Think About Cont.

> But how much longer? Brother, I guess the Fed will keep doing what it is doing until it can't. By that I mean when inflation finally starts to heat up. Until then, relax man. Enjoy your cheap money while it lasts, that is what everyone else is doing.

When all is said and done, the Fed has painted itself into a corner. It can't stop buying bonds each month without interest rates skyrocketing. Period. Now that you know the total amount of US publicly traded debt outstanding, you can deduce a 1% increase in borrowing costs could ultimately lead to an increase of $115 billion in our annual interest costs, assuming our accumulated indebtedness doesn't miraculously shrink.

Therefore, the Fed can say what it wants to about tapering off monthly bond purchases as much as it wants. There isn't any good immediate reason not to do so, and every knows, or should know, that. IF the worst case scenario is going to happen, well, there is already enough fuel on the fire. What is a few months more? Just throw on with the rest of the idle cash….it truly don't cost nothing.

But, hey, have a great weekend.

Disclosure