

Christopher Whalen Interview: Bob Eisenbeis on Seeking Normal at the Fed

Our chief monetary economist, Bob Eisenbeis discussed the Fed with Chris Whalen this week. Below, we reproduce the entire interview courtesy of Chris and *The Institutional Risk Analyst*.

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In this issue of *The Institutional Risk Analyst*, let's first ponder last week's revelations that the European Central Bank is taking a loss on its purchase of bonds issued by Steinhoff International, the high flying (and highly levered) South African-based home retailer that was struck down by an accounting fraud scandal. This event illustrates how central banks have distorted the credit markets and allowed inferior borrowers access credit at investment grade spreads.

This notion of central bankers booking trading losses on their extraordinary open market intervention over the past decade is important because it provides context to understand their decision making. For example, based on our conversation last week with Bob Eisenbeis, Cumberland Advisors' Vice Chairman and Chief Monetary Economist, we're pretty certain that the Federal Open Market Committee will further flatten or even invert the Treasury yield curve in 2018 and for reasons that will astound and amaze many investors.

Going back as early as 2010 ("MBS – When Will the Purchases End and What Will Happen to Mortgage Rates?"), Bob has been

writing timely analysis for Cumberland describing the dynamics of the Fed's large scale asset purchases, euphemistically known as "quantitative easing," and what would happen to the bond markets once QE ended. Now that the end of QE is in sight, we ask Bob if the return to normal will be as "beautiful" as Mohamed A. El-Erian suggests in his effusive *Bloomberg* commentary.

The IRA: Thanks for speaking with us Bob. We wanted to talk a bit about your recent comment on Marvin Goodfriend's nomination to the Fed Board but also talk about your broader view of the normalization process. You may have seen Mohamed A. El-Erian's fulsome public praise for the FOMC's policy direction. We've always been of the view that the Fed should have stopped after QE1. How do you see it?

Eisenbeis: When you look at the research on QE, the opinions are all over the map both inside and outside of the Fed. I think there is a consensus that there were diminishing returns in the additional QEs that were engaged in after QE1. Then it's a question of what are the costs and benefits of getting out of the program. Those who suggest that QE has been a huge success are premature in my view. You don't really know until we are completely out. It looks to me like we are going to be OK on balance, but what really bothers me is this constant drum beat inside the Fed and by some outsiders about the huge "profit" earned from QE. They have the accounting all wrong.

The IRA: Well, the board is aligning itself with the idiocy on Capitol Hill, where the interest earned by the Fed is viewed as "income" for budget purposes. Most members have not read your 2016 testimony on the Fed's fiscal relationship with Treasury. But Bob, really, is it possible that PhD economists don't understand the financial relationship between the Treasury and the central bank? We always like to remind people that the US Treasury issued the original \$150 million in greenbacks directly into the market to help Abraham Lincoln fund the Civil War. The Fed is the Treasury's alter ego and is

an expense to the government, which is subtracted from the earnings on the portfolio and then returned to the Treasury.

Eisenbeis: Correct. The Fed almost by definition cannot make a profit. It baffles me how people inside the system can fail to see the accounting reality here. The Fed issues short term liabilities to buy Treasuries taking duration out of the market. The Treasury makes interest payments to the Fed who takes out its operating costs, including interest payments on reserves and returns the remainder to the Treasury. If this intra governmental transfer were settled on a net basis like interest rate swaps, there would always be a net payment from the Treasury to the Fed. It is too obvious, yet I am not privy to the sidebar conversations on this issue. But back to the point on QE, if the Committee can run off the portfolio through attrition, then they'll probably escape any need for additional action barring some unforeseen change in the economy. The current path for growth and employment in the third quarter seems pretty positive.

The IRA: Does the FOMC understand how their actions and the actions of the ECB, Bank of Japan, etc has not only pushed down the price of credit, but has suppressed volatility since these positions are not hedged? Just as with the Volcker Rule and bank investment portfolios, there is no trading around Treasury and mortgage backed securities (MBS) positions held by central banks. As we told CNBC, "Financial sector on fundamental basis is considerably overvalued," it's no surprise to see Citigroup (C) and other banks guiding the Street lower on trading results for the year. The dearth of duration and trading volumes is a direct result of QE, correct?

Eisenbeis: The volatility impact of QE is not something that was on anybody's radar screen at the time to my knowledge. The bigger concern was that the longer you keep rates low, you start to get dislocations that take place in various markets. Everybody is looking for a bubble here or a bubble there, but

the only place you can really argue a bubble exists is in the stock market. But that is really the concern, not the volatility issue or the impact on the markets.

The IRA: That suggests a remarkably linear view of the bond market on the part of the Fed. In the \$1.7 trillion MBS portfolio, the Fed has sequestered a huge amount of duration extension risk. If prepayments fall due to rising rates, the effective maturity of the security extends and the price of MBS can fall faster than that for benchmark Treasuries. But nobody is hedging the Fed or ECB or BOJ or Bank of China holdings of MBS. As a result, we seem to be headed for a flat or even inverted yield curve environment and with flatlined volatility. Do the folks at the Board understand what the combination of passive central bank portfolios and falling trading volumes is having on large bank earnings?

Eisenbeis: If you would see anybody in the system focused on this question it would be the Fed of New York. You mentioned the May 2014 FRBNY blog post on convexity of MBS in your comment earlier. I haven't seen anything in the FOMC minutes suggesting that Bill Dudley raised the volatility issue during his tenure. But I think the Fed is going to go very cautiously on rates for reasons you suggest. With a new Chairman and governors, you might think there would be room for some change, but in fact they are going to go very slowly. The Fed staff is going to describe to the new governors why certain things were done and under what circumstances.

The IRA: So you don't see a lot of change in policy under Chairman Powell?

Eisenbeis: Not a chance. He and the new governors are going to move slowly in terms of any change in direction. They are looking for a community banker for the Board and that person will also tend to be cautious. And the appointment process in the Senate is likely to be slow and contentious. Marvin Goodfriend is too experienced to come onto the FOMC and start

rocking the boat. The four bank presidents who are economists and voting on policy in 2018— Bostic, Dudley, Mester and Williams – are all very solid and experienced, so I'd look for a pretty slow and steady process from the Fed. Some of the governors (Powell and Quarles) and presidents, who will be FOMC participants this year, are not economists, which has a big impact on the policy process from a research perspective.

The IRA: Well, back to the market, the folks at the Fed who brag about making money on QE are about to let the markets take the risk on a bunch of FNMA 3s and 3.5s that contain a lot of duration extension risk. As this paper is held by private investors, the positions will be hedged and volumes and volatility should be restored or not?

Eisenbeis: What that will do is essentially put upward pressure on rates. This would moderate the need to make policy changes. We published a comment on the runoff of the Fed's portfolio and when it would come into "equilibrium" so to speak in terms of size. There is no coincidence that MBS on the System Account are paying down about \$20 billion per month and the Fed has chosen \$20 billion threshold number for monthly portfolio reductions. We estimate that according to the Fed's plan, the portfolio necessary to restore the currency-to-GDP ratio to its pre-crisis level, would be about \$1.9 trillion and normal runoff would achieve this objective in the fall of 2023. Just from a runoff perspective, though, the impact on the markets is not going to depend so much on the Fed as on the Treasury as their issuance needs increase. The Fed is going to reinvest portfolio maturities across the yield curve in proportion to the Treasury issuance.

The IRA: Well, precisely. This goes back to the earlier point about profitability. The Fed and the Treasury are one and the same. Different faces of a Hindu deity.

Eisenbeis: But this is precisely why these MBS cannot be sold.

The IRA: Is this an institutional issue for the Fed? Are they avoiding sales of MBS to avoid taking a loss on the portfolio and thereby eroding the need for chest thumping about the profitability of QE?

Eisenbeis: I think that is a good bit of it. If you recall, the Treasury robbed the Fed's capital a few years back to fund spending for a highway bill. There's a cap now on Fed equity at \$40 billion. And the Fed cut a deal with Treasury that if the Fed takes a loss on the sale of assets they don't have to write it off against capital. They create a "negative asset" account. What is that? You can do the math and see that the bank's net worth may be negative.

The IRA: It's like a net operating loss for a central banker. But Bob are you suggesting that the Fed is more worried about the possibility of embarrassment over taking a loss on the sale of MBS than they are about the impact of policy on the financial markets? Even to the extent of seeing a negative yield curve in the Treasury market? How can we do three hikes in 2018 and not have an inverted curve?

Eisenbeis: Substantively as we've discussed, it is the Treasury that backs everything up. But it's the optics that matter. The optics of the Fed losing money or being insolvent are bad, both in Washington or around the world. Thus they will run off the MBS naturally via prepayments to the extent possible and avoid losses on sales. More important, though, it is very clear that we will have a flat yield curve both on the long end with continued demand and on the short end with the Fed raising benchmark rates. But all of this means that the Fed will go slow.

The IRA: Thanks Bob

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