

Bianco Research L.L.C.

An Arbor Research & Trading Affiliated Company

Independent · Objective · Original

Volume 19, No. 24

1731 North Marcey, Chicago IL 60614

www.biancoresearch.com

Commentary

Market Opinions and Topics of Interest

By James A. Bianco (847) 304-1511

April 4, 2008

The Fed Inspires Hope - Will It Work?

The following will appear in the April 2008 edition of Asia Asset Management

Raise your hand if you don't quite understand this whole financial crisis. It has been going on for seven months now, and many people probably feel as if they should understand it. But they don't, not really. – [The New York Times](#), March 19, 2008

Hedge fund managers generally see themselves as smarter than the average investor. ... Lately, though, even these high-finance wizards seem lost. In their letters to investors, many hedge fund managers have conceded that they have little to no idea what's in store for the markets, which have been careening in directions that fancy computer models could never predict. -- [DealBook](#), April 2, 2008

[Last month](#) we defined the current financial crisis as resulting from a shrinking financial system due to losses from falling home prices. This cannot coexist with an expanding real economy, which requires an ever larger supply of credit. Markets are rationing credit not by the normal interest rate mechanism, but rather by supply constrictions independent of rates. Is this understood? The quotes above suggest no.

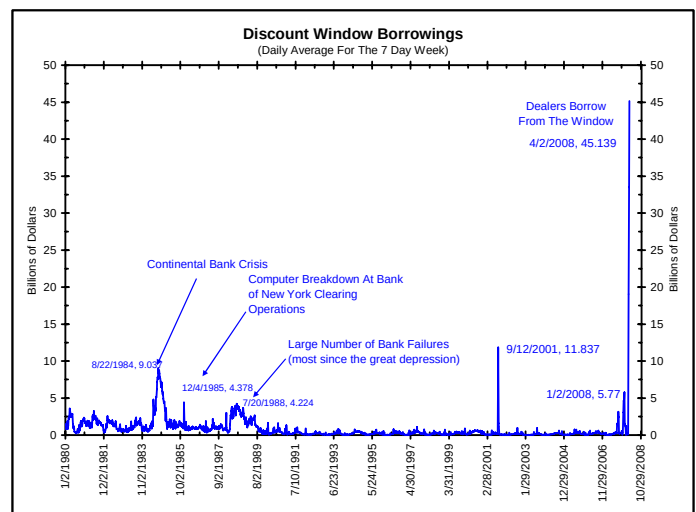
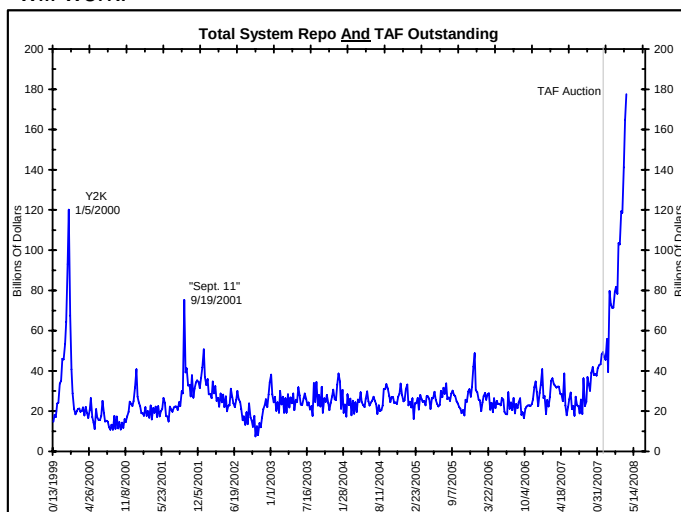
Despite this lack of understanding, equity markets are rallying on the **hope** the extraordinary efforts by the Fed in recent weeks will end the crisis. The **hope** is Bernanke understands the problem and has the right solutions to end it.

Let's look at what the Fed is doing and then see if it will work.

Collateralized Loans

To assess if the Fed is making the right moves, we first need to explain what they are doing. Simply put, the Fed is making collateralized loans. They come in various forms; system repurchase agreements (system repos), Term-Auction Facilities (TAF), Securities Lending and discount window borrowings. The following charts show the extent of these loans.

The chart on the left shows the combined size of system repos and TAF loans outstanding. The chart on the right shows the outstanding size of discount window borrowings. In both cases the level of these loans are at all-time highs.



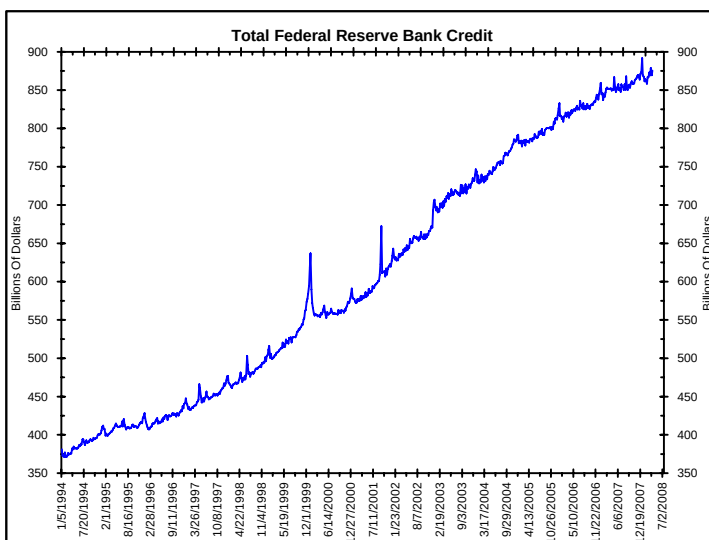
But what exactly are these loans? In simple terms the Fed regulates the amount of money in its member banks' reserve accounts. When the Fed adds liquidity, such as we see in the charts above, it credits the reserve accounts of the member banks. To be clear, the Fed is not strictly trading for its own account. All their actions affect the reserve accounts of the member banks.

Why do this? It is assumed that banks will actively and closely manage their reserve accounts, which are supposed to be a certain percentage of their total business (known as "reserve requirements"). If they have excess reserves, they will either lend them out (that is, "sell" fed funds) or expand their balance sheets accordingly. If the Fed drains reserves, banks can either borrow reserves ("buy"

fed funds) or shrink their balance sheets. This is how the Fed regulates the overall growth of the banking system.

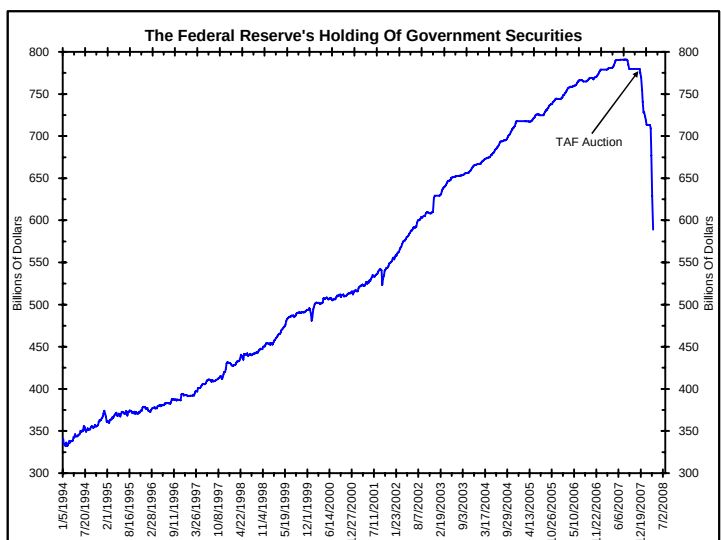
"Sterilizing" Their Actions

One complication to all this is the Fed targets the federal funds rate. If the charts above represented the only actions of the Fed, it would mean a massive, maybe unprecedented, injection of liquidity in the reserve accounts of member banks. With all these reserves pouring in, the need to borrow in the fed funds market disappears and the **effective** fed funds rate would plummet. But as the next two charts show, the above actions are not the only things the Fed is doing.



The chart to the left above shows the total amount of Federal Reserve Bank credit, \$875.5 billion as of April 2. Notice the relatively smooth line higher. If the Fed is pumping all that liquidity via collateralized loans as shown in the first set of charts, they must be "taking something out" or total bank credit would skyrocket. The chart on the right above shows the Fed's holdings of government securities. The steep drop in these holdings over the past few months shows what the Fed has been "taking out" of the system.

The Fed's holdings of Treasuries are in the member banks' reserve accounts, \$589 billion as of April 2. Seventy-two percent of all Federal Reserve Bank credit was Treasuries. Notice the Fed has been selling Treasuries to a degree they have never done before. This selling is expected to accelerate in the coming weeks as they add collateralized securities loans to the mix.



Therefore, the Fed is offsetting or "sterilizing" their collateralized loans as they cut the **target** federal funds rate. They are doing this to keep the **effective** fed funds rate in line with the target rate. It largely has worked but with a larger than normal degree of intraday volatility.

How Much Ammo Does The Fed Have?

It has been pointed out that when all the Fed's programs are up and running, as much as 60% of member bank reserve accounts will be collateralized loans. This means that Treasuries as a percentage of all bank credit could plummet from over 90% last fall to less than 40%.

Has the Fed "shot its bolt?" If the credit markets falter again, and with half the Fed's balance sheet already loaned out, what else can the Fed do? The Fed can expand its balance sheet by letting total bank reserve credit boom higher. The Fed can purchase assets against its own credit and expand reserves into infinity. If the Fed does this, however,

there would never be another reason to borrow in the federal funds market again. This means the **effective** funds rate drops to zero, regardless of what the official **target** rate is. This is what Japan did in the 1990s and it was called "Quantitative Easing" or "Zero Interest Rate Policy" (ZIRP).

The problem with this approach is highlighted in the quotes at the beginning of this piece. So few understand what the credit crisis is about and even fewer understand exactly what the Fed is doing. So, they **hope** that this will work. However, should the funds rate drop to zero, the psychological reaction on the dollar and commodities could produce a host of unintended consequences. Or, if the Fed had to resort to inflating its balance sheet and dropping the funds rate to zero, they would be in a race to end the credit crisis before gold exceeded \$1,500 and the dollar dropped below 2.00 versus the euro.

Conclusion - The Hope Trade

The equity markets are rallying and credit spreads are tightening because they **hope** the Fed actions will alleviate the credit crisis. Hope is a powerful aphrodisiac. It has produced a "tradable low" in the financial markets for now. If the Fed's actions do work, this tradable low can become much more, maybe the end of the credit crisis altogether.

For it to work, one has to agree the Fed's actions are the answer to the problems. Unfortunately we do not.

The purpose of the Fed's collateralized loans program is to address liquidity concerns. In normal times, the Fed is constantly tinkering with the levels in the member banks' reserve accounts. So, instead of making its member banks constantly buy and sell possibly illiquid securities, they can use them as collateral for short-term loans (usually overnight) to easier stay in balance with the Fed.

If the banking system's problem was they are under-reserved, then the Fed's action of dramatically expanding these lending programs makes sense. But, this is not the problem.

The problem is the entire financial system's capital base is shrinking. Another problem is financial firms

do not trust the economic health of their counterparties. So, they are forcing a de-leveraging of positions to reduce exposure with these counterparties.

This is a more complex problem than merely over reserving member bank accounts or using illiquid securities as collateral in a loan. That illiquid collateral still belongs to the financial firm and if its value continues to shrink, their capital is further eroded. This will make them **less** likely to do anything aggressive with the funds from the loan, or the more liquid Treasury securities.

The best solution is for the Fed to force the banks to raise capital. In testimony on April 2, Ben Bernanke said the following when asked a question by New York Senator Charles Schumer:

As supervisors, we continue to insist on strong capital and push banks to raise capital. We also have a particular interest -- particularly strong interest now in liquidity, as we have done over the last few months. ... Yes, Senator. Both capital and liquidity are important. And we are urging firms to raise more capital. The fact that we saw yesterday a large bank and an investment bank raise capital is suggestive that capital is available in the marketplace.

The problem is the Fed's encouragement has so far been inadequate. According to statistics recently compiled by *Bloomberg*, total bank system losses have topped \$238 billion, yet capital raised has totaled only \$136 billion. Banks are not raising enough capital to cover their losses. So, the financial system continues to shrink.

For this crisis to truly end, more collateralized loans are not the answer. More capital, in excess of the losses to-date, is the answer. This way the financial system can again expand to meet the needs of the real economy. The problem is this is painful for existing shareholders because of its dilutive nature. So, financial firm executives are willing to do or try anything else before forced into this option. This includes **hoping** the Fed's aggressive loan campaign will work.

Bianco Research L.L.C.

1731 North Marcey, Suite 510
Chicago IL 60614

Phone: (847) 304-1511

Fax (847) 304-1749

e-mail: research@biancoresearch.com
<http://www.biancoresearch.com>

For more information about the contents/ opinions contained in these reports:

President (847) 756-3599

James A. Bianco jbianco@biancoresearch.com

Strategist/Analysts (847) 304-1511

Howard L. Simons hsimons@biancoresearch.com

Greg Blaha gblaha@biancoresearch.com

Ryan Malo rmalo@biancoresearch.com

For subscription/service Information:

Arbor Research & Trading, Inc.

Director of Sales & Marketing (800) 625-1860

Fritz Handler fritz.handler@arborresearch.com

Arbor Research & Trading, Inc.

1000 Hart Road, Suite 260
Barrington IL 60010

Phone (847) 304-1560 Fax (847) 304-1595

e-mail inforequest@arborresearch.com
<http://www.arborresearch.com>

Domestic - For more information about Arbor Research & Trading and its services:

Chicago Sales Office

1 North LaSalle Street, 40th Floor
Chicago IL 60602

Daniel Lustig dan.lustig@arborresearch.com

Phone (866) 877-0266 Fax (312) 269-1681

New York Sales Office

The Chrysler Building, 405 Lexington Ave
New York, NY 10174

Edward T. McElwreath ed.mcelwreath@arborresearch.com

Phone (212) 867-5326 Fax (212) 370-1218

International - For more information about Arbor Research & Trading and its services:

London Sales Office

4 Broadgate, 2nd Floor, Room 57

London England EC2M 2QY

Phone 44-207-965-4784 Fax 44-207-965-4787

Neil Tritton neil.tritton@arborresearch.com

Ben Gibson ben.gibson@arborresearch.com

European Sales

James L. Perry james.perry@arborresearch.com

Phone (847) 756-3510 Fax (847) 304-1595

Rich Kleinbauer rich.kleinbauer@arborresearch.com

Phone (41) 22 363-9229

Far East Sales

Robert Reynolds robert.reynolds@arborresearch.com

Phone (847) 756-3680 Fax (435) 647-3073