Joseph Wang: Post-FOMC Rundown

March 17th, 2022

Erik: Joining me now is Joseph Wang, proprietor of fedguy.com. Joseph, it's great to get you on the show. This was an FOMC week. Why don't we start with what happened? I don't think the 25 basis point hike really surprised anybody but give us the bigger picture. This is one of the most anticipated rate hikes in all of history. The beginning of a cycle that a lot of people have their eyes on. What should we take away from this week's FOMC and what other perspective do you have on what's going on?

Joseph: Hey Erik! First of all, I want to thank you very much for inviting me. I've actually listened to MacroVoices every week for the past few years. So it's a great honor to be here. So today's meeting was as you mentioned, highly anticipated. Again, we're at liftoff again. And what I see is that we're kind of at an inflection point for a global monetary policy. For the Fed, for example, we're hiking today, but not just the Fed. If you look across the pond at the ECB, at the BoE in many developing market central banks, everyone is getting more hawkish, less accommodative, everyone except the BoJ but they got to do their own thing. So today, if you look at the market reaction, you might think that it was dovish. You see equities rallied, you see the two year yield, the one that's most sensitive to Fed policy, the rates went up a few basis points, not much and the 10-year went up a little bit as well.

But if you look at the SCP dotplot, I think what you see is, I think, a much more hawkish response. You see the Fed revising up their expected Fed funds rate by 100 basis points for the next three years. You see inflation expectations rising and expected real growth markdown so basically stagflationary. And the other thing that happened during the FOMC is that Powell seems to be ready to go forward with QT at the next meeting. So when you put those together, in my view, it seems like a rather hawkish meeting. Although to be clear, inflation is very high and the Fed is far far behind the curve. The way that I see this biggest thing that could happen in the coming weeks is that we have a very aggressive quantitative tightening. And that's actually be hinted at by Powell at his house testimony a couple of weeks ago. And that I think, could be a big change for the markets much more so than just hiking the short rate by a couple 100 basis points would imply.

Erik: Joseph, I get a little bit concerned when I hear Jay Powell invoking references to Chairman Volcker and I forget who else. Several other people in media in the last couple of weeks have made these references to Volcker like it's time for Volcker. And I can't help but remember one interview I saw with Chairman Volcker before he died, where he said very clearly

that the aggressive hiking approach that he took in 1980 could never work today because we have a fundamentally different debt backdrop. And it's a completely different scenario and that approach would never work. And now I hear people sounding like they're saying they're going to be like Volcker and do what he would have done, even though he already told us that that wouldn't work. Am I missing something?

Joseph: Yeah, I don't think Powell's any closer to Volcker. I mean just not too long ago, rates were at zero and we were doing QE and inflation was at 7%. That's not what Volcker would do. But I think there's a point there in high debt loads. So mechanically, what happens when you're hiking rates, what you're doing is you're reducing the value of fixed income. Now, that's really problematic when you have a very high degree of fixed income in the financial system. If you think about it, you know, Treasury securities are kind of a form of money in the system, people hold them as safe assets. And it's a integral part of a lot of strategies from risk parity, to target date funds, to your generic 60/40 portfolio. So when you have a very high amount of debt, a lot of it taken out at very low interest rates, there's an enormous amount of interest rate risk there.

So if you even just hike rates slightly that poses significant amount of losses on those portfolios. In a sense, money in the system disappears and that I think has tremendous financial stability and wealth effects. So we definitely have trouble hiking rates the way Volker did simply because the reverse wealth effects so to speak, will be very strong and the system might become unstable. Politically, it's a difficult thing to do as well. So I think that's actually part of the reason why we don't really hike rakes as much. If you think about what happened during the last hike cycle, the Fed got to bit over 2%. And then equity markets melted down. When I see that though is that it's kind of the pain point for that given level of debt. And today we're at a much much higher level of debt since then so it stands to reason the pain point would be a little bit lower.

Erik: So where are we headed? In terms of the Feds options with all of this? It seems like people talk about Volcker as if his strategy was somehow an option, even though we know it's not. And we know that the amount of hiking that it would take to really stop inflation would result in an untenable cost of borrowing for the federal government. They would almost bankrupt the federal government if not outright bankrupt the federal government by having interest rates that increase borrowing cost that much. So what are the options that are really available to the Fed?

Joseph: So I would push back against that a little bit. So the federal government really isn't constrained by interest rate costs as well, it can always just rollover it set forever, like what it's been doing the past 10 years, or push came to shove, it could just have the Fed borrow all of it. So having high interest rate costs is not a constraint to the government at all. But it does potentially incur high inflation. What I do think though that the Fed could do is actually just reduced asset prices. So if you look at Federal Reserve data, the net worth of the public, it's as high as it's ever been. And that's part of what's behind the enormous amount of demand that we see everywhere. People who bought let's say, FAANG stocks, or anyone who bought a house past few years ago, they're seeing their net worth skyrocket, that gives them money to go and buy other things which increases demand.

The irony is that if you think back what happened during the post-GFC world, the Fed began trying to stimulate a wealth effect to try to boost growth and inflation, it knew that it could not give money directly to people. So it thought that maybe if we could force an asset bubble to get people to spend more because they felt wealthier, that might improve the economic conditions. Now having the wealth effect as part of their toolkit, it seems though, it's become a very important part of it. And they should probably just deploy it again but in reverse. By hiking the interest rates, the Fed funds rate by 100 or 200 basis points, it's hard for me to see how that actually feeds into the real economy. I can't think of anyone who would really change their buying or selling decisions in the real economy for just purely on 100 or 200 basis points, but it would affect the financial markets a lot. And maybe that's the primary channel that the Fed actually acts now.

Erik: Joseph you studied all of these cycles. Walk us through what a quantitative tightening cycle should look like? What should we expect from it and particularly, how did this go last time when it was supposed to be a quantitative tightening cycle then after a certain point, we got to the so called Powell pivot where it was, well, it was going to be a tightening cycle but we changed our mind. Should we be watching for that kind of reversal again, and what will be the signs that it's coming?

Joseph: The Fed has a history of hiking till things breaks. So that's probably what we should watch. But so you are right. I worked on, I was on the Feds trading desk at the time during quantitative easing and I studied this quite a lot. So when you're on the Feds trading desk, you have access to basically everyone's reserve account. You can talk to the Treasury teams of banks, you survey them and talk to the dealers. So you get a very good sense of just how the mechanics of quantitative tightening works. So just as a big picture, the way that you can think about this is that so quantitative easing increased the level of reserve assets and deposit liabilities in the banking system, and from the non-banks perspective, decrease the amount of say treasuries and increased amount of bank deposits and quantitative tightening will reverse all that. So banks will have fewer reserves and deposit liabilities and non-banks will have fewer deposits and more treasuries. So I guess just as a just by way of background, it's important to understand that we have a two-tiered monetary system where people who can bank at the Fed they hold reserves is muddy, and people who can't bank at the Fed. So let's say me, you, or any other investor we hold bank deposits as money. And these two systems interact.

For example, if you're an investor and you're selling a treasury to the Fed, what happens is that the Fed sends reserves to your bank since the Fed deals in reserves. And since you don't have a reserve account, then the bank turns around and credits deposits to you. So at the end of the day, instead of holding treasuries, you hold some bank deposits and your bank will have more reserve assets and deposit liabilities. And that's basically what QE does. And Qt reverses all that so it will reduce the cash balances of banks, which is reserves and for the private sector increases the amount of duration that they hold. But exactly how that impacts markets, though, it's not really dependent upon the Fed, it's going to be dependent upon how the US Treasury reacts. So the big impact of Qt back in the last cycle when things blew up really had to do with what happened during the bank in the banking sector when the reserve balances declined. So

as I mentioned before, Qt shrinks the cash balance of banks, and increases in the duration held by non-banks. So back during the prior Qt episode, banks were taking all their excess cash and you were investing in repo. So, there was insatiable demand for repo financing, you can see that in public data. So repo volumes are rising, pushing repo rates above interest on reserves, banks saw that, you know, they could earn an extra return by investing in repo.

And under the regulations, repo and reverse were fungible, they began lending into repo and became the marginal lender. Qt basically shrink their cash balances such that there's less money going into the repo market, until kind of hit an air pocket and repo rate spiked. This time around though, the banks are behaving very differently. They're not investing in their marginal dollars into repo. They're buying treasuries and agency MBS. And so what would happen from Qt at least in that mechanism would suggest higher rates rather than anything to do with repo at all. But just moving on to the non-bank side on the amount of duration, the private sector has to bear. I say that's a decision by Treasury because it's Treasury that decides what insurance will be. So mechanically, what happens is the Treasury is going to issue new debt and take the proceeds from that debt to repay the treasuries held at the Fed. So someone in the private sector is basically going to refinance the debt that's currently held at the Fed. Treasury has discretion as to where along the curve they can issue. They can issue 5, 10s, bills, and so forth. And that, I think, is going to be the biggest determinant in what happens to private sector duration. If the Treasury decided to issue a whole bunch of bills, that would just take money out of the R&P facility, and he would have very little impact on interest rates, or the treasury should take advantage of historically low interest rates, issue a whole bunch in the longer dated treasuries, and that would put upward pressure along the curve.

Erik: I know that you're a regular listener Joseph, I'm sure you heard Charlie McElligott's interview a couple of weeks ago where he told us that in these tightening cycles, history teaches us a couple of months in which suggests May or so would be about where you would expect a bottom in equity markets. First of all, do you agree with Charlie's outlook, that there is likely to be some weakness in equity markets as a result of QT? And if so does May sound about right? How does your Outlook compare with Charlie's?

Joseph: I absolutely agree. So mechanically, so I do think Charlie McElligott is a master in options markets. I see things from the mechanics of the monetary system. So mechanically, what happens during quantitative easing, is that you take treasuries out of the system and add bank deposits but the two are not perfectly substitutable forms of money. Bank deposits are not free of credit risk, and they are zero yielding. So if you're someone who needs yield, you're going to have to buy something else. Maybe a corporate bond, maybe even equity, maybe further out the curve. If you're someone who can't take credit risk, you're going to have to buy longer dated Treasury or maybe an agency MBS. Qt reverses all that. It takes out bank deposits. So the quantity of zero yielding bank credit risk, deposits declines less of it needs to find a home, and there's more safe assets to buy. And so that's very negative for all risk assets, you can think of if QE was good for risk assets, Qt logically is not good. So, I think that's exactly right. Once we have the more contours of Qt, that should mechanically be a tailwind for risk assets.

But there's other things to keep in mind as well. We are, we appear to be in an inflationary cycle. In my view, largely driven by deficit spending. When you think of what the Treasury is doing, whether deficit spending is they're buying goods and services, but they're paying by printing Treasury securities, I contend that Treasury securities are basically a form of money. So if you think about it, if you go to a restaurant, you can't buy... let's say you can buy dinner with a 10-year note. But a 10-year note can easily be liquidated, either in the deepest cash market in world or the trillion dollar overnight repo market. If you think that $100 bill issued by the government is money, then, you know, $100 10-year note is basically just money that pays interest. Now, from this perspective, every year, the federal government is printing, you know, a trillion to a trillion and a half of money to fund its spending. That's inflationary. And that's risk positive. So in the long run, we can have these corrections. But as long as deficit spigot keeps flowing, it's hard to see risk assets or actually all assets do anything but go up.

Erik: Joseph last time that we went through this, the Fed kind of changed course when the markets as you put it broke. Would you expect that to happen again, that we're going to see the Fed stay on this course until something breaks? And how long do you think it takes before something breaks?

Joseph: Yeah, the Fed always stays on course until it breaks.

Erik: So how long does it take to break this time?

Joseph: I think so I'll give, I lay out some numbers for you and maybe that can help give you a concept of what's happening. So, again, what QT is doing is increasing the amount of duration, amount of longer-dated debt risk free assets, agency CMBS, or treasuries that the private sector has to absorb. Powell noted in his congressional testimony a couple of weeks ago that he was expecting QT to take about three years to get the balance sheet back to normal, generously thinking, let's say the balance sheet is $9 trillion now. Let's say $6 trillion is normal. This is a conservative, it could easily be $5 trillion. So if you're thinking we have to shrink $3 trillion in three years, then that's about a trillion a year, which means the private sector is going to have to absorb a trillion dollars a year in duration. And on top of that we have the Treasury itself, forecasting about one and a half trillion in net new issuance this year and next year and the year after that. So the private sector is going to have to absorb a historic amount of duration. That means rates, long-dated rates mechanically, just by supply and demand very likely to go higher. And through the mechanism that I discussed earlier. So risk parity strategies, for example, targeted funds, when you have the bond market sell off, risk assets have to sell off as well, because they're linked by these strategies. So I'm not sure exactly but I would be surprised if we got through a year of QT without someone breaking possibly something, let's say in the belly or longer end of the curve, that would force a rethink of what the Fed is doing.

Erik: Joseph, let's talk about the securities that are being purchased. Everybody assumes it's Treasury securities, T-bonds, T-notes and so forth. But it actually also includes mortgage backed securities, doesn't it?

Joseph: Yeah, yeah. That's actually an important part of what happens to... so the MBS portfolio is going to roll off a little bit differently than the treasuries. The way that a treasury rolls off like I mentioned earlier, the US Treasury issues new debt to a private sector investor and takes the proceeds of that to repay the Fed. But here, usually what happens is that the mortgages that the Fed holds, it can either repay by just normal principal and interest payments over a 30-year term. Or it can be repaid if the mortgage borrower either refinances their mortgage or buys a nice house. In the US, mortgages are pre-payable. So if you have a 5% interest rate mortgage. Mortgage rates drop a percent to 4%, you can take out a new mortgage loan to repay that own mortgage, that's one way the Fed could be repaid. Another way is if you have a house, and you decide to sell your house, then at that moment, when you sell the house, the proceeds of that sell are used to repay the mortgages is held by the Fed. Now, in the current context, what's going to happen is that because so many of the mortgages were taking out, when interest rates at generationally low levels, they're unlikely to repay, and the people who bought houses are unlikely going to give up their historically low mortgage rates. So the only way that the Fed is going to be able to roll off its mortgage portfolio is either to wait patiently, or to actually start selling their CMBS portfolio. That's been mentioned by a few Fed presidents. At the moment, the projections by the Fed are an agency MBS portfolio, that gets paid down at a rate of about 25 billion a month. So it's not super slow. But eventually, you might have to sell it a bit if you want to hit that 3 trillion 3-year target.

This matters because as Jay Powell once noted before, the Fed buying agency MBS in a sense, it's shorting volatility. Since owning an agency CMBS, you're selling a call option since the CMBS can repay. Now, if a private sector investor holds it, they might want to hedge that convexity. So usually, that means more volatility in the rates market. If you think back to what things were like pre-GFC, Fannie Mae and Freddie Mac had investment mortgage portfolios together about one and a half trillion. So that meant that when rates went higher, they have to hedge by selling treasuries. Since when rates went higher. If they wanted to maintain their current duration, they'd have to go short since when rates are higher, that meant that they would be fewer prepayments. And if rates went lower, then there would be more prepayments. Duration was shorter and they'd also have to buy treasuries or Treasury futures or stretch through options to maintain their current duration. So that itself exacerbates rainfall. And if you look at the move index, you can kind of see rate vol ticking higher as well. So in the future, you might not just have higher interest rates, but you could also have more volatile interest rates.

Erik: Joseph, as you know, the entire world's financial system really centers around US Treasury bonds, as financial reserve assets. So that's essentially the piggy bank, if you will for a central bank, the entire country's piggy bank. What is it going to mean if we have changed the rules through the recent news events? And I know you wrote an article about this on your website called breaking the system, which I recommend to our readers. What is it going to mean if we kind of find out that the rules of this game are that all the sovereign nations are equal on the same footing except the United States gets to cancel anybody's foreign exchange reserves if they're upset with them, and clearly, the US had very good reason to be upset with Russia recently.

But essentially, without any due process of law without any court judgment without any decision from a judge or a jury. The United States decided that Russia doesn't have its foreign reserve assets anymore. Essentially use some as I understand it, some Federal Reserve computer trickery to make that money go away. What are the long term implications of this on the rest of the financial system? Particularly, I have to imagine that other central bankers are thinking, hey, wait a minute, what if I ever get in the Feds bad graces does that mean they're going to cancel our reserves as well? Or their credibility issues for the viability of the US Dollar as the world's global reserve currency if the US government is going to have this ability to kind of undo people's savings when they want to?

Joseph: Erik I think you're exactly right. And what the US government did not just US, the European Union as well was tremendously dangerous. And we're seeing it not just happen in the sovereign space, but on the retail space as well. If you look at what happened in Canada. Prime Minister Trudeau basically unbanked everyone who dissented. So what we're seeing globally is a worldwide weaponization of the banking system. And that's extremely extremely dangerous. Because the banking system fundamentally rests on trust. You have money, you're giving it to a complete stranger you don't know at all. And all you see as proof are numbers on a computer screen. That's true for the retail depositor as it is for a sovereign investor. All they see are, say digits, probably not at the Fed, but at some other European Central Bank. So if you see, if you think that this is weaponized then fundamentally, what you thought was risks free, is no longer risk free. And if this isn't risk free, then if you're a sovereign investor, or any conservative investor, you can't put a lot of value in it, you can't hold it.

So I think this has tremendous damage to the banking system. But I'm not sure that it spells the demise of the US dollar. So I would say that the two can coexist, you can have a great decline of confidence in the financial system, but you can still have the dollar remain preeminent. The truth is, the world runs on dollars, the dollar is the currency of global trade. So internationally, about half of all transactions in trade, the trade is invoiced in dollars, that's not just trade with the US, US actually is not that big in global trade. It's trade between non-US parties. So if you are, let's say, Indonesian firm buying from a Vietnamese firm, often things would be invoiced in dollars. And if you look at the FX space, about the vast majority of FX pairs are against the dollar.

So you're going to need dollars just for day-to-day transactions for global trade, even if you don't have confidence in it. But what could change though, is where you store your let's say, foreign reserves or your safe assets. Because let's look at China for example. It has three and a half trillion dollars in foreign reserves, it definitely does not need to have all that to trade with the world. So there's no reason it needs to hold a lot of it in foreign currency. And that's true for any sovereign. So what I think you could see, it's just a massive reshuffling of foreign reserve holdings, such that sovereigns hold fewer foreign currencies, and more dollars. And you can even think of this as a national security issue. So if you're a Foreign Sovereign via China, via India or Russia, and you want to be able to conduct your foreign policy without being threatened by anyone, you want to be a sovereign state. Then you kind of have to be able to just survive a

confiscation of your foreign assets. If you think back to what happened during World War Two, the US showed the world that they had nuclear weapons, and everyone was scared even the US allies, and even their allies wanted to have nuclear weapons. Why? Well, just in case it's a national security issue. I think he could see the same thing happen for all the foreign reserve managers and in the world after seeing what happened with Russia. It's not that they're not friends with the US or that they don't need dollars, but they don't need as much. And there's a national security issue to be able to survive a confiscation just in case.

Erik: Now you say that everyone needs dollars. But the question in my mind is why is that still true? And how long is that going to stay true? And specifically, the question I want to ask you is who outside the United States is left who still thinks that the US dollar being the global reserve currency at the center of the financial system for the rest of the world is a good thing. Certainly, I see the many reasons that it benefits the United States Government for that to continue to be true. But who outside the US still favors that and how long will it take for them to come up with an alternative to the US dollar, which it seems like they've been incentivized to work on it if we continue to have policies that I think are alienating to some foreign investors.

Joseph: So we see whispers of alternatives to the dollar, I saw an article where Russia is trading with India using non-dollars. And of course, China and Russia both have interbank payment systems that they're trying to get the other set up. But the truth is, there's no real alternative. If you look at, if you look at China for example, which many people think of as maybe one day creating a system that rivals the dollar. Having a global currency entails giving up some sovereign power. For example, you're going to have rule of law. So foreign investors are going to have to be treated equally then local investors, even if the local investor is a very important member of the government. And foreign investors who put money into your currency need to be able to a) park it in something that's deep and liquid and b) being able to take it out whenever they want. So that means no capital controls.

Now, if you do this as a government, you kind of receding some power. You can't treat your own people, your friends better than other people. And you can't just shut it all down to prevent financial panics. So that's kind of losing a policy lever as well. So there are benefits and costs and just looking at, you know, some governments out there, I don't think they're ready to do that yet. Another alternative could be something like the European Union. But if you look at how the Euro has been doing the past few decades, it doesn't seem to be gaining steam as the global reserve currency. It seems very much should be a huge regional currency. Something interesting to note, during the March 2020 pandemic, we had a huge scramble for dollars, the Fed rolled out the FX swap lines with take up almost half a trillion dollars. The ECB also rolled out Euro FX swap lines will take up about $1 billion. So it's it's very clear that it's not a global currency. So Erik just looking across the world, there's no one that can replace the dollar. And I don't see that happening soon. But that doesn't mean people could diversify out of the dollar. They could still, as I mentioned, you can have the dollar system remain. But have it weakened and have people diversify into say, gold, which central banks are historically comfortable with.

Erik: Well Joseph I can't thank you enough for a terrific interview. Before I let you go, though, please tell our listeners a little bit more about fedguy.com. You were a trader for the Federal Reserve in New York. How did your departure from the Fed come apart and why are you taking it upon yourself to educate people about central banking now?

Joseph: So I think of working as just as a learning process. The Fed is a great place to learn. And I felt like I had learned all there was to learn there. And so I left and now I write this blog. I teach people about what's happening in the financial system. I help people learn about it. I have a book, Central Banking 101, that goes into more depth about how the Fed works, monetary system works. And I also have a few online courses on my website for those who are more interested in more deep dives on securing money markets like repo and the Fed's balance sheet.

Erik: And that's all at fedguy.com. Patrick Ceresna and I will be back as MacroVoices continues right after this message from our sponsor.