Epsilon Theory

Coal Mine, Meet Canary

October 8, 2019

Jay Powell announced today that the Fed would expand their balance sheet "organically", meaning that the "temporary" expansion of overnight repo operations is about to become not-so-temporary. Rather than continue to treat the recent spike in demand for cash as an anomaly, the Fed will satisfy that demand going forward as an ongoing, more-or-less permanent adjustment to the Fed's balance sheet.

"It's a feature, not a bug." That's what Powell said yesterday.

Powell went to great lengths to explain that, in his mind at least, this balance sheet expansion was NOT Quantitative Easing, because the intention here was NOT to provide stimulus for the real economy or any impact on longer-term interest rates, but rather to "maintain a firm grip" over short-term rates. In Powell's mind, balance sheet expansion is a rectangle and QE is a square … all QE is balance sheet expansion, but not all balance sheet expansion is QE. Whatever.

I say whatever because I don't think the question I hear people asking – is this QE or isn't this QE? – is particularly helpful. Why not? Because the engine that makes QE "work" (and by work I mean its impact in pumping up financial asset prices, not any supposed impact on the real economy) is not so much the mechanistic effect of balance sheet expansion per se, but is the ***narrative*** of monetary policy support in the form of associated forward guidance. And that narrative ain't happening here.

So yes, this is balance sheet expansion. It's more than just a "reverse-twist", where the average duration of the Fed's holdings are shortened but the size of those holdings remain the same. And if your definition of QE is balance sheet expansion, then you're right in saying this is QE. What I'm saying, though, is that a mechanistic, balance sheet approach to the *meaning of QE for markets* is weak sauce. The WHY of balance sheet expansion matters a lot more for market impact than the FACT of balance sheet expansion.

But that doesn't mean that Powell's announcement yesterday is no big deal. It's a huge deal. I think it's a dead canary in the coal mine of monetary policy.

I think these emergency actions in the repo market – and to be sure, these ARE emergency actions – and now the expansion of the balance sheet to get more cash into the system, are the clearest indications yet that the Fed has lost its fundamental credibility with Mr. Market.

What do I mean by fundamental credibility? I mean the belief that the Fed sets the price of money on the basis of its legal mandate – full employment and price stability. Not to weaken the dollar. Not to juice the market. Not to influence the 2020 election. Not as a negotiating chip in a China "trade war". *Not as an overtly political entity.*

It's not possible to see recent Fed easing actions as anything but a non-mandated political reaction to external pressures.

It's not possible because They're. Not. Even. Pretending. Anymore. It's not possible because Jay Powell TOLD US this is why they are easing. It's not possible because Jay Powell TOLD US that the Fed is concerned about "maintaining a firm grip" on short-term interest rates.

THE FED IS CONCERNED ABOUT "MAINTAINING A FIRM GRIP" ON ITS CONTROL OVER THE PRICE OF MONEY.

As they say in the twitterverse, let that sink in.

Are these emergency actions in the repo market a problem for the market? No, not at all. The Fed can literally paper over this doubt in the overnight repo market by shoveling limitless money at the doubters. And they will. (see *The Right Price of Money* for more thoughts on this) But this is a disturbance in the Force. This is a dead canary.

The Right Price of Money

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What I'm trying to figure out is where this failure of credibility – *this mistrust in the stated price of money* – will bubble up next.

I think it shows up next in HY corporate credit. Unlike the overnight repo market, this will be a slow-motion train wreck. But I do think it will be a train wreck. And I don't see how this gets papered over so easily.

As always, I'd love to hear your thoughts on all this. Still trying to figure it out. But I think I'm on the right track.

DISCLOSURES