



MACROVoices

with hedge fund manager Erik Townsend

Steven Van Metre: The Last Deflationist Standing

April 1st, 2021

Erik: Joining me now is Steven Van Metre from stevenvanmeter.com also the host of his own macro YouTube channel but most interesting to us at MacroVoices as perhaps the last deflationists standing. Not actually the only one Steven, but you're one of few so why don't we start with just the big picture. You know, a lot of us myself included have really come around to a view that we're looking at a shift towards secular inflation. Different people think different things about how far off it is. There aren't too many of you guys left that don't see that way at all so tell me where you want to start. Either with why deflation or why not inflation?

Steven: Yeah you know Erik, I think it's easy to see why we should have inflation right. I mean housing prices are up, stock markets up, treasuries up, crude oils up, i mean food prices are up. I mean it's hard not to think that we're going to see this secular rise of inflation and yet we continue to see these deflationary pressures on the economy and people say well that will go away as soon as the reopening is done.

Once people get back to work but yet when you when you look at this from a monetary perspective and when you really understand how quantitative easing works and its effect on the economy. What you find out is we're in a liquidity trap and even worse the fed created the liquidity trap and the problem with liquidity traps is they're disinflationary and if they're let run too long, they become outright deflationary and so when you understand that we're in a liquidity trap, you realize that these disinflationary pressures aren't going away and the biggest risk we have then is turning into deflation.

Erik: Let's start with quantitative easing because that's something a lot of people have in some cases mistaken assumptions about. One of them is a lot of us in the beginning thought QE itself was going to be inflationary. We didn't really understand where that money that was being created was going. So, tell us a little bit about quantitative easing, how it really works and how that differs from the way some people perceive it to work.

Steven: Yeah i think that's a great question Erik because you're right. We do have this view that is inflationary is meant to cause interest rates to go up but really the purpose of QE is to strengthen the dollar and lower treasury yields and what's odd about this, what people don't understand is that QE traps money in the financial system and you have this view that okay we can see this right. In the M2 money supply we see all this deposits, we see this money, we say okay. This has to be inflationary until you find out that money is actually trapped in the

commercial banking system via QE and is not coming out and in fact its movements are very limited and so what happens is QE becomes deflationary or you could say it's disinflationary until it becomes deflationary until there's enough lending growth because that's where dollars are created and that's really the key here. A lot of people think QE creates money and we'll get into that. The real creation of money is when people borrow and when a loan is originated. So if you really think about what QE is trying to do, it is trying to lower interest rates, raise the dollar, get people to borrow, create money and then you get this big pulse of inflation from that borrowing.

Erik: Okay now with respect to a historical review of how QE has worked, I agree with you completely, a lot of people myself included got it wrong. We thought it was going to be inflationary when it wasn't because as you say QE really is an asset swap. It's creating more bank reserves but it's not really pumping money out into the real economy so I agree with you there but hang on a second, Steven. That was then, this is now and it seems to me that the big political change that we've seen is now all of the sudden, there's a huge amount of political focus on what some people call QE for the people or helicopter money.

It's not going to be another round of the same kind of QE that we've had before. It's going to be the creation of money out of thin air for the purpose of delivering stimulus transfer payments directly into John Q. Public's pocket or checking account and that's why it is different this time and it is going to be inflationary. Do you disagree that it's different this time or are we only talking about what's happened in the past or why don't you see the current MMT, Modern monetary Theory inspired desire of politicians to hand out money to the general public as not being inflationary.

Steven: Yeah I think that's really it right. I mean, we look back to QE of old QE 1, 2, 3 which is the same QE as we're doing now. But it's like adding the turbocharger to your car. You put fiscal stimulus and the answer is how can this not be inflationary. And I think the key step here is we need to kind of review how QE works.

And then we can kind of dovetail that into how does fiscal stimulus actually play into this? And why did Powell go around? I mean, did people wonder why in all these press conferences and FOMC meetings. Everywhere Powell went, he was beating his drum on fiscal stimulus. Now was it because he actually believe that fiscal stimulus is inflationary? Or is there actually a whole another reason that most people aren't even considering? And so, if we can, I'd like to go through how QE works, just to make sure all of our listeners are on the same page, if that's okay with you, Erik.

Erik: That's perfect. And I want to let our listeners know that Steven prepared a chart deck to accompany today's interview. Registered users will find the download link in your research roundup email, if you're not yet registered, just go to our homepage, macrovoices.com. Look for the red button that says looking for the downloads just above Steven's picture and just below the green donate button. Hit me up. Steven, let's talk about how QE really works.

Steven: Perfect. Well, so we understand that QE is a reserve swap. So let's kind of reverse engineer this. And for those who understand I'm not going to go too deep, but just enough to bring everyone up to speed. So when the Fed does QE, all they are doing is they're taking a bank reserve held by a commercial bank, and they're swapping it for a reserve asset and that's all the process is. But sometimes we kind of miss a part of well, where did that bank reserve come from? How did it come into existence?

And the way a bank reserve comes into existence is when you deposit money in a commercial bank, and I want you to be thinking like the Wells Fargo, JP Morgan, Bank of America, the big commercial banks. As this money is deposited, well they have to pay interest on that. And there's two ways they can do it, they can either lend against that, which they're not doing a lot of and we'll talk more about that later on. But the other way they can do it is they can take those bank deposits, and buy Treasury securities, and use the interest from the Treasury securities to pay depositors. And so that's where you get a bank reserve from. As a bank takes bank deposits, customer deposits and create a bank reserve. And then the Fed comes along and swaps it. Now, Eric, have you ever played the game? Pac-Man?

Erik: I have not.

Steven: You've not. But are you familiar with it?

Erik: I am familiar with it. I've seen it, but I've never played it myself. Not a video game guy myself.

Steven: Well, perfect. That's okay. But you understand that there's a little Pac-Man that goes around the board and eats what are called pellets, snack pellets. And as Pac-Man eats these dots, it's a lot like quantitative easing. Because one thing that people don't understand is they think that quantitative easing creates the growth in the money supply, when in actuality, the quantitative easing needs a growth in money supply. And that's where we start to learn why Powell wanted fiscal stimulus. So what Pac-Man does, QE is it goes around the board and it eats these snack pellets, which are effectively customer deposits at commercial banks that get converted into reserves, which then get eventually converted by QE into reserve assets. And so as Pac-Man goes around the board, the way the game is won is he eats all the snack pellets.

Well, there's a problem. If QE eats all of the bank deposits, then the Fed either has to stop QE or scale it back so much just to handle whatever new deposits are coming in. And so this was a challenge because the Fed was doing so much QE, they were running out of bank deposits. And they knew this and it was coming. So how do you get more bank deposits, when you can't create that? Well, you have to do fiscal stimulus. And you have to go out and borrow this money from non what I'll call non-M2 sources.

Now, when I'm using the term non-M2 source, Erik, is I'm either referring to money outside the commercial banking system that's in the US or money outside the United States, that's not in

the commercial banking system that might be held by a foreign central bank, a foreign government, a foreign insurance company that would look to buy Treasury securities. And so what happens is, the Fed needs non-M2 money to be borrowed by the US Treasury, and then paid out as fiscal stimulus. So American taxpayers will get that money and deposit it into the banking system, knowing that some of that will land in the commercial banking system, where then it can be converted to a reserve and then eventually to a reserve asset by QE.

So the idea that QE of old and QE of new are really different. The only thing that's different is the Fed was actually kind of run out of deposits for the QE Pac-Man to chew up, and he needed some more. And that's why he really needs fiscal stimulus, not because he believes it's inflationary. Maybe he does. But he needs it to continue doing quantitative easing, because you and I both know, the Fed Chair Powell has clearly stated we're gonna run QE for several more years and maybe even longer, we don't know.

Erik: Now help me understand Why this need for bank deposits exists. it seems to me, QE, as I understand it involves the Fed purchasing treasury bills. So they're buying US Treasury securities from the government or from a private holder on the free market. But one way or another, they're buying up US Treasuries with money that is essentially created out of thin air by clicking a button. Why do we need to have existing bank reserves in order for that transaction to occur?

Steven: Because when the Fed engages in QE, they're not directly going out to the public. They cannot go to the Treasury auctions, they can only purchase them from the large commercial banks who participate in the QE program. And so the only way the commercial banks are getting these Treasury securities is by using customer deposits to create reserves.

So you see this process where the Fed is effectively just taking customer deposits that are being turned into reserves by the banks and then swapping them. They're not going out to you or I. They're not, again, not going out directly, you don't see them as bidders at the US Treasury auctions. They're getting them from the large commercial banks.

Erik: Okay. So to summarize your argument, Steven. It is essentially that in order for primary dealers to be able to sell treasuries to the Fed, they need to have those treasuries and the only way to have them is as a reflection of customer deposits. Seems to me, there are other ways, we've heard stories about these large primary dealers literally front running the Fed by buying securities, which they sell back to the Fed three days later. Do they really need to have customer deposits in order to backstop those transactions?

Steven: The way I view it, is the primary dealers are selling treasury securities to the commercial banks. Now, just so happens that many of the primary dealer banks are owned by commercial banks. So we have trouble seeing that separation there. But it's the commercial banks who are then taking those treasury securities, or using customer deposits to buy those Treasury securities that are being swapped. So that's the way I see the process being done.

Erik: Okay, and where does this leave us now as we get into this next big round of stimulus, which seems to have different political drivers behind it. We've got a new administration in the White House as well as in Congress. Where are we headed?

Steven: Well, we're clearly headed for more fiscal stimulus, because in order to continue doing QE, you need more customer bank deposits, you need more of those deposits to convert into reserves, and then you need to be able to swap those reserves. So then the kind of the question is, well, how do you encourage people to deposit money in the bank? How does that work? And why are they sitting on all this money in the bank. And that, again, now comes back to what was one of the purposes of QE is to lower interest rates.

So let's say I, as an American consumer goes down and deposit money in the bank, and maybe I'm just building up a reserve, my emergency account, and let's just say that number is \$10,000. It's not really relevant to the size of it. And let's say over time, I've now grown that to \$15,000. Well, what do most consumers do is they'll take the extra amount, the \$5000, and they will seek to get more return on it. It doesn't mean they're going to run out and open a brokerage account and buy stocks, it might mean they'll put their money out at a slightly longer term. Maybe in a CD, maybe in some other longer term deposit.

But what happens to QE is the short term rates are suppressed so much that a consumer goes down to the bank and looks to reinvest some of that money and finds out that there really isn't much of extra interest to tie their money up. So they leave it as a deposit. And that's really what's critical of QE is it needs customer deposits, to convert to reserves. And by suppressing interest rates, it encourages customers to keep money in the bank earning, you know, 0.1%, or whatever the banks are actually paying today.

Erik: Now, you argue that we're headed toward a liquidity trap. Why is that? And how are we defining liquidity trap?

Steven: Yeah, I want to go through before we get there a little bit more on what QE does in terms of locking down interest rates and how it traps money into the financial system. Because I think it'll make more sense because people are hearing that all the time from other people, that money gets tied up there. Okay, well, how is it getting tied up there?

So let's kind of broadly talk about how interest rates are suppressed by QE. And it all depends on the size and scope of the program. So if the Fed is focusing on the front end of the curve, or the long end, or broadly, like they are now. Well, with the exception that they're not doing T-bills right now. Well, what you're finding out is they're reducing the supply of treasuries on the market by 80 billion a month now. I don't know what the net new issuances, but they're reducing the supply. And so the idea is pretty simple is when you reduce the supply of something, you're kind of hoping to increase the value of what is remaining. And that would mean bond prices rise and interest rates fall.

The other thing they're doing, Erik, which I find pretty interesting is they're actually changing the nature or the duration of a bank reserve. So let's just say for an example, a commercial bank buys a two year Treasury Note. They're obviously using customer deposits and then the Fed comes along and swaps that, well, when that swap occurs, a two year Treasury Note is now being removed from the supply. It is going on to the Fed's balance sheet, we can see it, it's accounted for there, interest is paid to it, but we can't buy it off the Fed, we can't short it, and we can't go visit it. But what do the banks get in exchange? The banks get a reserve asset, and it's an overnight duration effectively is a cash reserve and matures every day, and it pays 0.1% interest.

So it's not, you know, in a sense, overly attractive in terms of being a high interest vehicle. It's designed to reduce the duration or reduce the maturity of the bank's reserves. And when you piece that all together, you find out that, okay, this is really designed to lower interest rates. And one of the ways we can see that, and let's go to chart one, where I've got the monetary base on the left and cash assets at all commercial banks. Now, Eric, you know, this, the monetary base used to be bi-monthly, and then recently, the Fed decided they're only going to put it out once a month, which was unfortunate for those who enjoy looking at the monetary base, twice a month, we could no longer do that.

But what's interesting is, in the weekly H dot eight data, there is something called assets and liabilities of all commercial banks. And there's a subsection called cash assets. And that includes all cash, cash items in the process of collection balances due from depository institution and balances due from Federal Reserve Banks. And so when you chart them together, what you see is these balances due from past Federal Reserve Banks, well, there's your reserve assets that are created as a byproduct of QE. And the reason I like this is because it comes out weekly. And it has a very strong relationship with the monetary base, which makes perfect sense, because the monetary base is those reserve assets plus cash in circulation.

So we know as cash assets at banks go up, and the Fed continues to do quantitative easing, and that the monetary base should follow it. And if we go to the second slide, where we start now looking at this effect on interest rates, because the popular belief right now is that interest rates are going up, they're going to go up substantially. And they're probably going to go up even more after that.

And yet, when you understand the effects of quantitative easing, and this liquidity trap that we're going to get into, is it's actually designed for interest rates to go down. So what I've done on slide two, Erik, is I've inverted cash assets. And for those who are looking at the slides, wondering where I created them from, these are from the St. Louis Fed Federal Reserve database is free to access so you can go on there and you can recreate these charts yourself.

And you see there's a minus sign in front of cash assets. So now I've inverted that. If you don't like using cash assets, you can certainly use the monetary base. And I've overlaid 30 year Treasury yields. So we can go back and look at 2010, where you see yields rising as cash assets are flat, and you see that hard reversal of yield and then you see yields went back up

cash assets shown inverted now rising, but going down on this chart, and then you see the hard reversal of yield and then you see it again in 2013. All right, here's going to be reflation, interest rates are going to go up and cash assets start rising, again shown inverted, and interest rates reverse. And now here we are, again, in 2021. Interest rates are rising, cash assets are rising, and everyone believes interest rates are going to continue to rise. But yet, due to the effects of QE on the bond market is suggest that no interest rates, while they could continue to rise are going to have a hard reversal at some point.

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Erik: So you're expecting that hard reversal in interest rates? What is the trigger or driver that would cause that to happen?

Steven: Well, I wish I knew exactly what that would be. At the moment, it just appears that there are a lot of people shorting the bond market, a lot of people have sold bonds, no one wants to own a global government debt of any form. They believe inflation is coming. And you know, if inflation was coming, that would probably be one of the easiest trades to make as you just simply short the bond market.

But one of the challenges is, as we'll get into the monetary system eventually rejects higher yields, because there's not a lot of demand for them. And before we get into that, if you don't mind, Erik, I'd like to talk about how this cash piles up in the bank and actually can't get out because I think that's the part that people really are focused on and saying, look, all this money is in this banking system. It's gotta come out. And there's no way you can convince me otherwise, that when it does come out, that it is not going to turn into inflation.

Erik: Well, Steven, let's dive further into this. Because frankly, from the things you're saying, you know, there's got to be more fiscal stimulus, a whole lot of fiscal spending. I agree. And the politicians have signaled very clearly, that's coming. Seems to me like that's a heck of a lot of inefficiently spent government money, that's probably going to go into driving inflation. So help me understand why this isn't inflationary, and how you get to the deflationary view from this.

Steven: For sure and that's a great point, Erik. So what QE does is it reduces the velocity of dollars, because the Fed has no mechanism to create or destroy money. Now, I know a lot of people think that QE creates money, it doesn't. As we've kind of just pointed out, it's the Pac-Man, it eats bank deposits, it doesn't create them, it eats them. So how does the Fed strengthen the dollar? Or how does QE lead to a strengthening of the dollar? Well, it does that by trapping dollars inside the commercial banking system once they're tied to a reserve asset.

And what this does is what I call it creates a Dollar prison. So let's move to slide three. And let me explain to you how this dollar prison works. And then it'll make sense when we look at the third slide. So when that swap, that reserve asset swap happens, the reserve asset created by the Fed is actually held at a Federal Reserve member bank. And it's accounted for on the commercial bank's balance sheet. So the commercial bank says, look, here's my balance sheet, I've got this reserve asset, but they don't control its destiny.

Now, when a bank creates a reserve out of a customer deposit. It chooses what it's going to buy, and it can choose when to sell. But when that reserve is swapped for a reserve asset, the Fed is now in sole control of it. The bank cannot force the Fed to sell that reserve asset, the

bank can move that reserve asset inside the commercial banking system. So it can swap with another bank for, say, a treasury security, but that reserve asset cannot leave. And so what happens is, this money is tied into the commercial banking system, these deposits, and they can't move around because there's not a large number of commercial banks, where these reserve asset can move around.

So what it does, Erik is it causes a velocity of money to get absolutely crushed. And this is what we're showing on the third slide where you have velocity of M2 on the right. And you have cash assets, again, shown inverted. So as cash assets in the banking system rise, well, it causes velocity of money to get suppressed.

And this is how and absolutely is the inflation killer. Because as you and I both know, there's two ways you can create inflation. You can either create a lot of money either, even though we can't print money, but a central bank, a foreign central bank might either print money or in our system, you need a lot of lending growth. But what's the killer to that? Well, if it can't move around the system, then you can't get inflation. And so what you're seeing here is as those cash assets rise, the expectation is the velocity of money should continue to fall.

Erik: Where does the liquidity trap fit into the story?

Steven: Well, that's a great question, because what's the liquidity trap is a dollar shortage. And this is something that a lot of people really don't understand is, it's kind of like a black hole. You and I could, you know, point a telescope at a black hole, and all we would see is black space. And the Fed says, look, liquidity traps don't exist. And if we zoom out our telescope, we can see that there's a black hole by what's going on around it. And when you get stuck in one of these, it's possible to get out, but it's very, very difficult.

So a liquidity trap occurs when the demand for money, which is quantitative easing. We just discussed how it creates a demand for money and bank deposits is proportional to the money supply, which would be the M2, then you get stable inflation. Now when the demand for money increases less than proportionally than the money supply, so the money supply is growing at a faster rate than QE, well then you get inflation. But where we're at now, is when the money demand increases more than proportional to the money supply, there is disinflation, or eventually deflation, because that gap between the demand for money and the money supply can only be filled by a decline in aggregate prices mean consumer prices must fall to close that gap.

Now, if we go to slide number four, this is what's called the money multiplier. And from one of your past guests, and I know very famous guests, someone I'm a big fan of Dr. Lacey Hunt, he talks about the money multiplier. Well, here's actually how you chart that you take the money supply, and you divided by the monetary base and you notice I've made a small adjustment so we get the proper ratio. And what you're seeing in slide number four is what the liquidity trap looks like. And when you see the money multiplier, declining as it is now that is a sign of the liquidity trap. Ehen it is flat which it generally isn't, rarely is flat maybe between, maybe in 2017 it

was flattish then you have stable inflation and when it is rising that's where you're, you can get inflation. Doesn't mean you will, it just means you have the potential now because the money supply is growing more proportional to the demand for money.

And if we go to the next slide, slide number five all I've done is overlay treasury yields here again and here we see the 30 year and we see that similar relationship as we looked at with cash assets which is just a different way of looking at the liquidity trap where you see this decline in the money multiplier leads to persistently lower treasury yields and when you see the money multiplier rising it has the potential to lead to higher yields but as soon as that starts to roll over then you'll notice yields fall again. So this chart here is suggesting that treasury yields are headed lower.

Now if we go to chart six, we're going to come back to cash assets inverted and I'm going to add consumer price index but instead we're going to look at the core CPI and we're gonna exclude food and energy. We'll talk about them on the next slide but what I want your audience to see Erik is that there is a relationship here that as we do more QE, that it is putting downward pressure on the core CPI because when you really understand liquidity trap is you can have higher prices in the economy. So for example maybe the economy says we want higher crude prices. Well fine we can have that but that has to be offset somewhere else or we can have higher home prices or higher food prices but it has to be offset somewhere else due to the fact that the demand for money is growing more proportionally.

So when you understand that gap has to be filled, something has to go down and that's why every month when the CPI comes out people are always talking about okay this is the report where we're finally going to see inflation and then it's like oh but that there was a one off you know on this statistic and it went down well next month it'll go up. Well the next month comes along and something else goes down and here we can see that relationship between the core CPI and cash assets shown inverted suggesting that in the future the core CPI is going to continue to decelerate. Now I know a lot of people say well yeah but what about the headline CPI.

Well let's go to slide seven and what I've done here is I've added the CPI to the core CPI where the core is in red and the broad CPI is in blue and we notice that the CPI tends to follow the core but I've also added the trade with the dollar and the reason I did that is not because food and energy prices are solely tied to the dollar I mean we both know that.

But it does have an impact on the value of crude and food prices and so if we understand that quantitative easing and this liquidity trap leads to a stronger dollar then that's going to put downward pressure on food and energy prices. It doesn't mean they can't still rise it just going to put downward pressure on them and if we know that the core CPI is going to continue to decelerate because of liquidity trap then we know eventually that consumer prices are going to roll over and we're going to see that disinflation and if it goes low enough, it will turn into outright deflation like we saw during the great financial crisis.

Erik: What are the consequences and implications of being in this liquidity trap that you're describing and what are the ways that we can get out of it?

Steven: Yeah well the danger of this Erik is there isn't enough money and that is what a liquidity trap is. There's not enough money in the system because it keeps getting trapped in the system and so there's three ways you can really get out of it. And when people ask well what would change your mind Steve, well these are the ones that will do it. Number one, the Fed could start raising the federal funds rate and unwind their balance sheet via quantitative tightening. That would reduce the demand for money, it would drive up interest rates, and then you'd see money exiting the banking system but we know that's not going to happen at least based on what we've heard from Fed chair Powell over the last year.

The second way out is you can get lending growth and we're going to talk more about this in a moment because I want to get to the third one which is fiscal stimulus but lending growth is really important. The third one is fiscal stimulus and I know some people say, ah ha ah ha there it is fiscal you're gonna agree that this is a solution.

Well, the problem is you need persistent fiscal stimulus, you need fiscal stimulus almost every month and not only that but you need an increasing amount of fiscal stimulus because what happens with fiscal stimulus is it gets into, part of it ends up getting trapped in the commercial banking system, if we just use kind of generically a third is used for debt reduction which is money destruction, a third gets saved. Some of that being in the commercial banking system which will get caught up in QE. And then the other third is use for mostly non discretionary and when you have higher energy and food prices, that's going to suck up that money. So you do need a lot of fiscal, but what you really need the fiscal to do is to create lending growth.

And so, you know, as we come back to this big picture now of this liquidity trap. It starts to make some sense. Why does the Fed want a stronger dollar and lower interest rate? Well, how do you get people to borrow and create inflation? Well you do that by driving the dollar up, so that way American consumers will borrow money, because now interest rates are lower, and they will spend that money abroad outside the US system. And as you know, from your many conversations with our mutual friend, Jeff Snyder, and the euro dollar system that he's gone over is the Euro dollar system creates a lot of money. So you need to get money out of the US into the euro dollar system, work, and move around a bit, and start creating inflation.

And when you get too many dollar building up in the euro dollar system, the foreign central banks will take those dollars, and they will recycle them back into the us through Treasury auctions. And then the US Treasury will pull that money in, the federal government will spend it back out. And then of course, due to a relatively strong dollar and low interest rates, American consumers will continue to perpetuate that cycle until enough dollars are created, where you actually can break out of the trap, and you see sustainable inflation.

And that's why on chart number eight, for not seeing this. So here's all loans and leases and bank credit on all commercial banks. And on a year over year basis, it's at 0% right now. And if

you look at the three and six month rate change, well then, you know, it's headed negative. And the problem with this is, when you see a contraction in credit, it actually is destroying money. So it actually puts downward pressure on the growth of the M2, which now puts us in a situation where the growth of the M2 is going to become highly dependent on future fiscal stimulus. Meanwhile, as the Fed continues with that Pac-Man, if QE gobbling up those customer deposits, you're going to see further disinflation. And even the risk of if this is allowed to go long enough, outright deflation.

Erik: Okay. Let me just summarize to make sure I understand this and keep me honest, because I don't want to put any incorrect words into your mouth. As I understand it, you're saying that your view is this liquidity trap requires that we're going to need the fiscal spending that's already being planned.

But if I'm understanding you correctly, what you're saying is that fiscal spending unto itself is not going to be inflationary, unless or until it causes an increase in consumer borrowing as a result of that spending. And it's only when that borrowing that creates new money in the commercial banking system occurs, that potentially your deflationary or disinflationary view, could be coaxed to change to inflation at that point.

Steven: That's absolutely correct Erik, and we see the evidence. You probably remember the Chicago Fed National Activity Index recently came out for February. And what did we see like a -1.09 print on that. That is highly recessionary and that was just after we had a fiscal stimulus bill that was passed in December. Checks went out, receive in January and here we are seeing that in February.

And so the problem is a fiscal stimulus isn't big enough, it's not persistent enough, and it's not leading to lending growth. And so now the problem is, since we're having to do fiscal, we're being forced to borrow from outside of the money supply. The US money supply, so we're having to pull money in from foreign sources of dollars. And that's reducing the supply of dollars in the foreign markets. And it's all it's doing is taking dollars and trapping them inside the commercial banking system and as you shrink these dollars down, no matter where they're at, and you trim their velocity down to next to nothing.

What you find out is that you can't sustain inflation, you can't sustain higher asset prices, because there isn't enough money to keep stocks up, to keep commodity prices up, to keep real estate prices up there. there is a shortage of money. So either the monetary system needs to forcibly cause interest rates to fall to create lending growth, or you run the risk of an outright financial crisis because well, then how do you get people to borrow money? If there's a dollar shortage and their asset prices are too high? Well, then asset prices need to come down and so that's the danger of this. The longer you stay in this liquidity trap, the worse it gets.

Erik: Steven, let's talk about what this means for bond yields because that's definitely a topic on everybody's mind this week. It sounds like you're saying the backing up of yields that we've

seen is I hate to use this word but transitory and not likely to continue. Is that right? And if so, why is it happened as much as it has already?

Steven: Yeah, you've got it exactly right, Erik. I mean higher Treasury yields, higher interest rates, higher crude oil prices, higher food prices, all it's doing is sucking up what little money is out there in the system. So what you actually want to get out of this trap is you want lower commodity prices, lower food prices, lower interest rates. And if you don't get that, then again, the problem is there isn't enough money to continue to support these higher asset prices. So why have we seen interest rates been driven up?

Well, if you look around the world, you see everybody is either short government bonds, or they're selling government bonds and every which way possible. Nobody wants to own these things because the broad view is we are going to have inflation. And well, if we are, then the last thing you really want to own is government bonds of any country. But yet if you realize we're stuck on liquidity trap, and you realize then that interest rates are more likely to go down than up. Then the only thing you really want to own beyond perhaps the US dollar is long term, government Treasury securities.

Erik: So it sounds like what you're saying is the reason that long dated Treasury yields are backing up is because everybody's kind of got the story wrong. And it's going to continue to backup until people get the story, right, at which point, you expect a reversal to lower yields again,.

Steven: Right, and the evidence of that is you can see the lack of demand. We see that in lending. I mean, if you look at the weekly mortgage application data, and you see is approximately down 25% from its recent peak. That is an indication that consumers are rejecting higher interest rates. And so if there isn't demand for people to borrow these higher rates, that doesn't matter how many people are shorting them or don't own them, rates will have to come down until borrowers are found. The problem is, the longer you extend this out, borrowers go on to find some house, buying a home they decide maybe they'll just stay in their home.

And so that's why you see, and we can see that on slide number eight, that yields tend to or loans and leases contract outside of recessions. Well, if I had overlaid Treasury yields on this, you would see that outside recessions, yields tend to make new all time lows. And why do they need to do that? Well, they need to fall far enough to get people to come out and borrow and create new money.

So yes, it doesn't matter how far yields are backed up at this point. At some point, they will go no further, and they will make likely new all time lows as we've seen over the past 10 years, every time there is a liquidity trap yields fall enough to create lending growth. Now the only question is, how low will they have to fall to create lending growth. And my guess is you're going to see the entire curve go negative or very close to zero, even all the way out to the long end.

Erik: And the only thing that reverses your view, to make it inflationary would be if you saw some event cause an increase in consumer borrowing so that new money supply is being created in the commercial banking system by loaning those dollars into existence.

Steven: At this point, yes, because I'm gonna assume that, I'm sure you probably will agree with me I don't think the Fed is going to do quantitative tightening or raise rates anytime soon. And the fiscal stimulus, I mean, there's a limit. We're already seeing that in the Treasury auctions where foreign governments are not as excited about lending us money. So there is a point where you can only push fiscal so far before then you either, then you have to raise taxes, well, no, that's just cycling money inside the system. So that's not really going to accomplish a whole lot of things. It is still going to end up getting money trapped inside the commercial banking system as long as the Fed is doing QE.

So the only out right now, is there has to be a substantial amount of lending, which is going to be really difficult given the high rates of unemployment. And the fact that banks have kept lending standards relatively tight, I don't see they have much of a desire to lend. And if we look at that loans and leases chart, we were seeing kind of a deceleration going into the pandemic.

And the main reason we saw lending jump was simply because companies were pulling their credit revolvers and people are borrowing money to get through the pandemic and look what's happened since. The year over year rate change is zero. I mean, that is highly unusual. Usually it doesn't go to zero and or start contracting till outside of recession, not during. So yeah, this is a very dangerous situation that will only likely be resolved by treasury yields falling substantially.

Erik: Well Steven, I can't tell you how much we appreciate your coming forward with, uh, we'll call it the last deflationists standing perspective. Before I let you go, tell us a little bit more about the YouTube channel that you produce and the other things that you're involved with.

Steven: Yeah, thanks, Erik. I appreciate that. So I do manage a macro fund that implicitly falls my thesis. I also created an investment strategy called [Portfolio Shield](#), which is a long-only equity strategy. It is completely formula based but it has a very unique hedging mechanism. It takes the weaknesses of asset allocation and volatility control strategies and takes it to the next level. It's a really neat strategy and if anyone is interested in that, they can find it at [portfolioshield.net](#).

And I've even so strongly believe in I think this is kind of the next generation of risk reduction strategies. I've even shopped it around a couple large insurance companies as a potential option for their variable sub-accounts and index sub-accounts. But unfortunately, I don't have a big name. I'm not a hedge fund manager or don't work for a large mutual fund company, as I was told, and so doors were politely shut in my face.

But I think if anyone wants to go take a look at that, because I'm very optimistic someday, Erik that the right people will see that I've created the next generation of strategies for terms of hedging customer downside returns, and still give them a lot of upside potential. And so for now,

it's available only through me and my firm and you can find more information at again, portfolioshield.net. And then last, I host, a macro show on [YouTube](https://www.youtube.com) and you can find it by just punching my name into the YouTube search engine. And three days a week we talk about macro, the economic data, liquidity trap, and how all this stuff intertwines.

Erik

Steven, thanks so much for a terrific interview Patrick Ceresna and I will be back right after this message from our sponsor.