The Federal Reserve's Bazooka CAN'T SAVE THE MARKET OR THE ECONOMY

MONEY MORNING

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Dear Reader,

If you think the Fed's going to fire hundreds of billions or trillions of dollars of "stimulus" rounds at the coronavirus crisis and pierce the virus's grip on mankind, on the market, and on the economy, you're wrong.

This is an existential threat to humans, markets, and economies, which the Fed's ammo can't kill but sure can make it worse.

Here's what the Fed's doing, what it's going to do, why it won't work, how you'll know it's not working, and how they're going to make everything worse.

Bazookas and Moving Targets

Back in July 2008, as the financial crisis was heating up, then-Treasury Secretary Hank Paulson asked the Senate Banking Committee for an unlimited amount of credit to rescue Fannie Mae and Freddie Mac, explaining, "If you've got a squirt gun in your pocket you may have to take it out. If you've got a bazooka, and people know you've got it, you may not have to take it out. By increasing confidence, it will greatly reduce the likelihood it will ever be used."

Paulson got his bazooka but still had to run back to Congress two months later in October 2008 and beg for $700 billion more, this time to bail out Wall Street.

The Federal Reserve, America's private central bank, on the other hand, doesn't have to go to Congress, it's got its own bazooka and an unlimited amount of ammunition, which it's already been firing at targets right, left, and center.

The Fed can "print" as much money as it wants without asking anyone for anything and fire its funds at will.

It's already fired hundreds of billions of dollars at its primary target, the too-big-to-fail (TBTF) banks that feed the Wall Street money-making machine, and lately, once again, money-losing machine.

On Tuesday, March 3, 2020, with bad news about the novel coronavirus infecting U.S. equity markets faster than its human infection rate, in a surprise move at an "emergency meeting," the Fed cut the fed funds rate, the rate at which banks lend money overnight to each other, by 50 basis points, to a range of 1% to 1.25%.

Then on Wednesday, March 11, 2020, the Fed said it was increasing the amount of overnight lending it directly favors big banks with from $200 billion to $500 billion a day, if needed.

Then, on Thursday, March 12, 2020, in an official "Statement Regarding Treasury Reserve Management Purchases and Repurchase Operations," the Federal Reserve Bank of New York, the Fed's most important Regional Bank, where it conducts all of its open market operations (trading), announced it was upping the amount of short-term loan money it would make available to banks to $1.5 trillion.

“Term repo operations in large size have been added to enhance functioning of secured U.S. dollar funding markets,” was the core message.

The New York trading desk would immediately offer $500 billion in three-month (term) loans that day, another $500 billion in three-month loans the next day, and another $500 billion in one-month loans to whoever wanted a shorter-term loan. Additionally, the Bank’s statement declared the term loans would be offered continuously on a weekly basis through month-end.

What the Fed’s doing is flushing up its TBTF banks with “liquidity,” meaning money they’re tight on. Why are they tight? Because the money they should have available, their excess reserves, are parked in accounts at regional Fed banks collecting interest.

Since the Fed’s offering really cheap money loans, term loans, as a matter of fact, banks are borrowing from them and not pulling the $1.5 trillion in excess reserves they have parked at the Fed and are collecting interest on.

If America’s banks are in such great shape, which we’ve been told for years by the banks themselves, who keep making outsized, record profits and buying back their own shares, why do they have to borrow from the Fed like they’re facing an existential threat?

If they don’t need the money, they’re borrowing to trade. They’re borrowing to buy Treasuries, which they lend overnight to each other as collateral for more loans, which they use to buy more Treasuries, which lowers yields, which makes interest rates a lot lower, which scares the public who think the “flight to safety” is a harbinger of horror to come, which prompts the Fed to cut more, which lowers rates, which, most importantly, increases the price

of existing Treasuries, which gives the banks a profit on their holdings, on their Treasury trading.

That's how the game works.

Are banks in trouble or are they just being greedy? The answer is both. They're trying to trade Treasuries to make money to help their financial condition, which is shaky, but not yet unsound.

If the TBTF banks are in trouble, and they may be headed in that direction, we're all in trouble, again.

After the Fed's extraordinary liquidity measures were announced, Brian Sack, who ran the New York Fed's markets desk from 2009 to 2012 and is now the director of economics at hedge-fund manager D.E. Shaw Group, said, "Financial markets are not functioning well, and the liquidity situation is evolving into something that necessitates a broader and stronger response by the Federal Reserve."

If they're really in trouble, maybe the big banks are making money, courtesy of the Fed, to offset losses on their equity capitalization as their stock prices get hit in the market selloff.

Either way, the Fed has no place paying big banks' interest on their excess reserves. That's crooked. If big banks couldn't earn risk-free interest on their excess reserves, they'd have to lend them out into the economy to earn interest on that capital.

That's what banks should be doing with their excess reserves, lending them out and not parking them at the Fed to collect interest.

The reason the stock market fell on news the Fed was cutting the fed funds rate 50 basis points is investors took the cut as bad news. Maybe the Fed knew something they didn't, maybe things were about to get worse.

The reason the stock market continued to fall hard after the Fed announced it was making $1.5 trillion available to banks is if banks need that much money, immediately, they're in trouble.

We don't know if they're in trouble or just being their usual greedy, self-serving selves.

Either way, how's any of that confidence-building? Firing the Fed's bazooka at banks has had the opposite effect.

But the Fed Didn't – Make That "Couldn't" – Stop There

On Sunday night, March 15, 2020, before Asian markets opened, in another "emergency meeting," the Fed announced it was cutting the fed funds rate another 100 basis points to zero. The new effective range, they said, would be 0% to 0.25%, with the focused rate being zero.

And that wasn't all. Because cutting the fed funds rate to zero is a worthless exercise on account of the fact that banks that weren't lending to each other to make 1% surely won't lend to each other to make zero interest, the Fed had to restart its infamous quantitative easing (QE) program.

At the same emergency meeting, the Fed said they'd buy $700 billion of Treasuries and mortgage-backed securities from their constituent banks, rekindling what is now QE4.

That's all about the banks, and it's not good. If they need that much liquidity, they're in trouble.

And par for the course, the Fed's panicky moves, instead of instilling confidence, frightened investors, who immediately knocked 3,000 points off the Dow Jones Industrial Average the very next day, Monday, March 16, 2020.

After markets convulsed on Monday, the Fed had to do something on Tuesday.

With corporations in trouble because the country's economy is shutting down, the Fed announced it would make $10 billion available to buy commercial paper from the highest-rated companies needing short-term loans.

Not to scare you, though you should be scared, the commercial paper market shutting down in October 2008 is what almost pushed the entire U.S. financial system over the edge it was already puking over.

Commercial paper is what corporations offer investors when they want to borrow money over short periods, anywhere from a few days to 30, 60, 90 days, and sometimes longer. Commercial paper is a loan document. Investors buy commercial paper from corporations who promise to pay them interest for the short-term loans they're getting. When commercial paper "matures" in a few days or weeks, corporations usually roll over those loans, often again and again.

Other companies who have short-term money to lend buy commercial paper. But most commercial paper is bought by money-market funds, who buy it to collect whatever little interest they can to pass along to shareholders, who buy shares in money-market funds to have ready access to their cash.

In 2008, the commercial paper marketplace ceased.

Money-market funds stopped buying companies' commercial paper because no one knew if companies would be able to pay back the money they needed to borrow. At the same time, investors in money-market funds wanted their money back and liquidated

their money-market funds. The funds, most famously, the Primary Reserve Fund, couldn't meet redemptions.

People couldn't get their money out. That caused a run on all money-market funds and on banks.

Are We There Again?

Not yet. We're getting there and could get there again. That's why the Fed, in conjunction with the Treasury Department, set up a $10 billion fund to buy commercial paper directly from highly rated companies who can't sell their paper to money-market funds.

Is $10 billion enough?

No.

The commercial paper market is at least a $1 trillion market. $10 billion is a drop in the bucket.

This time around, the Fed lowering rates and providing "stimulus" to the economy in the form of cheap money, won't result in a "V-shaped" recovery.

The Fed admits as much itself.

In a November speech, Jerome Powell, chairman of the Fed, discussed the risky situation that the Fed has put itself in as a result of lowering interest rates, saying, "This low-interest rate environment may limit the ability of central banks to reduce policy interest rates enough to support the economy during a downturn."

The crux of Powell's speech was that interest rates are historically low but not high enough for them to be lowered to help stimulate the economy out of a downturn.

The position that the Fed finds itself in today, in which it has artificially boosted the market by suppressing rates, means that it faces a risk in terms of its ability to be a lender of last resort and provide the economic stability that it was designed to provide.

So much for the Fed's "wealth effect."

Recessions happen when consumer spending weakens, leaving companies with lower revenue and kicking off a dangerous cycle of job cuts, slowed purchase activity, and economic contraction.

The world's already seeing massive demand destruction from the coronavirus, with the U.S. only beginning to feel its impact. We're likely headed for a recession, probably a global recession, as consumer spending weakens for obvious reasons.

Goldman Sachs estimates 10% to 15% of U.S. GDP consists of services such as entertainment, restaurants, church services, and public transportation that would suffer if people limit interaction and avoid large gatherings. Goldman also estimates the disease will knock roughly three percentage points off annualized growth in the next quarter, with these demand-side effects accounting for almost half.

On top of demand destruction, the market tanking 25% in record time is killing the so-called "wealth effect," where people seeing equity markets soar feel richer and spend. That can easily work in reverse.

What makes the coronavirus unique is that it's arriving on both the supply and demand fronts.

So-called "demand destruction" from China's quarantine orders represents a serious near-term threat, **Morgan Stanley** analysts wrote in a note last Friday, adding that consumer activity would sharply decline in the tourism, entertainment, and physical retail sectors.

Manufacturing activities "will have a much wider impact on the global economy via the spillover effects to global supply chains," said the team led by Chetan Ahya, chief economist at Morgan Stanley.

The Fed can't offset these effects, said Jan Hatzius, Goldman's chief economist. "If you're worried about catching a virus, you're not going to be persuaded to put yourself at risk because of small changes in your wealth or borrowing rates."

Lowering already low rates won't cushion the hit to demand when employees lose their jobs because of supply disruptions or consumers staying home or when spending and investment retreats due to lower stock prices and uncertainty.

So, no, the Fed's bazooka won't work to stimulate the economy this time.

But it will make things worse.

This time, as goods and services become scarce on account of greatly reduced manufacturing and production, including in mining, agriculture, farming, and livestock production, prices are going to start rising.

This time the Fed's helicopter money is going to trigger inflation. And when prices start rising for goods and services, when demand returns, as it will eventually, the Fed's not going to be able to control "real" rates.

What's going to happen then to all the companies who are addicted to cheap financing and have been able to roll over their excessive leveraged balance sheets is they'll collapse.

Their lenders will suffer huge losses. Markets will convulse. And we'll see once and for all the emperor has no clothes.

You've been warned.

Sincerely,

Shah Gilani

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