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By John Mauldin | Sept. 17, 2011

What in the wide, wild world of monetary policy is the Fed doing, giving essentially unlimited funds to European banks? What are they seeing that we do not? And is this a precursor to even more monetary easing at this next week's extraordinary FOMC meeting, expanded to a two-day session by Bernanke? Can we say "Operation Twist?" Or maybe "Twist and Shout?" Not many charts this week, but some things to think about.

But first, I have had readers ask me about my endorsement of Lifeline Skin Care and whether I was still pleased. Quickly, let me say that I am more than pleased. I have not mentioned it recently, as the company had to deal with supply issues (partially, from too many orders, which is a good thing) but those have been handled. I read a lot of positive letters from people who use the cream with excellent results. I can clearly see a difference in my own skin. If you use it correctly you will get results

But a very interesting endorsement came by way of my cynical daughter Tiffani, who was in Europe recently for 6 weeks. She did not take her Lifeline with her but used another (very) high-end product. She came back and was complaining about how her skin looked. After switching back to Lifeline for two weeks, she notes that she can already see a difference, and the "feel" is improving. Many of the re-orders are coming from men (which is not surprising, as the bulk of initial orders came from my readers), almost the reverse of industry standards.

Basically, Lifeline uses patented stem-cell technology in its cream, and it promotes a visible rejuvenation of the skin in about 3-6 weeks (depending on the individual's skin, how often you use it, etc.) I encourage readers who are (ahem) of a certain age, or simply want to keep their skin looking younger, to click on the link to see a new, very short video; and if you like, you can order at the website. I and a number of friends are enthusiastic users. If you are interested in your appearance, you might want to consider becoming a Lifeline user. And you can use the code WAVE1 to get a \$40 discount! www.lifelineskincare.com/page/46/Video.html. Now to the letter!

Bailing Out Europe's Banks

Yesterday the Fed announced that along with the central banks of Great Britain, Japan, and Switzerland it would provide dollars to European banks that have lost their ability to access dollar capital markets (basically each other and US-based money market funds that are slowly letting their holdings of European bank commercial paper decrease as it comes due. And if they

are “rolling it over,” they are buying very short-term paper, according to officials at the major French bank BNP Paribas.

Are US taxpayers on the hook? We will deal with that in a minute. The more interesting question is, why do it at all and why now? Was there a crisis that we missed? Why the sudden urgency?

One of the little ironies of this whole Great Recession is that the central banks of the world rolled out this policy on the 3rd anniversary of the Lehman collapse. The Fed acted AFTER that crisis to provide liquidity. And we know the recession and bear market that followed.

The only reason for this move must certainly be that they are acting to prevent what they fear will be another Lehman-type crisis. Otherwise it makes no sense. They can give us any pretty words they want, but this was not something calculated to make the US voter happy. To do this, you have to be convinced that “something evil this way comes.” And to recognize the costs of not doing anything, and try to head them off.

My guess (and it is that, on a Friday night) is that the European Central Bank made a presentation to the other central bankers of the realities on the ground in Europe, and the picture was plug ugly. It should be no surprise to readers of this letter that European banks have bought many times their capital base in sovereign debt. The Endgame is getting closer (more on that in a minute).

Let’s look at just one country. French banks are leveraged 4 times total French GDP. Not their private capital, mind you, but the entire country’s economic output! French banks have a total of almost \$70 billion in exposure to Greek public and private debt, on which they will have to take at least a 50% haircut, and bond rating group Sean Egan thinks it will ultimately be closer to 90%. That is just Greek debt, mind you. Essentially, French banks are perilously close to being too big for France to save with only modest haircuts on their sovereign debt. If they were forced to take what will soon be mark-to-market numbers, they would be insolvent.

Forget it being simply French or Greek or Spanish banks. Think German banks are much different? Pick a country in continental Europe. They (almost) all drank the Kool-Aid of Basel III, which said there was no risk to sovereign debt, so you could lever up to increase profits. And they did, up to 30-40 times. (Greedy bankers know no borders – it comes with the breed.) For all our bank regulatory problems in the US (and they are legion), I smile when I hear European calls for US banks to submit to Basel III. Bring that up again in about two years, when many of your European banks have been nationalized under Basel III, at huge cost to the local taxpayers.

Next, let’s look at the position of the ECB. They are clearly seeing a credit disaster at nearly every major European bank. As I keep writing, this could and probably will be much worse for Europe than 2008. So you stem the tide now. But for how long and how much does it cost? A few hundred billion for Greek debt? Then Portugal and Ireland come to mind. If bond markets are free, Italy and Spain are clearly next, given the recent action in Italian and Spanish bonds before the ECB stepped in.

Could it cost a half a trillion euros? Probably, if they have to go “all in.” And that is *before* the ECB starts to buy Italian and Spanish debt (Belgium, anyone?), which no one in Europe is even thinking that the various bailout mechanisms (EFSF, etc.) could handle, which leaves only the ECB to step up to the plate. The ultimate number is quite large.

WWGD?

What Will Germany Do? That has to be the question on the mind of the new ECB president, Mario Draghi, who takes over in November, just in time for the next crisis. I believe German Chancellor Angela Merkel at her core is a Europhile and wants to do whatever she can to hold the euro experiment together. But for all that, she is a politician, who knows that losing elections is not a good thing. And the drum beat of the German Bundesbank and German voters grows ever louder in opposition to the ECB printing euros. Can she explain the need for this to her public?

As my friend George Friedman wrote today, Europe is complex. Speaking about Geithner going to the Eurozone finance meeting this weekend in Poland, he says:

“Geithner’s presence is particularly useful for two reasons. First, despite the vitriol that is a hallmark of American domestic politics, American monetary policy is remarkably collegial. The transitions between Treasury secretaries are strikingly smooth. Geithner himself worked for the Federal Reserve before coming into his current job, and Geithner’s partners in managing the U.S. system – the chairmen of the Federal Reserve and the Federal Deposit Insurance Corporation – are typically apolitical. Geithner holds the United States’ institutional knowledge on economic crisis management.

“Second, what Geithner doesn’t know, he can easily and quickly ascertain by calling one of the chairmen mentioned above. This is a somewhat alien concept in Europe, which counts 27 separate banking authorities, 11 different monetary authorities, and at last reckoning some 30 entities with the power to carry out bailout procedures.

“Getting everyone on the same page requires weeks of planning, a conference room of not insignificant size and a small army of assistants and translators, followed by weeks of follow-on negotiations in which parliaments and perhaps even the general populace participate in ratification procedures. The last update to the European Union’s bailout program was agreed to July 22, but might not be ready for use before December. In contrast, the key policymakers in the American system can in essence gather at a two-top table for an emergency meeting and have a new policy in place in an hour.

“Geithner will undoubtedly point out that the European system is not capable of surviving the intensifying crisis without dramatic changes. Those changes include, but are hardly limited to, federalizing banking regulation, radically altering the European Central Bank’s charter to grant it the tools necessary to mitigate the crisis, forming an iron fence around the endangered European economies so that they don’t crash everyone else, and above all

recapitalizing the European banking sector to the tune of hundreds of billions (if not trillions) of euros – so that when trouble further intensifies, the entire European system doesn't collapse.”

That is the standard Europhile leader's line. I talked this week with a leader of that faction, and that could be his speech. But again, that is not what Germany signed on for. They thought they were getting open markets and an ECB that would behave like the Deutsche Bundesbank. And it did for ten years. Now, in the midst of crisis, the rest of Europe is talking about needing a less restrictive monetary policy. That means potential inflation, which still strikes fear in the hearts of proper German burghers.

If George is right, Geithner will be speaking to (mostly) a receptive audience. But he is a central banker talking, not a politician. And his message will not play well in Bavaria, or in any country that still thinks of itself as a country, which is to say all of them. Remember this, in order to get the European treaty passed in France and in the Netherlands, they had to remove the parts about the flag and other symbols of unity. It is still 27 countries in a free trade zone, with different languages.

What Is the Fed Really Risking?

This will be where I lose a few readers. The actual answer to the above question is, “Not much.” The Fed is not lending to European banks or even to the various national central banks. Its customer is the ECB, which will deposit euros with the Fed to get access to dollars. Making the safe assumption that the Fed knows how to hedge currency risk (fairly easy), the only risk is if the ECB and the euro somehow ceased to exist. And these are *swap* lines. This is not a new concept; it has been authorized since May, 2010. The real difference is that previously it has been used only for loans with 7-day maturity, and now that is extended to 3 months. This gives the ECB the ability to lend dollars for 3 months, which they must think will entice US money-market funds back into at least short-term commercial paper. (Just stay one step ahead of the ECB and the Fed, and your loan is “safe.” We will see how enticing this is.)

Now, this is not without costs. It is effectively another round of QE, although theoretically less permanent than the last rounds, as the swap lines have a finite and rather short-term end. And those banks need the money for existing business, so it should not flood the market with new dollars. If that were to happen, the Fed should withdraw the lines or withdraw dollars from the system on its own. Allowing their balance sheet to expand through a back-door mechanism like this is not appropriate monetary policy and would draw deserved criticism.

Why do it? It is not for solidarity among central bankers. The cold calculation is that a European banking crisis would leak into the US system. Further, it would throw Europe into a nasty recession, when growth is already projected (optimistically) to be less than 0.5%. That means the market that buys 20% of US exports would suffer and probably push us into recession, too (given our own low growth), making a far worse problem for monetary policy in the not-too-distant future.

Finally (and this is one I do not like), if the ECB was forced to go into the open market for dollars, the euro would plummet. As in fall off the cliff. Crash and burn. Which would make

US products even less competitive worldwide against the euro. While I think we need a stronger dollar, that is not the thinking that prevails at higher levels. You and I don't get consulted, so it pays us to contemplate the thought process of US monetary leadership and adjust accordingly.

Finally, I think that the end result of lending to the ECB will be to postpone the problem. The problem is not liquidity, it is insolvency and the use of too much leverage by banks and governments. This action only buys time. And maybe time is what they need to figure out how to go about orderly defaults, which banks and institutions to save and which to let go, which investors will lose, whether some countries must leave the euro, etc. Frankly, the world needs Europe to get its act together.

What Will the Fed Do Next Week?

Bernanke has taken the highly unusual step of adding an extra day to next week's FOMC meeting. While that raised my eyebrows, I thought his monetary policy movements would continue to be constrained. Given yesterday's announcement of coordinated policy with the ECB, I am not so sure now. These things do not happen overnight or in a vacuum. The phone lines must have been open to Europe. The Jackson Hole meeting seemed innocuous enough, but I bet there were some very deep private conversations. This is something they have seen coming for some time. It is not like the whole euro problem is a surprise. Now, Bernanke has to bring his fellow FOMC members along for the next round.

Operation Twist seems to be priced into the market. The original Operation Twist was a program executed jointly by the Federal Reserve and the (freshly elected) Kennedy Administration in the early 1960s, to keep short-term rates unchanged and lower long-term rates (effectively "twisting" the yield curve). The US was in a recession at the time, but Europe was not and thus had higher interest rates. The equivalent of hedge funds back then (under the Bretton Woods system) would convert US dollars to gold and invest the proceeds in higher-yielding assets overseas. Billions of dollars worth of gold was flowing into Europe each year. (Incidentally, President Kennedy announced Operation Twist on February 2, 1961, which basically corresponded to the business-cycle trough.)

The notion behind Operation Twist was that the government would encourage housing and business investment by lowering long-term rates, and at least not encourage gold outflows, by maintaining short-term rates. Mechanically, the Federal Reserve kept the Federal Funds rate steady while purchasing longer-term Treasuries. The Treasury reduced its issuance of longer-term debt and issued mostly short-term debt. (self-evident.org)

Before I comment, let's look at what Bill Gross had to say in the *Financial Times*:

"The front end of the curve has for all intents and purposes become inert and worst of all flat as opposed to steeply positive. Two-year yields are the same as overnight fund rates allowing for no incremental gain – a return that leveraged banks and lending institutions have based their income and expense budgets on. A bank can no longer borrow short and lend two years longer at a profit..."

“By flooring maturities out to two years then, and perhaps longer as a result of maturity extension policies envisioned in a forthcoming Operation Twist later this month, the Fed may in effect lower the cost of capital, **but destroy leverage and credit creation in the process. The further out the Fed moves the zero bound towards a system-wide average maturity of seven to eight years the more credit destruction occurs, to a US financial system that includes thousands of billions of dollars of repo and short-term financed-based lending that has provided the basis for financial institution prosperity.**”

Bernanke made it clear in his infamous November 2002 “helicopter” speech that moving out the yield curve was in the Fed’s bag of tricks. By that, I mean they could do what Gross fears. They put a ceiling on the price of (say) the 10-year bond at 1.5%, in hopes of bringing banking and mortgage rates down, thereby theoretically spurring the economy and boosting the housing market. And in a normal business-cycle recession such a policy might work. But in a normal business cycle, it has never been necessary.

Twist and Shout?

The main point of Bernanke’s speech was that the Fed had many policies it could use, even if interest rates were at zero, if it needed to fight inflation. It was a nice academic speech given to professional economists. But it offers some insight into his thinking.

First, that was then and this is now, as my kids like to remind me. Then, deflation was an issue on the minds of many. Now, this week’s CPI data suggest that, at least for the near future, deflation is not the issue. The Consumer Price Index rose 3.8% for the month, compared to a year earlier. That’s up from 3.6% in July and is the highest reading since September 2008. On a month-to-month basis, prices rose 0.4% in August, twice the rate of increase forecast by economists surveyed by Briefing.com. (CNN.com)

Real yields (after inflation) are already sharply negative. A 10-year bond is only 2.05%. Five-year TIPS are a negative 0.83%! Three-month rates are 0%! How much lower can it get? Yes, they can go (briefly) negative, but that is not a sign of a healthy economy. See the chart below from Bloomberg.

Government Bonds						
U.S.	UK	Germany	Japan	Hong Kong	Australia	Brazil
U.S. Treasuries						
	COUPON	MATURITY	PRICE/YIELD	PRICE/YIELD CHANGE	TIME	
3-Month	0.000	12/15/2011	0.00 / 0.00	0.000 / 0.000	09/16	
6-Month	0.000	03/15/2012	0.02 / 0.02	-0.005 / -0.005	09/16	
12-Month	0.000	08/23/2012	0.07 / 0.07	-0.010 / -0.010	09/16	
2-Year	0.125	08/31/2013	99-29½ / 0.17	0-01½ / -0.024	09/16	
3-Year	0.250	09/15/2014	99-24+ / 0.33	0-02¾ / -0.029	09/16	
5-Year	1.000	08/31/2016	100-14 / 0.91	0-04¾ / -0.031	09/16	
7-Year	1.500	08/31/2018	100-07 / 1.47	0-07½ / -0.036	09/16	
10-Year	2.125	08/15/2021	100-22 / 2.05	0-09¾ / -0.034	09/16	
30-Year	3.750	08/15/2041	108-08 / 3.31	0-27½ / -0.043	09/16	

Second, high rates are not the problem with the housing market. Rates are already historically low. The “problem” is that bankers now want 20% equity at reduced prices to grant a mortgage. Imagine, bankers wanting to get paid back! Even very creditworthy refinancings cannot get done, because borrowers must bring cash to the table, even as their home values have fallen.

The same holds for business borrowing. The latest NFIB survey shows the vast majority of small businesses have access to all the lending they want or need. The survey shows the #1 problem they face is sales.

Do consumers need lower rates? Consumer spending is now an almost-record 71% of GDP. Consumers are repairing their balance sheets and reducing debt. (Personal anecdote: next month I will buy a new car, as my youngest son will claim possession of my present car (which has only has 100,000 miles on it and is in very good shape. Checking out new cars, I find that rates are anywhere from 0% to a high of 3%. While I am happy about that, if I did not have to get another car, no matter how low rates went, I would not buy. Auto sales are not even at replacement level in the US. We are clearly driving our cars longer.)

And retirees are being savaged by low interest rates on their savings. Do we really want retirees increasing their risk by seeking more yield? Just as we are going (in my opinion) into recession? That is precisely the wrong policy to pursue. I know rates would naturally be low as the economy slows, but pushing them down further and for longer is not helpful in a world where core inflation is over 2%.

This next Fed meeting will likely produce a very interesting statement at its conclusion. If the Fed does nothing, you do not want to be long. If they go “all in” you do not want to be short. Guessing what they will do is very serious business, so let’s go back to another Bernanke speech

from October of 2003, called “Monetary Policy and the Stock Market” (hat tip, David Rosenberg). You can read the whole speech at www.federalreserve.gov/boarddocs/speeches/2003/20031002/default.htm, but let me highlight a passage to give us a preview of this week’s FOMC meeting:

“Normally, the FOMC, the monetary policymaking arm of the Federal Reserve, announces its interest rate decisions at around 2:15 p.m. following each of its eight regularly scheduled meetings each year. An air of expectation reigns in financial markets in the few minutes before to the announcement. If you happen to have access to a monitor that tracks key market indexes, at 2:15 p.m. on an announcement day you can watch those indexes quiver as if trying to digest the information in the rate decision and the FOMC's accompanying statement of explanation. Then the black line representing each market index moves quickly up or down, and the markets have priced the FOMC action into the aggregate values of U.S. equities, bonds, and other assets.

“On occasion, if economic conditions warrant, the FOMC may decide to make a change in monetary policy on a day that falls between regularly scheduled meetings, a so-called intermeeting move. Intermeeting moves, typically agreed upon during a conference call of the Committee, nearly always take financial markets by surprise, at least in their precise timing, and they are often followed by dramatic swings in asset prices.

“Even the casual observer can have no doubt, then, that FOMC decisions move asset prices, including equity prices. Estimating the size and duration of these effects, however, is not so straightforward. **Because traders in equity markets, as in most other financial markets, are generally highly informed and sophisticated, any policy decision that is largely anticipated will already be factored into stock prices and will elicit little reaction when announced. To measure the effects of monetary policy changes on the stock market, then, we need to have a measure of the portion of a given change in monetary policy that the market had not already anticipated before the FOMC's formal announcement.**”

From that speech, Bernanke clearly believes that stock prices are a tool of monetary policy. He goes so far as to say that the Fed should not try to “prick” what might be perceived as a bubble, because “... attempts to bring down stock prices by a significant amount using monetary policy are likely to have highly deleterious and unwanted side effects on the broader economy.”

But a rising market is evidently not a problem. He uses all sorts of statistical research that shows a seemingly clear correlation between stock prices (risk assets) and monetary policy. I would argue that correlation is not causation. The data is basically over the last 60 years and does not include a balance-sheet/deleveraging recession like we are now in. The underlying economic tectonic plates have shifted. Ask Japan how much an easy monetary policy helps stock prices.

There has been some chatter that the Fed move to coordinate with the ECB will provoke Tea Party criticism, not to mention Governor Perry’s. I hope not, as that would be foolish, and show that whoever takes that tack is not thinking seriously or simply does not get the broader

macro environment. To think that policy would be any different under a Republican means you are not paying attention. This should not be that controversial.

But if the Fed does indeed pursue an Operation Twist or “moves out the yield curve,” then vehement criticism is more than warranted. I will be shouting myself!

Europe, Houston, NYC, and South Africa

I have enjoyed being home for the last nearly two months. But next Friday my “vacation” ends and I go “on the road again.” I have an aggressive travel schedule, where I am gone for about 40 of the next 50 days. I think I will add close to 70,000 miles to my airline mileage.

I leave Friday for a whirlwind trip to Europe (London, Malta, Dublin, and Geneva) and then back. A quick trip to Houston for an excellent conference with very good speakers (www.webinstinct.com/streettalkadvisors), and then I fly to New York for the weekend, where I will be speaking at the Singularity Summit, October 15-16. You can learn more at www.singularitysummit.com/. And then I’ll fly to South Africa for two nights, and head back home.

We are already planning next summer. Tiffani has once again arranged for us to rent a small villa in the village of Trequanda, in Tuscany, Italy. It will be our third year, and it is a slice of heaven. You can pick your own fresh vegetables and herbs from the garden. Walk to fabulous restaurants. Have gourmet chefs come in and cook. All at very reasonable prices. (If you are interested in the villa, you can go to www.ifiordalisi.com/)

And this next time we intend to go to Il Palio in Siena, something we have wanted to do for a long time (http://en.wikipedia.org/wiki/Palio_di_Siena). It is quite the spectacle. It is far more than a simple horse race.

This Sunday the award-winning design team of Bob and Dylan from Fahrenheit Studio come for a few days of much-needed strategy. There is so much going on. If you like my website, you can see more of their work at www.fahrenheit.com, or call them at (310) 282-8422. They will plunge into a raucous Mauldin family brunch, with guests and sundry hangers on.

This is a night for firsts. I got up from writing to go to Tiffani’s house for a Shabbat (long story). It was the first one for her on her own, and she wanted me there. It was also the first time I interrupted a letter in progress on a Friday evening. And this is the latest I have ever stayed up writing a letter. It will be 5 AM before this is off, but it is my privilege to come into your homes each week. And tonight, I just kept editing and adding! But I’m ready to call it a morning and hit the send button.

Have a great week! Trade carefully out there! And I hope you have wonderful fall weather! Something should go right this week!

Your looking forward to Ireland analyst,

John Mauldin