From: Ben Hunt
Sent: Saturday, September 15, 2012 5:43 PM
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Subject: Dude, Where's My Financial Repression?

In the classic movie "Dude, Where's My Car?", stoners Jesse and Chester go in search of their misplaced car, but along the way become embroiled in a search for the "continuum transfunctioner", described in script notes as "a mystical device that could save or destroy the world."

If there is a better description of open-ended QE asset purchases than "a mystical device that could save or destroy the world", I have yet to find it.

Open-ended QE is an inflation engine (or if you want to call it a continuum transfunctioner, that works, too). The Fed is betting that by inflating financial asset prices (all of them, indiscriminately), we can work our way out of an otherwise intractable sovereign debt problem. The on/off switch for the inflation engine is real economic growth, as measured by improving employment. If growth happens, then the inflation engine is turned off because growth will solve the debt problem. If growth doesn't happen, then the inflation engine runs and runs until the debt problem is solved in that manner. Once the debt problem is solved, either by growth or inflation, then the stage is set for still more growth.

The high priests of the Keynesian faith will proclaim that the inflation engine can itself spur real economic growth, while the clerics of the Austrian School will roar that the opposite is true. I see merits in both arguments, but both are tautologies. For a Keynesian true-believer, if the Fed policy fails, it just means that the program should have been even bigger. It is the Gambler's Fallacy writ large, where you can double-down to infinity. For an Austrian true-believer, if the Fed policy succeeds, it's only a temporary success. The end of the world is always just around the next corner.

A pox on both their houses, I say. Let's deal with the world as it is. Maybe the wealth effect from a rising stock market will drive a surge in consumer demand and business investment, creating real economic growth. I doubt it, but let's see what happens. Maybe the uncontrolled expansion of the Fed balance sheet, coupled with commodity price inflation, depresses consumer demand and business investment, creating stagflation. That actually seems more likely to me, but let's see what happens.

Like it or not, the Fed has turned the inflation engine on. That creates significant investment opportunities today (long and short!), most of which are pretty obvious to everyone reading this note. Those opportunities will remain so long as the inflation engine stays running, so my focus now is on what makes the Fed turn it off. The inflation engine will stay on until real economic growth occurs OR exogenous events occur that force the Fed to stand down. I see two potential exogenous events with the power to fight the Fed: a) a strongly negative political reaction to Fed policy, and b) inflation expectations that become "unmoored".

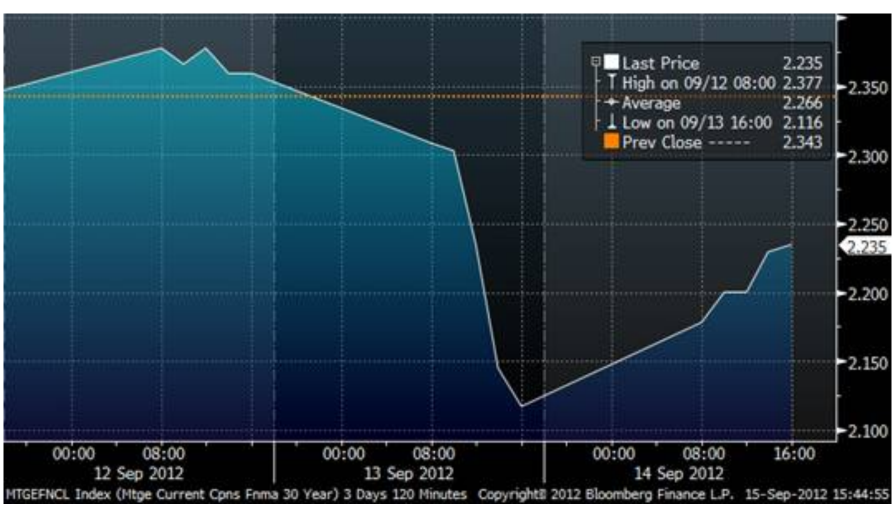
There are two possible paths for a negative political reaction to open-ended QE. First, if Republicans win the White House and Senate in November, then we set the stage for a change in Federal Reserve leadership and philosophy. This will be a process, and a slow process at that. But by the summer of 2013 we should have a very good idea of who will replace Bernanke (and it makes a big difference whether it's someone like Glenn Hubbard or whether it's someone like John Taylor), and we should have a good idea of the political desire to "rein in" the Fed, perhaps by moving to a single mandate (read Sen. Bob

Corker's recent FT op-ed for a clear-eyed argument in favor of this shift: http://www.ft.com/cms/s/0/125d3a64-f0fa-11e1-89b2-00144feabdc0.html). Second, regardless of the new constellation of Democrat and Republican forces in Washington post-election, if a long-term budget agreement is not reached by the spring of 2013, then the continual and continuing expansion of the Fed balance sheet will magnify the problems associated with Treasury debt levels in a meaningful way. I can promise you that the credit rating agencies do not see the Fed as somehow alien to US sovereign obligations.

As for the unmooring of inflation expectations, I think this is the only thing that really scares the Fed. I also think that it's already starting to happen. Take a look at UST 10-year yields over the past three days:

Yields never even hit the lows of the day following the Fed's announcement, and we had a 14 bps move wider in rates on Friday.

What about mortgage rates, the direct target of Fed asset purchases? Here's the three day chart of the 30-year FNMA current coupon:



Do rates take a tumble on the Fed announcement? Yes, but only 17 bps, with more than 60% of that taken back on Friday.

I don't think it's inconceivable … in fact, I think it's likely … that we see mortgage rates increase as a result of the Fed's open-ended QE program.

30-year mortgage rates can diverge a bit here and there from 10-year UST's, but the correlation between the two is incredibly high. Moreover, the 10-yr UST is the dog and mortgage rates are the tail … the former wags the latter. There is no way, not even with an active Fed purchase program, that mortgage rates can do down and stay down if UST rates are backing up in a major way.

So why are UST rates backing up in the face of the Federal Reserve saying that they are going to buy MBS and UST's till the cows come home? Why isn't the market reaction exactly the opposite?

As I've written about pretty extensively in the past few weeks, prices of safe haven securities like UST's and German Bunds are, I believe, driven primarily by market perceptions of systemic risk. Here's the 6 month chart of 10-year Bunds:

Until the Fed's announcement on Thursday, Bund yields have been unable to break through the 1.60% level, no matter how ebullient the market reaction to Euro-centric policy developments in mid-June (Greek election relief, Spanish bank bail-out relief), mid-August (ECB promise of bond-buying), and early September (ECB details of OMT bond-buying program). But now that the Fed is running the financial asset inflation engine, Bund yields are going up, up, and away.

My strong belief, and we'll see how this plays out over the next few days and weeks, is that the impact of an announcement of open-ended asset purchases on market perceptions of systemic risk is much greater than the actual market impact of those asset purchases. The primacy of perception over reality is what Mario Draghi noted in his press conference last week, and it's why, I believe, the common knowledge (CK) game framework is so effective. I think that we are going to see a significant move up in safe haven yields from here.

So what happens if the UST 10-year breaks 2.00% next week, and 2.25% the week after that? You still wouldn't be at the high watermark for yields for 2012 (2.38% in mid-March), but there's a big difference between now and mid-March. In March the dominant narrative was that the LTRO had at least tranquilized, if not eliminated, European risk, and – crucially – that you had a self-sustaining recovery well under way in the U.S. Today you've got a similar narrative around Europe ("the ECB has got your back"), but the Fed has made it abundantly clear that we do not have a robust economic recovery in the US. Instead, the Fed has announced that the recovery is so weak that they feel compelled to turn on an inflation engine!

Let's say you are an owner of UST's. You've just lost a lot of money in a very short amount of time (10-year UST was at 1.55% on September 1), and the Federal Reserve of the United States has turned on an inflation engine. What do you do? I don't think you have to be Nostradamus or Einstein to predict that you sell like there's no tomorrow.

UST 10-year yields won't stop at 2.0% or 2.25%. I don't know where they stop. But I know that as they go up, mortgage rates are going up, too, and $40 billion in Fed purchases next month isn't going to make a whit of difference. I know that the dollar will go down and that dollar-denominated commodities will go up. It will cost more to buy a gallon of gas or a loaf of bread. It will cost more to borrow money to buy a home.

This is how inflation expectations become unmoored.

Batten down the hatches, ladies and gents, the global storm is just getting started.

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