



MACRO Voices
with hedge fund manager Erik Townsend

Ralph Delguidice: Demand is being manufactured for US Treasury paper

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Erik: Joining me now is Ralph Delguidice, global macro strategist for [Pavilion Global Markets](#). Ralph put together a terrific slide deck for today's interview. You'll find the download link in your Research Roundup email.

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Ralph, it's great to have you on the show. I know that you are a regular listener. And I want to take advantage of that, because I know you've been listening to my interviews with Jeff Snider.

Something Jeff has said that just really threw me for a loop when he said it recently is he said, you know, really, we have to just accept that US Treasury bonds are not really an investment anymore. Big institutions need to have them as a balance sheet management tool, but they don't make any sense as an investment.

And I thought about that after the fact. I thought, holy cow, what are all of the knock-on implications of the United States Treasury bond? You know, the full faith and backing of the United States government (cue the patriotic music), most safest, reliable investment on earth, and it's not even an investment in Jeff's eyes.

How did we get here? What does Jeff mean by that? And what's the story of regulatory changes that have gotten us to this point?

Ralph: Thanks for having me on, Erik.

Jeff's point is very well taken. I don't know what Congress and the Fed intended. Dodd-Frank was written right after the Great Financial Crisis. And it may have come down to don't just sit there, regulate.

But the rules are the rules. And the banks have had to buy a trillion dollars in Treasuries since 2017 just to stay legally solvent. And now they're in the process of phasing in new margin rules for derivatives that are going to need another trillion to be bought and get posted.

It's a giant financial transactions tax, really. And the markets are forced to deleverage and hold

emergency liquidity in safe assets. And the regulators define “safe assets” as US Treasuries. Which lowers borrowing costs. And who’s going to complain about that?

The problem, of course, as Jeff points out, is that Treasuries are no longer really bonds then. They decouple from inflation and rates and even potentially credit quality. And the banks don’t care what the real returns are. They just want to stay in business.

Erik: Okay, Ralph. So to summarize, before the Great Financial Crisis we had this whole banking system all levered up in these derivatives that didn’t really have a lot of collateral behind them. Regulators step in and say, hey guys, you want to play this game, you’ve got to have collateral backing this.

That forces financial institutions to need to have a whole bunch of safe assets, collateral, on their balance sheets in order to continue to have the same derivative exposure they had before, under the new rules.

Now, I think that probably is going to answer one of the biggest questions that I had as I was reviewing your slide deck. Let’s go ahead and jump in to Page 2 of the slide deck. Again, listeners, you’ll find the download link in your Research Roundup email.

Now, Ralph, this is a story that I’ve seen before. But at the time it had a very different ending. And what I’m talking is, 10 years ago, so many people were talking about, look, the US government has this completely unsustainable borrowing habit of spending beyond its means.

How is that made possible? It’s because China keeps accumulating US Treasuries.

Someday, China is going to stop accumulating more and more US Treasuries. In fact, what could be worse is they might even start to divest their existing holdings. And watch out, baby, that’s going to cause an epic crash of the US Treasury bond market. We’re going to be unable to finance the US government’s borrowing. The sky is falling. The world is coming to an end, that’s it.

Well, the crazy part, Ralph, is a lot of that story came true. China did stop accumulating Treasuries and it did divest a lot of its holdings. But, not only did it not crash the bond market, but we’ve got all-time new lows in terms of Treasury yields.

Is that because of this phenomenon of the banks being forced to buy all these Treasuries?

Ralph: Right. Exactly. And, frankly, this chart is still the bare case. Who is going to buy all of the new issuance if the foreign officials buying from China and Japan and etc. can’t keep up?

And it ignores the regulatory bit. It’s a perfectly fair question.

In a two-factor world, rates would be 10%. But we’re not in a two-factor world. We’re in a

world, again, where significant demand has been manufactured specifically by the regulations and by the rules that can only be satisfied with Treasuries.

And this is how you can have Chinese holdings fall and still have rates fall like they did last year. It's ironic, but the Treasury really isn't making enough new debt to go around.

Erik: Okay, Ralph. Not enough to go around. That really makes me wonder how sustainable this is, how long it can last.

When you say there's not enough to go around, is it going to stay that way? And what do we see here on Page 3 where it says the Fed is back?

Ralph: What you see on Page 3 is that the Fed is already back buying bonds and adding to the balance sheet at the fastest rate ever. Look, we saw a lot of back and forth in the financial press over why the Fed had to stop quantitative tightening and return to adding to the balance sheet.

But the reason is actually pretty simple. The Basel rules made repos stupid-expensive, particularly at quarter-end. And it's important to remember that repo was never really a business anyway. It was something that dealers did for clients that bought a lot of bonds the same way your car dealer would give you a loan if you bought a car.

So now, with the Basel rules, the dealers don't want to do it because it's going to tie up capital. And it's pretty obvious the Fed had no clue how fragile these markets were until the meltdown in September.

So now, to keep repo viable, what the table shows is that, given the Basel arithmetic, the Fed is back in buying Treasury bills faster than the Treasury can issue them. And trying to force feed enough reserve liquidity to dealers to restart the private markets.

And Page 4, our table here shows what the supply and demand looks like for 2020 and 2021. It's back of the envelope and there's a lot of moving parts, but it will give you the general idea.

So we see that issuance for 2020 is \$1,050 trillion. And that's a big number, no question.

But what you see, again, is what the Fed's announced – that they're going to be buying bills for at least the first four or five months of the year at \$60 billion a month. And that, as they rebalance the portfolio away from mortgage-backed securities and reinvest the proceeds into coupons, they're going to be taking back coupons as well.

So you start with a trillion in issuance but by the time the Fed gets done taking back what they plan to take back – some of which, remember, is a consequence of the regulations – you're left with around \$600 billion to go around.

Erik: Ralph, moving on to Slide 5, you're showing this very interesting and sudden change of

direction, I guess, between government and prime money-market funds.

So first, what are we talking about here? What is the difference between government versus prime money market funds?

And why is it that we're seeing this huge growth in government and, really, prime fell off a cliff going into the end of 2016 and has only slowly recovered since then?

Ralph: What Slide 5 shows, Erik, is the regulatory impact on the money market fund industry of Basel and Dodd-Frank. In 2016, 2a-7 reform mandated that if you are a money market fund and you want to have a fixed net asset value, you can only buy Treasuries and agencies.

Of course, they still have prime funds that can buy CDs and can buy commercial paper. But you see significantly less demand for those post the Basel rules. And if you drill down into the prime funds, what you find is about half of their assets are Treasuries and agencies as well.

So the point here is that, after the Fed gets done, there is \$600 billion give or take available to the private markets. And what you're seeing in the money market funds, last year we saw \$500 billion of fund inflows with a stock market of 25%.

So the demand for money market funds continues to grow.

And now with the rule changes, they are only able to buy Treasuries and agencies. Which, again, is the manufacture of demand on a regulatory basis for Treasuries, or Treasuries and agencies, which is going to result in lower borrowing costs.

Erik: Moving on to Slide 6, you're saying here that Treasury and investment-grade bond demand flows will remain solid. Talk us through this slide.

Ralph: Sure. This is a little bit like the money market funds slide. What it's showing is that, as a consequence, really, of – this isn't so much regulation. It's just demographics. The baby boomer population is getting ready to retire. So there's a demographic bid for stable income.

And you're starting to see that play out in substantial institutional demand for investment-grade corporate bond funds. And, just like the prime money market funds, when you dig down into investment-grade corporate bond funds, you realize about 40% or 50% of the holdings are Treasuries and agencies.

And the tighter spreads get – and spreads are getting very, very, tight – the tighter spreads get, the more viable or the more substitutable Treasuries become for corporates. You just can't find enough investment-grade quality corporate paper, so you just buy Treasuries and agencies.

And, again, this is just an example of the manufacture of demand, the natural capital markets' demand for safe assets that comes on top of what the banks are having to buy and what the

derivative books are having to buy to stay solvent and to stay in business.

Erik: Moving on to Slide 7, how do German bunds play into this story?

Ralph: Well, domestic demand for Treasuries and safe assets is only part of the story. There is also significant international demand for Treasuries. Especially when, as we see on Page 7, the supply of bunds in circulation, that is the supply of German debt that's available after the ECB gets done buying as much as they're going to buy under the capital piece, which is all they can find.

And the same thing is true on Slide 8. When you look at Bank of Japan buying of JGB issuance, there is a tremendous amount of foreign demand for Treasury assets that's going to result as a consequence of the fact that institutional accounts in Japan and Germany, and really everywhere, can't find enough assets at home to buy.

I saw an estimate from a Japanese dealer not too long ago that suggested that there is \$800 billion US dollars' worth of JGBs in Japanese insurance company portfolios that all have yields of 1% and 2% that were issued years ago that are maturing in the next two years. And those portfolios are looking at nothing to buy at home at 0%.

Erik: Okay, Ralph, so all of this really is a result of the fact that a lot of foreign institutions, by mandate, they can either hold their own country's sovereign debt or they can hold US Treasuries as safe assets. So if all of their own country's debt has been bought up by the ECB and there is none left to go around, that's even more demand for US Treasuries.

Let's move on to Slide 9. You're showing this very obviously pronounced uptrend in the US dollar funding gap.

What exactly do we mean by the funding gap? And why is it growing this way?

Ralph: What this is showing you is the IMF actually measures how much demand there is from foreign institutions to borrow dollars so that they can pay for the Treasuries that they need to portfolio because they can't find anything to buy at home.

As of the end of 2018, the IMF tells us that that was \$1,400 trillion. And this number is doubling every four years.

Erik: Ralph, moving on to Slide 10, LCRs have been falling. For any of our listeners who are not familiar, what are LCRs? And why are they falling?

Ralph: Well, here is where we get to the direct impact of the Basel rules on bank appetite for Treasuries. This is where you got the demand to buy a trillion dollars in Treasuries to stay legally solvent.

“LCR” stands for “liquidity coverage ratio.” It’s a complicated calculation that banks have to do on their balance sheets to quantify the amount of money that could potentially run, the amount of wholesale financing they have that could potentially run under stressed conditions.

And the LCR is a ratio that forces them to hold a certain percentage of that money in assets that can be sold very, very quickly if necessary. Of course, Treasuries and agencies.

And what you see in this chart is that, since 2017, the average LCR across the four biggest banks – that is the cushion, the buffer that they’re holding – is beginning to fall pretty sharply. It’s down from 124% of the regulatory minimum to somewhere around 115%.

Now, 15% is still a good cushion. But, remember, the banks would be insolvent if they failed to be 100% in their LCRs. So they can’t take the chance. You reach a certain point where they have to start taking these buffers back up again. Then that will mean buying more Treasuries.

Erik: Moving on to Slide 11, you’re showing the impact of Dodd-Frank on US Treasury demand. Talk us through this chart.

Ralph: Well this is really a chart of what the primary dealers – which are, once again, the big four, the big banks – what the primary dealers are beginning to hold in terms of Treasuries. Some of it is to satisfy their LCRs. And some of it is in anticipation of increased demand for all the reasons we’ve discussed above.

But, once again, what you see is that, ever since the Basel rules were phased in, the primary dealer Treasury holdings have gone up very, very significantly.

Erik: Ralph, so far we’ve talked about the implications of existing legislation that’s already on the books and what it’s done to dramatically increase demand on US Treasuries.

I want to move on now to pending legislation which hasn’t taken effect yet but which has [been] proposed and may affect this. Talk us through what’s going on on Page 12.

Ralph: What Slide 12 shows, Erik, is that, in addition to the LCRs, in addition to the next stable funding ratio and all of the various rules with respect to the banks, Basel also mandates that all uncleared derivatives have to have initial margin posted. There has to be a two-way exchange in initial margin on all uncleared derivatives.

Erik: Okay, Ralph. You say on all uncleared derivatives you have to post margin. Now that margin is not cash. Presumably it has to be more safe assets.

So do you have to have Treasuries in order to meet this margin requirement?

Ralph: Well, what you see is – it gets very nuanced and very dense – but the cheapest [way] to deliver security against your initial margin requirement turns out to be Treasuries. There are

some reasons why cash is difficult to post. Because cash has no yield. It also it's difficult to post cash and segregate it and have it be bankruptcy remote.

What you see in Slide 13 is that, of these regulatory initial margins that's already been posted – and, as of last year, that tells us – the top 20 biggest firms, which is currently the firms that are being captured by the rule (it's going to be expanded in September of this year to cover several hundred firms, including buy-side firms) – but, of the 20 firms that are currently captured by the scope of the rule, the vast majority of the collateral that's getting posted is Treasuries. And so this is manufacturing demand for Treasuries.

If you want to stay in your derivative trade, you're going to have to post initial margin. And the cheapest [way] to deliver security is going to be Treasuries.

So this manufactures considerable incremental demand, probably on the order of somewhere around another trillion. This is estimated in the slide on Page 12 that under the best-case scenario, – which would be all firms using internal models and a \$50 million threshold – in other words, below \$50 million there's no requirement to exchange – that using the \$50 million threshold and using the internal modelling, that the best case scenario is that \$800 billion (line C) is going to have to be posted as margin.

Erik: And what do the pie charts on Page 13 tell us?

Ralph: The pie charts show you that, to date, the exchange of initial margin has been predominantly Treasury securities.

Erik: Okay, hang on a second Ralph. Because I hear what you're saying when you make the point that it doesn't matter if there is no yield because what they need it for is safety.

But wait a minute. That's true for all of these big institutional holders of Treasuries who have to have collateral for their big fancy-pants derivative positions. But what about the rest of the financial institution that used to rely on US Treasury bonds as one of the single most important instruments in every portfolio?

We used to – in the good old days, most pensions had a very large percentage of their holdings in Treasuries. Because it was guaranteed completely safe and it returned 5% or 6%, which was more than double inflation.

And it was a pretty darned good return for a large pension fund which is really worried about servicing a basic obligation of cash flow, not trying to make a fortune like a hedge fund. We had the standard 60/40 portfolio of bonds and stocks.

Everybody is being forced to reach for yield and they're into junk now. So it seems to me there are a lot of knock-on implications to Treasuries no longer being suitable as investments.

Ralph: Well, they're already substantially below the return hurdles that the insurance companies used to expect. And what you'll see is you'll see further reach for yield. You'll see further yield compression. This is going to enable much, much more risk-on. Because if interest rates are zero, then equity multiples are infinite.

And what you'll see is you'll see companies issuing debt and buying back shares and leveraging up their balance sheet. And you'll see retail investors and many institutions with no choice. They have to take whatever's there.

You already see it in the high-yield markets where spreads are at historic tights and have nowhere to go but lower.

This is the business we've chosen.

Erik: So what are the implications in terms of systemic risk? I mean, we haven't had a significant downturn since 2009. What happens when we get a significant downturn and all of a sudden it's not straight-line up for stocks and bonds the same time the way it's been for the last 10 years?

It used to be everybody had a cushion because they had plenty of good old guaranteed, reliable US Treasury paper returning 5% or 6% in their portfolio. That's gone.

Everybody that was forced to reach for yield is into junk now and other riskier assets. What does that mean in terms of what could happen in the next downturn?

Ralph: Well, there's two different systemic risks here.

The first one is the risk that's being built into collateral transformation trades. Because these Treasuries aren't being bought to satisfy these ratios, Erik. They're being borrowed.

And what you've seen is a huge business develop around lending out Treasuries, not against cash collateral but against non-cash collateral.

The International Securities Lending Association tells us that there is a trillion dollars in securities out on loan. More than half of those securities are sovereign bonds. And more than half of those sovereign bonds have been lent against non-cash collateral.

And the way that works is, you're an insurance company and you need Treasuries to satisfy your new initial margin rules for the uncleared derivatives that you want to hold. And not having swaptions is just not an option.

You're going to want to continue to hold derivatives. So you need Treasuries to post. And you don't have them. You're not in the business of having Treasuries and having cash sitting around on your balance sheet earning nothing. So you need the Treasuries.

So you go to a custody bank and you say, I need to borrow Treasuries to post for margin. I don't have any. And they say what do you have? And you say, well, I've got Triple-B bonds.

And what's happening now is you're beginning to see collateral transformation trades that allow for borrowing the Treasuries and posting much, much lower quality assets as collateral.

Now you over-collateralize them. You don't get a dollar's worth of Treasuries for a dollar's worth of Triple-B junk bonds. You have to over-collateralize.

But the question is, are you getting the haircuts right? You begin to see, as these numbers get bigger and bigger, how the potential for a 2008-style run happening all over again – only 10 times bigger this time – is getting baked into the system, where you had these trades that the Treasury owners want them back or need them back and the custody banks are unable to re-establish the positions.

So that's one kind of systemic risk.

The other systemic risk, it seems to me that you're going to have – we're going to get to the point where, when the curve goes completely flat, the banks are going to surrender.

They're not going to want to stay as big as they are because there is no carry. There is no reason to be big anymore.

So at a certain point after the curve goes flat, the banks begin to shrink. They start to buy back their own shares. They start to issue debt, buy back their own shares. But they don't need to hold as many Treasuries because they're not as big.

And as they begin to shrink, and as they are holding fewer and fewer Treasuries, that's going to come right at the same time that rates are zero or rates are negative. And zero rates are enabling MMT.

They are enabling – you're already seeing it in Germany where even the Germans are having difficulty explaining why they're not borrowing money at negative rates to spend on social programs.

And so what I like to say is that zero rates, MMT, QED. This is what you're going to get. This is what enables the fiscal monetization push that – you know Congress never has a problem spending money. They just fight over what they're going to spend it on.

So you reach a point where the banks surrender. They shrink. And their demand for Treasuries shrinks with it at the same time that the government is ramping up to take advantage of the new lower rates. And at that point, interest rates and the dollar can become very highly unstable.

You combine those two risks and what you realize is that – it's ironic, but the regulators had nothing but good intentions. The way they designed the regulations has made the systemic risk worse, not better.

Erik: Okay, Ralph, help me understand how and when that worse systemic risk comes into play. Because, from everything you're saying here, it sounds like, at least for the immediate foreseeable future, what happens is there's lots and lots of institutional demand for Treasury paper globally.

And that does, in fact, make it possible for the US government to continue borrowing at very low or maybe soon even zero interest rates. And they'll probably borrow a whole lot and spend a whole lot.

When does the monkey wrench get thrown into the works? And what is the proximal catalyst that causes that monkey wrench to gum up the works?

Ralph: Great question.

In 2006, Ben Bernanke very famously said that no central bank need countenance deflation. They have something called the printing press.

And he was half right. The problem with QE, the reason why it has not engendered inflation, is because, as they learned in Europe, it's actually limited. Even though the Fed has a printing press and they can print a lot of money, they're constrained by the available assets they can buy to create the reserves.

Once you move to – once negative rates or zero rates or very low rates enables the MMT, enables the fiscal monetization – you're already seeing it in Europe. Christine Lagarde was hired to preside over precisely this. To convince the Germans to go ahead if rates are negative, borrow the money and spend it. It's the only way to get inflation.

So what you're going to see here is, once Congress embraces the MMT idea, once they begin to increase deficit spending to simply take advantage of the fact that rates are negative, at that point you're no longer limited by the amount of Treasuries you can buy.

Quantitative easing – the printing press can truly work. Because there is no limit. The Fed and the Treasury together can say to the markets, we're going to continue to do this. The Treasury will issue debt, the Fed will buy the debt, monetize the debt. They'll enable the fiscal monetization until we get the inflation we desire, until we can re-steepen the yield curve.

And that's the point at which the system can become, from the point of view of being long-duration at that point, the system can become very, very unstable.

I think the Fed's convinced itself that they can probably control this, that they can dial it up and down based on how much they want to monetize and how much new Treasury issuance there is. And they're probably right.

What they can't control, it seems to me, is the risk, again, of collateral transformation. Because it's the way the market is satisfying these new rules that's so scary. They're renting the Treasuries, they're not buying. And the collateral they're putting up in order to rent them is significantly lower-quality collateral.

And this is where the systemic risk event happens that doesn't just steepen the yield curve, doesn't just create a selloff in bonds that maybe they start a fire they can't control. Maybe rates start to go higher and it feeds on itself. But I suspect they've convinced themselves they can just back off on MMT and back off on printing and control that.

The question is the collateral transformation trades that are getting set up to enable institutions to meet these new Dodd-Frank requirements. That's where the real systemic risk is.

And it's a replay. It's a repeat of the systemic risk we saw in 2008 where – look, there's a lot of different opinions about what went wrong in 2008. But what was happening was you were creating synthetic safety.

You were structuring up sub-prime loans to create Triple-A securities that were supposed to be as good as Treasuries. And those were being rented to the money markets. And they were being rented to the money markets with assumptions about haircuts that proved to be wrong. As we all know, very few sub-prime loans actually failed, actually lost money. No Triple-As ever lost money.

The problem wasn't in the cash markets that you had – that prices in Triple-A and mortgage-backed securities and asset-backs collapsed.

The problem was in the repo markets that they'd gotten the haircuts wrong. They had been giving 50 turns of leverage a 2% haircut on the Triple-As coming off of these mortgage-backed. And the bonds went par-par-par-par-90.

And then the problem wasn't in the cash markets. The problem was in the funding markets. The problem was in the repo markets.

When you think about what's happening now in collateral transformation, it's exactly the same trade. It's exactly the same systemic risk. Only much, much larger. Because the same assumptions have to be made about what haircut I'm going to give you on the Triple-B bonds that you're going to post to me.

And it's all feeding on itself. Because rates are so low, there is no return on Treasuries. So you have a lot of passive holders of Treasuries who hold them in spite of the fact that they don't

have yield, precisely because they can lend them out. They can lend them out.

And what you see is the more aggressive they're willing to be, in the collateral that they'll take when they lend them out, that is the riskier collateral they're willing to take, the more they get paid.

So the more funds they attract – they're offering a higher yield to retail investors, they end up taking in more money. It's an unnatural selection. It's adverse selection in the markets.

Erik: Ralph, I want to come back to something you said a minute ago about when we get to the inflation that we desire. And this resonates so strongly for me because something I've said for years is the end game here is when we get to the inflation that we don't desire. In other words, when that starts to run away from us.

Because, from what you're describing, if there is this massive demand for Treasuries, and the way we supply that demand is a whole bunch more government borrowing and spending and more indebtedness, then we get to the point where, when you start to have an inflation problem, you can't increase interest rates in order to fight inflation. Because doing so would cause a fiscal crisis for the US government.

Some people think we're already there.

So it seems to me like the big trigger event is – at some point, if money is free and you're giving it away or governments are giving it away and spending it like crazy, eventually you get an inflation problem. And as that inflation starts to run away, you can't fight it with lower interest rates.

Is that the mechanism that eventually causes this house of cards to all come falling down?

Ralph: It certainly is a mechanism.

Again, I think the regulators may have convinced themselves, the Fed may have convinced themselves that the solution to the debt problem now is the same solution that they had after the second World War, when we had much more debt actually than we have now as a consequence, obviously, of fighting and winning the war.

And the way the Fed fixed the problem was through financial repression. They had 25 years where inflation was higher than the interest rate on Treasuries.

And if you can create that scenario and keep it in place long enough, the debt takes care of itself. The debt literally disappears.

This is part of the reason that they're so desperate to create inflation. They're always obsessed about inflation is below target, inflation is below target.

Erik: Okay, Ralph. It seems to me that the key to all of this is if they can stop inflation from running away, if we don't get into a runaway inflation problem, then, as you say, you just keep inflation above the Treasury yield for 20 or 30 years and it will inflate away through that process of financial repression. The debt effectively goes away. That is known to work.

So it seems to me the most important question to answer then is what are the conditions that can lead to a runaway inflation that you can't fight? And, remember, you don't have interest rates in your bag of tricks to keep it under control because you can't really increase interest rates very much at all under these circumstances without bankrupting the federal government in the process.

Ralph: That's a great question.

And I think the answer has to do with whether or not alternative currencies become viable. As long as the dollar – as long as the government has a monopoly on the medium of exchange, the store of value, and the unit of account – that is the US dollar – as long as there isn't an alternative to US dollars, they don't really run the risk.

They can just dial up and down the borrowing, and dial up and down the Fed purchases. And, in their own minds at least, they can keep financial repression in place and keep the curves behaved.

That all breaks down if there is an alternative.

If bitcoin, if gold, if transacting using some other kind of currency becomes possible – and this is where – this is very interesting – you can also look at stocks as an alternative kind of currency. There is no reason why you couldn't go into Walmart and buy everything you want to buy and simply transfer shares of your Fidelity S&P 500 account and pay for everything you want to buy in those shares and never go to dollars at all.

And so the degree to which equities collectively could become an alternative currency is something the government has to keep an eye on.

Erik: Well, Ralph, I can't resist but to plug my own book here. I published a book in 2018 predicting the black swan the US government doesn't see coming is the US dollar is going to lose its reserve currency status to a digital currency. Probably a central-bank-issued digital currency from a consortium of other nations around the world. (That's as much of a shameless plug as I want to spend time on in this interview.)

But let's come back to where else this might go in terms of if we don't see a runaway inflation situation – you know, we tried quantitative tightening once. Bernanke told us that they were going to be able to unwind all of this extra liquidity that's been created through quantitative easing.

What happens to the bloated balance sheet of the Fed for the next 30 years in that 30-year financial repression scenario that you described where they inflate the debt away that way? Do they just keep the Fed's balance sheet where it is?

Ralph: Well, the good news, really, here is that for the Fed it doesn't matter where the balance sheet is. Because as long as they have the Basel rules in place, they don't need a balance sheet to control rates. The banks do it for them. The banks are buying Treasuries; the Fed doesn't have to.

The bad news is what it means is they can't really exit. They can shrink their balance sheet. But they can't really tighten rates. Not as long as the Basel rules remain in place. And what this means is that, essentially, they've lost control of the yield curve itself.

And this is very important because eventually what you see is the flat curve destroys financial lending incentives. The banks are the ones that suffer when the curve goes flat.

And when the Fed is unable – as you see now – what I'm trying to tell you is it looks like the Fed is unable to keep short rates down, given the repo issues – the Fed cuts the targets.

And the dealer banks, as a consequence of Basel, just say, if you want money lent there, you lend it. We're not going to do it. We can't do it. Not under the rules you're making us live by.

And those very same rules create a situation where the belly of the curve, the middle of the curve, the 7- to 10-year range of the curve – they can't keep rates up.

Once again, as a consequence of the financial regulations, there is so much demand for Treasuries. And to stay legally solvent, the financial agents like banks and derivative books are being forced to buy them or borrow them, which creates the demand anyway. And you end up in a situation where the curve inverts.

And what this does is it destroys your banking system. The Europeans are already dealing with this. This is the first fallout from QE.

And without banks, without a healthy financial system, you can't really have the kind of recovery, you can't really have the kind of growth that's consistent with ever getting back to normal, ever getting back to a world where the Fed doesn't have to buy bonds and the government isn't confronted by negative rates and isn't forced to spend money to try to force rates positive again.

You also end up in a world where non-banks begin to take market share from the banks. Because the non-banks are much less invested in the actual shape of the yield curve. You end up with an awful lot of financial transactions happening outside the regulatory umbrella.

And of course we already saw this, again, in 2008. The problem in 2008 was the ingression of non-bank financials. The banks were simply enabling the non-banks. But it was the non-banks that were creating the asset-backed securities, that were pooling the sub-prime loans, that were creating the Triple-As.

And, again, they can do it without having to pay FDIC insurance, without having to have tellers, without having to have ATMs, without being regulated at all.

The non-bank financials, the banks can't compete anyway. If you're going to make the curve perfectly flat, then they're really in trouble. Because, over time, what the Fed has done is allow the non-banks to come in and take market share.

And this is a problem they're also going to have to deal with.

And I've often thought that what the Fed is doing here is actually creating a situation where – Basel may have been designed to hold the banks back, to keep the banks from making loans in the last 10% of the economic cycle.

And if the Fed knew that by doing that they would allow the non-banks to jump in and grab market share at the end of the economic cycle, and that when the credit bubble finally burst, when the market finally turned, that most of the damage would actually be confined to the non-bank financials, which was fine for the Fed. That's what they wanted.

As Biggie Smalls said, somebody's got to die. And JP Morgan is too big to fail.

Non-bank financials are not too big to fail. I won't name names. They're not too big to fail.

So, systemically, the Fed may have been trying to arrange things such that the non-banks ended up with the market share at the end of the cycle.

And so much of the damage – the question is – look, the Fed knows if they raise rates they're going to blow a \$2 trillion hole in the world. And the question is, can you do that without taking us back to another systemic event that's going to require you blow yet another bubble?

And I think what may have been in the back of their mind, since they discovered too late anyway that they really didn't want the non-banks to have this much market share – because if you wait long enough there won't be any banks left. The banks simply can't compete with the non-banks.

Again, different cost structure, different regulatory. So the Fed may have arranged things such that the non-banks end up taking the vast majority of the damage, taking the vast majority of the hit, when the credit cycle finally ends and when rates rise.

And that's just the best way the Fed can play a bad hand.

Erik: Ralph, let's translate this now for the traders in the audience to investment market implications that people can actually use to influence their trading decisions.

Obviously, the biggest and most obvious implication here is that your outlook is for lower Treasury yields over time.

What else can we take away from this in terms of trading signals?

Ralph: You want to own duration, clearly.

You want to avoid mortgage prepayment risk. You want to avoid, probably avoid financials because the flattener is going to mean that they underperform.

And I think you want to try to stay with fortress balance sheets that have been the best performers anyway – the companies that can take advantage of the fact that they're going to be able to follow the Fed, follow the rates down in the belly of the curve, follow the Fed down to zero, issue new debt at zero, and buy back their shares.

So that's the big companies that have fortress balance sheets that can take advantage of the fact that rates are going to continue to fall.

I would avoid financials.

Erik: And finally, before I let you go, Ralph, tell us what you do at Pavilion Global Markets.

Ralph: I'm part of a four-person macro team and we write a daily note. We're unconstrained. We write on international, on domestic. We write on regulation, we write on really anything that we think is investable and interesting.

Pavilion is based in Montreal and we provide institutional investors with that research. We also do global-agency-only equity trading. And we do transition management, which is helping institutions restructure and reallocate their portfolios when they change managers.

Institutional investors that are looking to receive our research or find out about our other businesses should send us an email: strategy@paviliongm.com (and that's "pavilion" with one "l").

Erik: Ralph, I can't thank you enough for a terrific interview. We look forward to getting you back on the program for an update at some point in the future.

Patrick Ceresna and I will be back as MacroVoices continues right here at macrovoices.com.