Fooled By The Policy Makers

The US Fed is Actively Managing Liquidity And the US Treasury Is Actively Targeting Duration

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Forget the latest headline 50bp cut in Fed funds. Far more important things are going on beneath the surface! US Treasury 10-year yields have been **biased downwards by over 100bp** by subtle, but deliberate policy actions. We figure that the US Fed has been targeting ***'liquidity'*** since late-2022. It latest move is to change the *Banks' Stress Test* rules. Alongside, the **US Treasury** is skewing issuance calendar towards bills and **shorter dated coupon issues.**

In short, the US Fed and the US Treasury are surreptitiously manipulating bond yields downwards by through an unconventional yield curve control (YCC). **They are working together to manage liquidity and duration in US markets.** As a result, they are actively manipulating the most important price in World financial markets, the price of the benchmark US 10-year note.

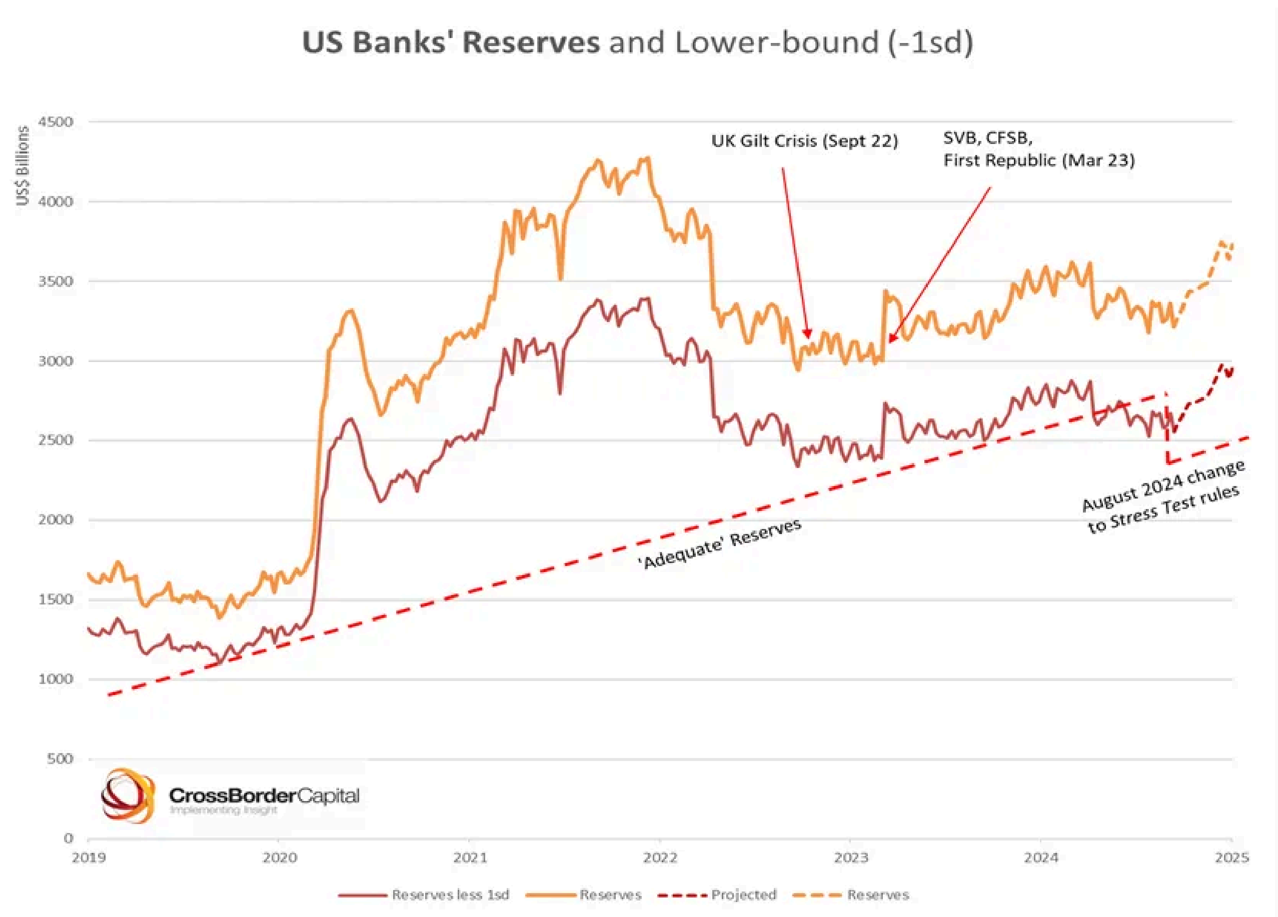
Taken together, these actions help cap the government's swollen interest bill, but at the ***cost of monetization.*** Put another way, underlying US inflation lies significantly above the cited 2% Fed target. On top, the economy is not recessionary but slow. These statements are less upbeat for conventional Treasury bond markets. But they give the clearest case to buy **monetary inflation hedges**, like gold and Bitcoin.

We suffer a topsy-turvy financial World, as a result. Consider: the 10-2 year yield curve has been falsely warning of recession for over two years; the gold price has broken its traditional relationship with real interest rates and US Treasury term premia, the benchmark for fixed income valuation, remain troublingly negative. On top, few know where the economy really sits: *nowcasts* suggest near 3% growth, but business surveys point towards recession.

Evidence how movements in the composition of the US Fed's balance sheet since late-2022, first stabilized and then increased money market liquidity, notably after the March 2023 SVB Crisis. Note also how latest changes (August 13th 2024) to banks' Stress Test rules are slated to unlock, perhaps, as much as a further US$500 billion from reserves.

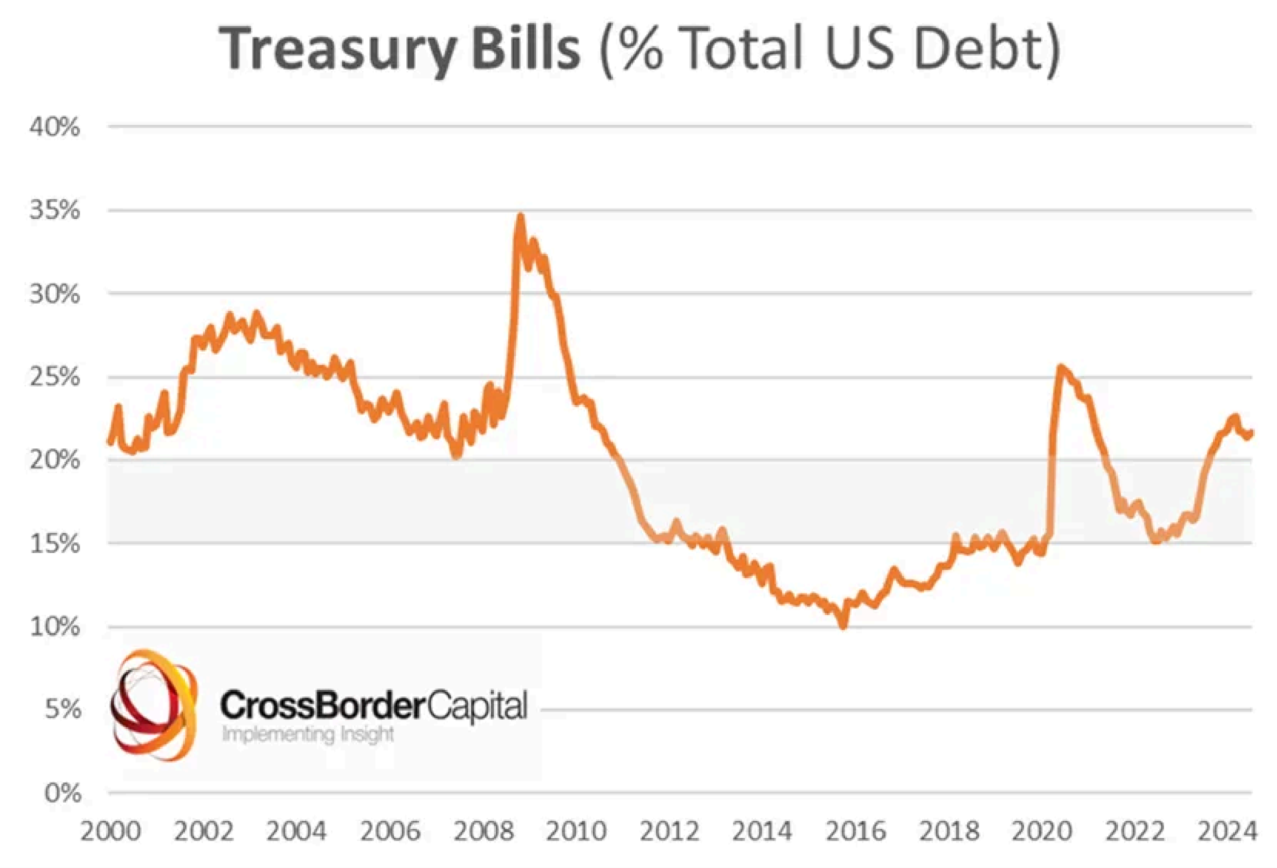
The chart below highlights our projections of US banks' reserves held at the Fed. These reserves have been an important source of liquidity to help banks meet monthly stress tests. However, the latest rules permit the inclusion of prospective credit from (a) discount window; (b) standing repo facility (SRF) and (c) loans from *Federal Home Loan Banks* (FHLBs). This means that US banks can switch large reserve balances into, says, Treasury collateral.

The lower reserve line is drawn at one-standard deviation below the average to capture the tail of reserve holdings across the smaller, regional banks. The broken line is our estimate of 'adequate reserves', with the latest step down indicating that **the revised stress test rules likely require fewer actual reserves held at the Fed.**



Alongside, the US Treasury has not only reduced the average maturity of Treasury issuance by over one year, since late-2022, they have also significantly increased the amount of Treasury bill sales in overall deficit financing. We term this unconventional form of Yield Curve Control (YCC), *active duration management* (ADM).

Consider, the following chart, which shows the rise of bill issuance from circa 10% in 2016 to 22% now



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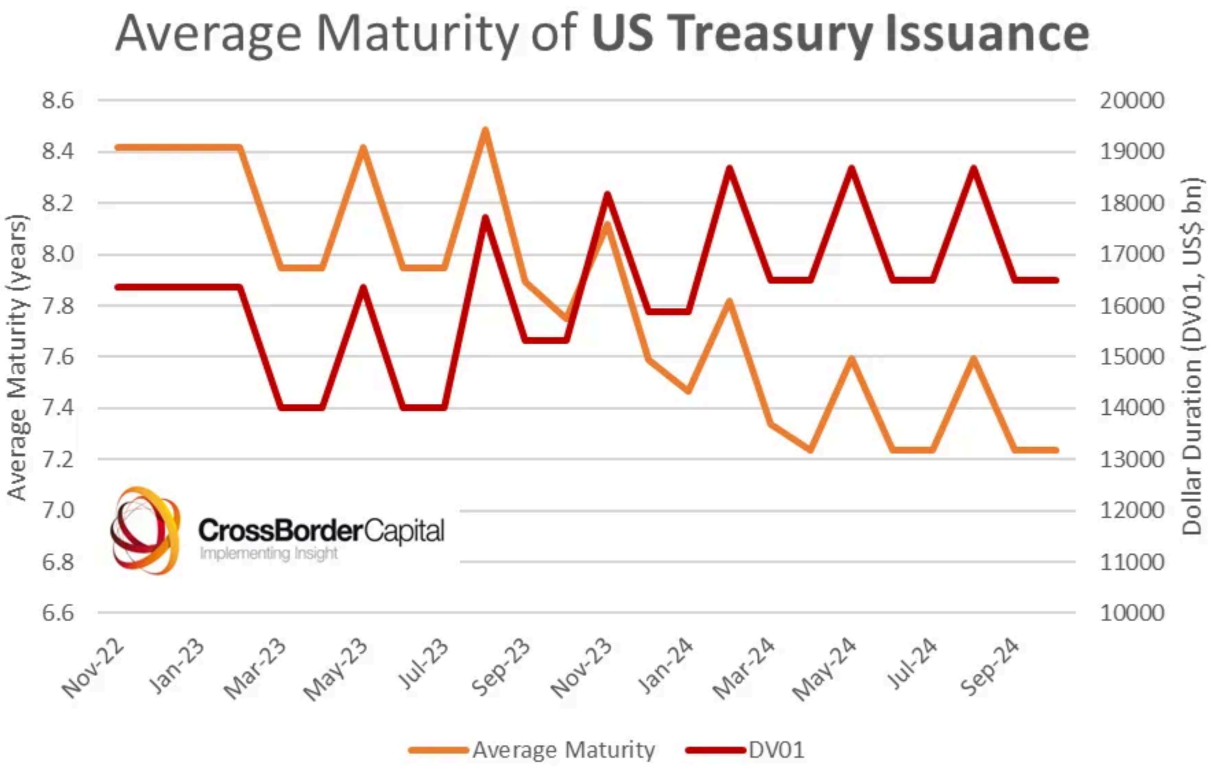
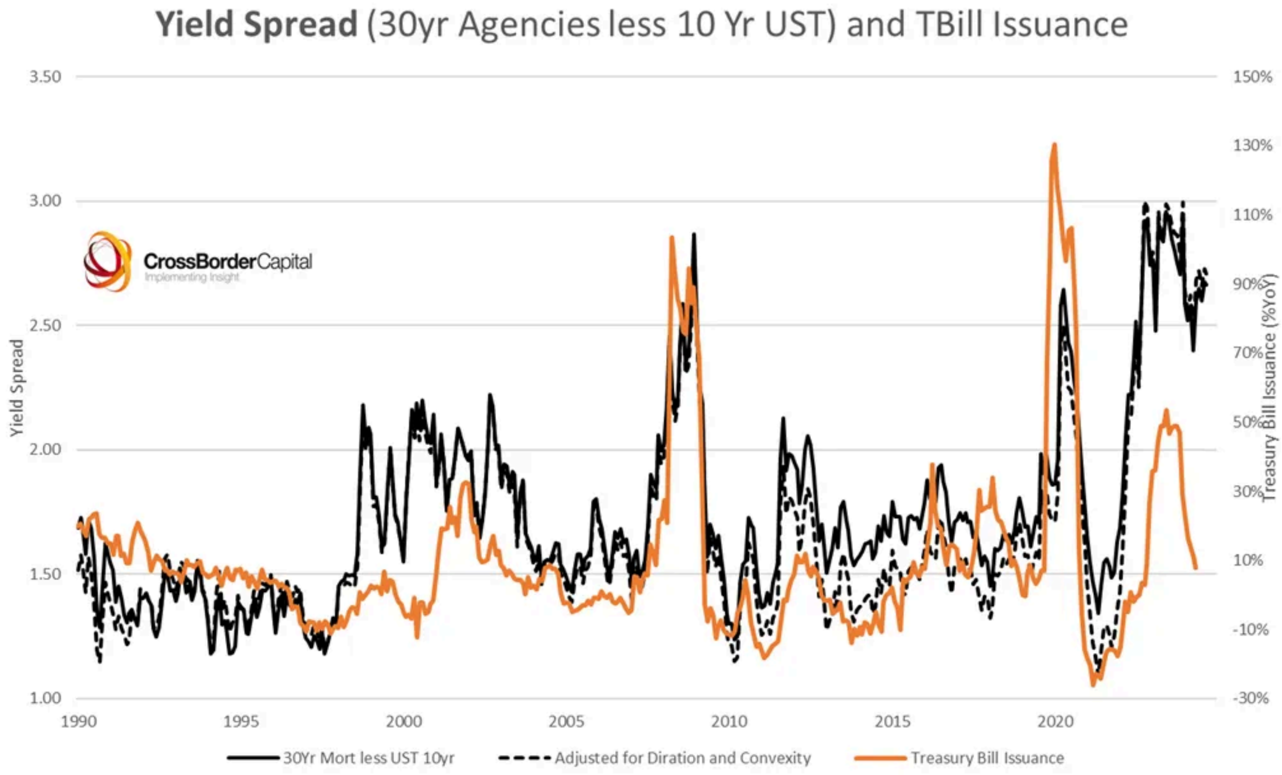
And, evidence below the 1.2 year fall in the average maturity of coupon issuance, despite the roughly unchanged nominal supply of dollar duration.



These changes have heavily distorted Treasury yields. Bill issuance helps to explain the unusually large 270bp yield spread between 30-year Agency mortgages and 10-year Treasury notes. It is some 120bp bigger than normal. This is highlighted in the next chart and occurs because institutional buyers are 'starved' of required Treasury notes and, hence, bond prices are bid higher. We estimate that around half of the difference is explained by greater Treasury bill issuance, and most of the other half comes from the skew towards shorter-dated coupons.



This same bias appears in the current low and negative estimates of US Treasury term premia. It also means that:

(1) The traditional **10-2 year Treasury yield curve** is biased towards inversion, which implies an upcoming US recession and greater future demand for safe asset bonds

(2) The **break-even inflation rate** in the TIPS market is similarly biased downwards, which suggests that inflation is less of a challenge than it really is

In short, both paint an unrealistically flattering outlook for the traditional bond markets. Yet, we should applaud US policy makers for their success in getting Treasury yields lower and saving the government and American taxpayers sizeable interest payments. Through managing liquidity and duration they have pushed 10-years down by at least 100bp, but this comes at a big cost:

- *Yield curve distortion* and **false positive** recession warnings
- *Breakeven inflation distortion* and **false negative** signal of low future inflation trend
- *Greater monetization* of the government deficit

The latter risk is not being sufficiently discussed, but it could be the most significant of the three costs. The Treasury's shift towards greater short-dated bond issuance will likely mean more monetization of the deficit. In short, it will create increased *monetary inflation*, i.e. depreciation of the paper dollar.

The ugly prospect of greater monetization means faster monetary inflation, the greater risk, therefore, of faster high street inflation, and the pressing need to buy more dedicated monetary hedges like gold and Bitcoin. **All this explains why gold has broken away from its recent real interest rate anchor.**

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Fed, Treasury joint YYC is not new... Nouriel/Stephen published this thesis earlier in july dubbed "Activist Treasury Issuance" saying the same and yellen had come out disputing...

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