

BULLETIN: US FED'S BATTLE INTENSIFIES

November 20, 2010

This piece is intended as a follow-on to our recently published (October 2010) commentary about: (1) the US bond market's current position, within the context of the last 50 years of its history, and (2) the zero interest rate floor it faces in carrying out massive Federal Reserve money printing activities to monetize the current fiscal year's (third straight) trillion-dollar deficit.

We speculated that Fed Chairman Bernanke's "unsustainable" characterization of US budgets, on a number of occasions over the past two years was not just so much tut-tutting; that word was and is highly descriptive of the situation. Few Democrats and Republicans on Capitol Hill have disagreed, but their collectively rancorous style that has prevailed since the early 1990s, stoked by newly specialized media programming and pervasive Internet blogs, has obstructed adult-level discussion of what might be done about it.

Federal debt and deficits in the cross-hairs

In February, President Obama created the National Commission on Fiscal Responsibility and Reform (there's that word, again). Its mission is to issue a report by December 1, 2010 setting out specific ways and means for the US budget to be balanced (not counting interest on the debt), by 2015. The Commission has 18 members, 12 of whom are sitting Members of Congress.

During the week ended November 13, 2010, the Commission's co-chairs held a press conference to, in effect, "front-run" the Commission's immanent, but unfinished formal report to the President. The co-chairs put forth a list containing both tax increases and paths to produce reductions in "discretionary" federal outlays. The list was quickly and predictably characterized by Washington hacks as "draconian", a pejorative that has been in favor since the 1990s-era demonization of House Speaker Newt Gingrich. This single word tends to exterminate proposals made by either political party, even before a legislative bill has been drafted. Example: One of the deemed-draconian proposals made by the Commission's co-chairs would gradually raise the eligibility age for social security retirement benefits, from 67 now, to 68 by 2050 and to 69 by 2075. But,

in our view, the keystone part of the proposal is for the retirement age to be *indexed to longevity*. Historical note: the social security retirement age was originally 65; it gradually climbed to its present 67 as a result of late-1970s reform made at the behest of President Jimmy Carter.

Greenspan drops bomb

On Sunday, November 14, 2010, NBC-TV's weekly interview program, Meet the Press aired a panel discussion segment billed as a "special focus on the economy, jobs and the [national] debt". The panel's makeup was former US House Speaker Newt Gingrich, chair of the Democrat Leadership Council/former Congressman Harold Ford, Vanity Fair magazine's Bethany McLean and former Federal Reserve Chairman, Alan Greenspan. Unlike most panel discussions in which participants bang out their predictable talking points (or, in Mr Greenspan's case, vague references), this group was, in our view, a veritable hot stove with all four of its burners going full.

In fact, until we obtained the transcript, we were not sure whether to believe we actually heard the following candid exchange between Meet the Press host, David Gregory and Alan Greenspan:

Gregory: "...Alan Greenspan...is there a second crash out there that you fear?"

Greenspan: "No, I don't....we're moving forward, but at too slow a pace to bring the unemployment rate down."

Gregory: "Well, let's talk about the Debt Commission."

Greenspan: "Look, I think something equivalent to what [co-chairs] Erskine Bowles and Alan Simpson put out is going to be passed by the Congress. **The only question is, is it before, or after a bond market crisis.**"

Gregory: "But you got to explain....."

Greenspan: *“Right now, we have very low bond prices; the markets are functioning in a reasonably good way. **The big, serious problem is whether or not the outlook for the longer term deficit spooks the bond market to a point where long term interest rates and mortgage rates move up very sharply. If that happens, that will cause the “double-dip”.** And I’m just basically hoping that we have enough sense to realize that we’ve got to resolve this issue before it gets forced upon us.”*

While we do share Mr Greenspan’s conclusions in this interview, it is very, very difficult for a rational citizen to find reality in his hope for political cooperation and action on the tough underlying decisions. Every sober American likely shares in that hope. Sober, or not, we all have an immense stake in the outcome. But years of highly partisan Congressional history more than strongly suggests that thousands of Washington lobbyists, assisted by Blame-Game philosophical devotees of draconianism will continue to form virulent obstacles that are well armed with pipelines of money.

The Fed soldiers on

Meanwhile, current Federal Reserve chairman Ben Bernanke appears to have lost his accustomed cool, reacting to an avalanche of widely respected domestic and international sources of criticism, including China, for his second round of Quantitative Easing.... (QE2)... the early November announcement that the Fed will buy up (i.e., print more dollars to acquire) an additional \$600 billion of US Treasury debt by June 30, 2011, at the rate of \$75 billion per month. The goals: (1) monetize the current fiscal year’s federal deficit and (2) buy bonds in the long-maturity segment of the market, so as to drive down their market rates of interest, in the same way the Fed has already hammered yields on short-maturity debt via QE1. If it is successful QE2 will, among other impacts, cause home mortgage rates to tumble even lower than their recent all-time record.

And there’s more. The Fed pledges to continue to “re-invest” in mortgage-backed securities that are maturing in its existing portfolio which will, we assume, continue to spare Fannie Mae and Freddie Mac from prostration in the cold, steely bond markets.

Since the Fed’s QE2 announcement, made just after the mid-term elections, the chairman has made speeches, the most recent of which was on foreign soil. The message of them seems aimed not only to rebut the critics who say that QE2 is intentionally burning the value of the dollar, but also Bernanke’s language, we think, amounts to dismissive talking-down to his critics, including China... a technique not known for its effectiveness, regardless of context.

Perhaps worse than verbal criticism (and maybe the real source of Bernanke’s visible irritation): the bond markets appear to have rather quickly voted against QE2. Stay tuned.