Credit Suisse Economics

Global Money Dispatch

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There is the QE problem, the Wells Fargo problem, and the taper problem…

The QE problem has to do with the Fed buying way too many mortgages, richening MBS relative to Treasuries. The Fed is buying $40 billion of MBS a month, and Bank of America is providing a tailwind by buying as many MBS as the Fed.

What will fix this issue is either the Fed buying less MBS and more Treasuries, or Bank of America doing the same – the Fed for "market functioning" reasons and Bank of America for relative value reasons. Either way, fixing the QE problem will require one of these banks to buy more Treasuries before taper commences.

If you are concerned about the MBS float, the last thing you need is the Fed suddenly lifting Wells Fargo's asset growth ban. Well Fargo has an unused balance sheet capacity of more than $500 billion, and after years of no growth and a shrinking loan book, it would be stepping into duration markets with force.

If the QE problem is bad enough for MBS and leads to a bid for Treasuries, the QE problem plus freeing Wells Fargo now would mean MBS trading even richer and, by extension, an even stronger bid for Treasuries. Timing is everything…

…and getting it right can turn a problem into an opportunity.

While lifting Wells Fargo's asset growth ban now would do more harm than good, it could come in handy when the Fed commences taper later this year or next. The market assumes that taper will lead to a sell-off in rates, like in the past – but that need not be the case. The Fed could announce its plans to taper, while at the same time announcing the end of Wells Fargo's asset growth ban, so that fewer purchases by the Fed would be offset by more purchases by Wells.

Less buying by the Fed and more buying by Wells Fargo…

…and rates don't have to sell off, *provided* there is coordination at the Fed. The monetary and regulatory arms of the Fed typically do *not* coordinate, but never say never. Using the Wells Fargo "option" could help the Fed make taper a smoother affair than the 2013 experience, which wasn't smooth to begin with. It's one thing to taper against a boring fiscal backdrop like during 2013, and another to taper against a backdrop painted with *cumulonimbi* of fiscal issuance – given the fiscal outlook, the Fed should be creative with the Wells Fargo option.

Then there is the consensus problem, which is that everyone expects rates to go up from here, and "*if everyone is thinking alike, then somebody isn't thinking*": the macro reasons for higher rates make sense, but the potential for more Treasury purchases either by the Fed or banks before taper commences, and Wells Fargo deploying $500 billion of balance sheet after taper commences, could set off a rates rally from here. Consider these problems at least as risks...

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