

September 29, 2010

Bubble in Gold and Bonds: When Will the Barbell Trade Unravel?

We expect a gradually strengthening U.S. economic recovery that will be sensitive to tax and regulatory policy but not to Fed purchases of Treasury bonds. As auto sales pick up and jobless claims gradually decline, we think talk of a large-scale Fed quantitative easing will subside, marking a bottom in Treasury yields and at least a temporary top in gold prices.

- Unless economic data strengthens in October, we think the Fed may use its November 3 statement to give itself intra-meeting flexibility to buy more Treasury bonds. The Fed will want to have something to show the markets if Congress fails to stop the tax hike (a distinct possibility). Extra tools will protect the Fed from criticism but won't have much impact on the outlook.
- With the Fed funds rate pegged at an emergency 0% for 21 months and massive excess overnight reserves already in the banking system, it's clear that **monetary policy has shifted to a regulated "credit rationing" regime from the normal price-based money supply allocation system** (see David's December 4, 2009 Wall Street Journal article on this.)
- Rather than traditional monetary policy, the credit-related growth issue is whether bank regulators, the Fed being one of the biggest, continue the credit crunch on small banks and small businesses and whether the resulting economy-wide consolidation process stifles innovation.

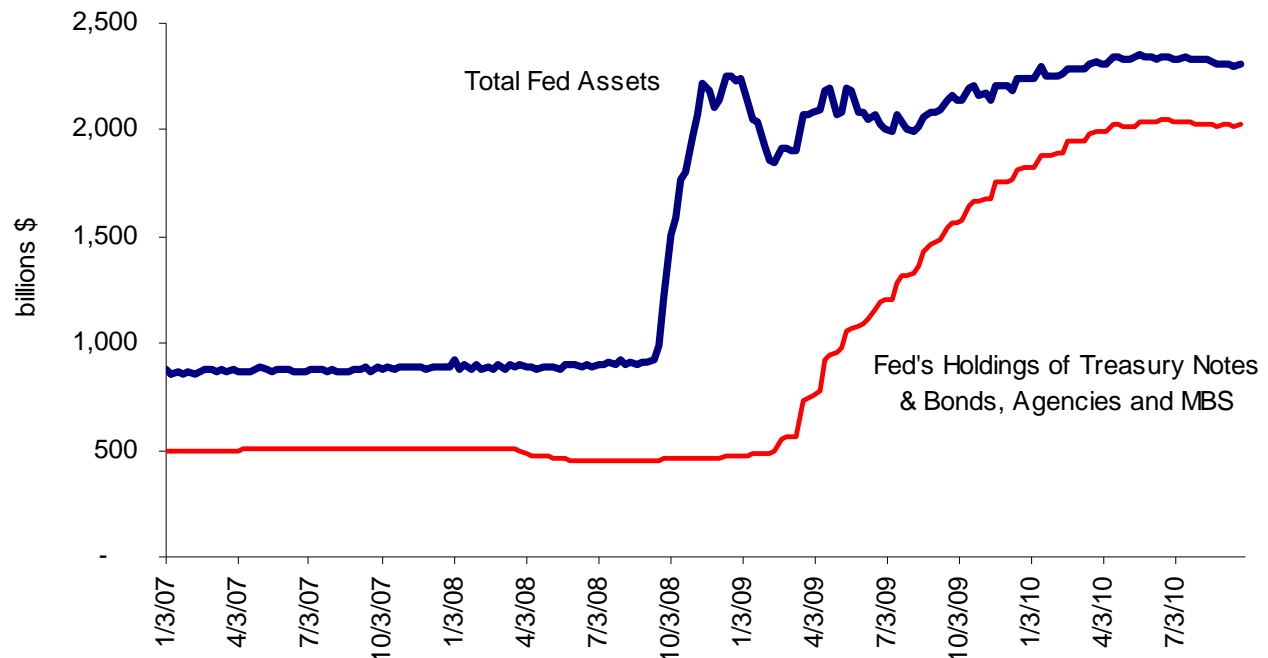
Bubble in Barbell Trade

We disagree with the view that possible Fed purchases of Treasury bonds are an important variable in the outlook or will have a material impact on growth. If the Fed buys more Treasuries without changing bank regulations, it will be pushing on a string from the standpoint of bank lending and will be flattening a yield curve that is already flooded with liquidity. The Fed is making \$100 billion or so per year in profit, mostly on duration risk – that's a tax on the private sector, so adding to it won't be stimulative.

- We think markets are overestimating the importance of the Fed's balance sheet, causing an overpricing of gold and long-term sovereign bonds. Much of the Fed's balance sheet is like a highly leveraged hedge fund rather than its traditional role as the back-stop for the money-multiplier activity of commercial banks. The Fed now pays interest on excess reserves which are not being lent, leaving the Fed borrowing overnight and lending long to the government with almost no equity capital at stake.

- The Fed's balance sheet has undergone two dramatic changes since the Lehman bankruptcy – it's larger and its assets (but not its liabilities) are longer maturity. The balance sheet has grown from \$900 billion pre-Lehman to \$2.4 trillion in May 2010.

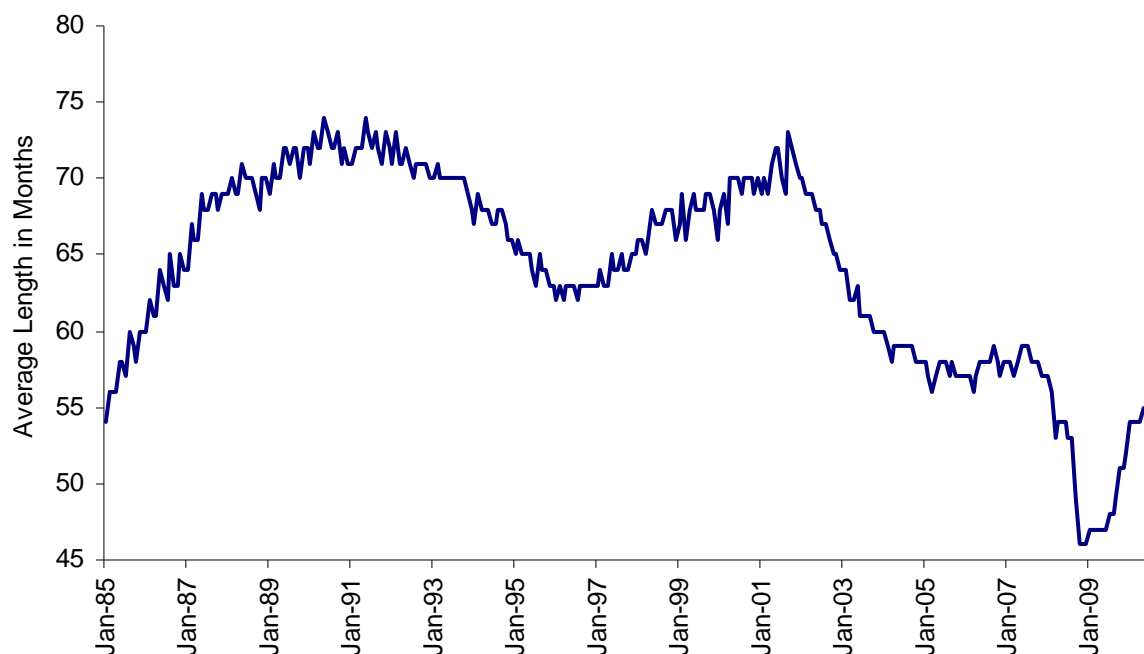
Fed Total Assets and Debt Holdings (last obs. September 28, 2010)



Source: Federal Reserve; Encima Global

- Pre-Lehman, the Fed's assets consisted of Treasury bills, short-term repos and some short-term Treasury notes (one-two year maturity.) In general, this matched the short-term nature of the Fed's liabilities, which were primarily bank notes (cash) and overnight loans from banks (bank reserves).
- The Fed now holds nearly \$2 trillion of mostly long maturity bonds including MBS, agencies and long-date Treasury notes. In economic terms, this shortens the already-short maturity of the marketable U.S. government debt. The graph shows the traditional presentation of maturity, which treats the Fed holdings as marketable (rather than treating them like a buyback of Treasury debt that reduces the average maturity.)

Maturity of Marketable Treasury Debt (last obs. June 2010, Fed treated like public)



Source: U.S. Treasury; Encima Global

- We think the low yield on Treasury bonds reflects past deflation crises, huge demographic demand from an aging population in industrialized countries and China, and heavy Fed purchases of a still-limited supply of long-term sovereign debt (Treasury is issuing mostly short-term debt.) The Fed now holds a material percentage of marketable Treasury bonds and government-guaranteed MBS, distorting pricing and resulting in an artificial deflation signal from bond yields.

Marketable Debt Outstanding (\$ trillions, last obs. Q2 2010)

	Treasuries	Agency	Govt MBS
Marketable Securities	8.1	1.6	4.4
Maturity (months)	55	71	71
Of which Fed Holdings	0.8	0.2	1.1
Marketable ex Fed	7.3	1.5	3.3

Source: Federal Reserve; Fannie Mae, Freddie Mac; Encima Global

- Comparing private sector bond yields for higher-yielding corporates versus high-grade credits shows no sign of an impending recession or deflation.

Baa – Aaa Spread (last obs. September 28, 2010)



Source: Federal Reserve; Encima Global

We've written about the barbell trade for a year now. To recap:

- We think markets usually underestimate the power of central banks – to break things and also repair them – so we've been sympathetic to gold and bonds as insurance. Since central banks alone print money, often with little oversight, they can cause inflations, deflations and currency weakness almost at will, as the Fed has shown.
- We encouraged the Fed to purchase bonds and MBS in our November-December 2008 pieces and were pleased when it finally did. Purchases at that time were stimulative given the high MBS yields and wide Baa/Aaa spread (see graph above.)
- The rationale behind the gold/bond barbell trade is that Fed policy -- the dual mandate, 0% Fed funds rate, politicization, sprawling regulatory role, and disinterest in the value of the dollar as an indicator of monetary policy -- argues for a repetition of the Fed's track record of wild inflations and deflations, justifying hedges into gold and bonds.

Gold Price (last obs. September 29, 2010)



Source: Wall Street Journal; Encima Global

- Our past pieces have noted the harm to the economy from Fed policy and this barbell trade – capital is flowing to mines and bond issuers (mostly governments and big corporations) but not to small businesses or new hiring due to the uncertainty over taxes, regulation and inflation/deflation.

10 Yr US Treasury Bond Yield (last obs. September 29, 2010)



Source: Federal Reserve; Encima Global

Bottom line: The most likely outlook, regardless of the Fed, is a gradual recovery from the 2008 panic that leaves bond yields higher than the present 2.5% ten-year yield and gold lower than the just-reached \$1310 record, at least until a new Fed blunder.

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