Sprott Gold Report: "QT" or Not to "T," That is the Question

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The turbulence which riled U.S. equities in early February spread to short-term credit markets during March. As the S&P 500 Index[1] slumped towards ongoing retest of February lows, various measures of dollar funding stress surged to post-crisis highs. Most notably, the Libor-OIS spread exploded to 59 basis points by quarter end, a near six-fold increase from the 9 basis points recorded as recently as mid-November. Just as February equity volatility was dismissed as ill-fated gamma at a handful of short-VIX ETFs, consensus is now writing off the Libor-OIS blowout to temporary market factors including repatriation flows and accelerated Treasury issuance.

Black Swan: The Blunt Force of the Fed's Monetary Brakes

We believe these rationalizations miss a black swan now unfurling in U.S. financial markets: ***the Fed is on the verge of major policy error by underestimating the blunt force of the monetary brakes it is applying***. In this report, we present analysis suggesting the Fed's dual agenda of rate hikes and QT balance-sheet reduction is already straining global liquidity to the peril of reigning financial asset valuations. In order to arrest deflationary forces, at least in part of their own making, we expect the Fed to scale back telegraphed FOMC policy by yearend.

Fed policy reversal would be the final component of a potent combination of fundamentals which has been developing in gold's favor during the past several quarters.

Libor-OIS: Widest Spread on Record Since GFC

In the interests of clarity, the Libor-OIS spread measures the premium of 3-month Libor (the rate at which 16 "panel" banks offer unsecured U.S. dollar loans to one another) to the fed funds rate (the rate at which banks make collective overnight loans to right-size their respective reserves at the Fed). This spread generally hovers around 10 basis points but can widen when overseas U.S. dollar liquidity is challenged or banks perceive elevated peer-lending risk. As shown in Figure 1, Libor-OIS topped out at 364 basis points during the October 2008 peak of the global financial crisis (GFC). In retrospect, the spread's initial spike above 50 basis points in August 2007 proved to be a prescient warning for mounting financial stress. ***For this reason, much attention is being paid to the fact that, outside the GFC, Libor-OIS is now registering its widest spread on record.***

Figure 1: Libor-OIS Spread (12/5/01-4/13/18)

Source: Bloomberg.

As during the summer of 2007, no one knows what the current Libor-OIS surge foretells, but somewhat unsurprisingly, market commentary continues to downplay its significance. Credit analysts cite three general reasons for panel banks to jack-up Libor quotes, with only one of the three signaling definitive financial stress. More benign motivations stem from a general dollar-liquidity shortage or market competition from a dominant lending opportunity, two factors currently at play in global capital markets. Post-tax-bill repatriation appears to be pinching overseas dollar liquidity, and explosive Treasury issuance has been the gorilla on the liquidity dance floor in recent months, siphoning-off available sources of dollar funding.

A third, more toxic catalyst for widening Libor-OIS spreads can be market concern over the solvency of one or more systemic financial institutions. At least to date, market participants remain confident that bank solvency is not a factor currently in play. Aside from Deutsche Bank's 32% swoon during February and March, the lack of confirmation from alternate stress barometers – credit default swaps (CDS), cross-currency basis) -- supports the view that the Libor-OIS flare-up reflects technical market factors likely to normalize in future months.

Libor Matters

Market consensus tends to look over its shoulder in expecting the ***next*** financial crisis to resemble ***prior*** experience. Along these lines, investors are reassured in 2018 that significant strengthening in bank balance sheets since 2008 renders reoccurrence of anything like the GFC unlikely. We believe dismissing historically wide Libor-OIS spreads under the logic that banks are in relatively good shape amounts to missing the forest for the trees. With $68.6 trillion in U.S. credit market debt towering above GDP of $19.7 trillion, ***it is rising Libor itself, rather than its indicative spread over fed funds, which should be sounding investor alarms***.

Because the world has operated for so long in a zero interest-rate policy (ZIRP) environment, we believe consensus has lost sight of how powerful the Libor mechanism can be in transferring Fed rate hikes through the full continuum of dollar-denominated debts. Current estimates from Gluskin Sheff (3/5/18) and MacroMavens (3/29/18) peg total notional value of Libor contracts at ***$350 trillion***. While the vast majority of these contracts are floating-rate derivatives, JP Morgan estimates in Figure 2, that ***$7.4 trillion of business and consumer loans float directly with Libor***.

Figure 2: Market Size of Libor-Linked Business and Consumer Loans

Table 1: LIBOR-linked debt of businesses and households

	Volume ($bn)	% LIBOR related	$bn LIBOR related
Syndicated loans[1]	3400	97	3298
Corporate business loans[1]	1650	40	660
Noncorporate business loans	1252	40	501
CRE/Commercial mortgages	3583	40	1433
Retail mortgages	9608	15	1441
Student loans	1131	7	79
Credit cards, auto loans, consumer loans	1795	Low	

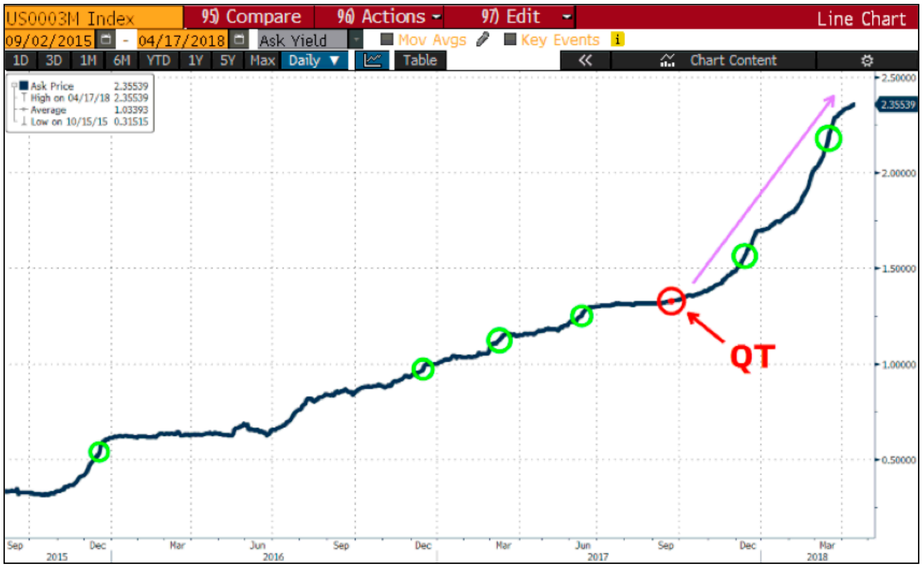
1. Some overlap exists between estimates of syndicated and corporate business loans.
Source: Federal Reserve Board, NY Fed, J.P. Morgan

Source: JP Morgan.

We believe the single most important development in financial markets during the past six months has been Libor's relentless advance. Importantly, the Fed's 9/20/17 launch of quantitative tightening (QT) distinctly accelerated the slope of Libor's rise. As shown in Figure 3, none of the four pre-QT rate hikes, nor either post-QT hike ***(green circles)***, had much discernible impact on the extended slope of Libor's advance. The Fed's QT announcement ***(red circle)***, however, separated Libor's path discernibly from that of fed funds. Since the Fed's 9/20/17 QT announcement, Libor had increased on 129 of 141 trading days through 4/13/18.

More importantly, while the Fed has hiked rates 25 basis points so far in 2018, Libor has jumped 66 basis points during the same span. Credit analysts can philosophize all they want about whether the current Libor-OIS blowout technically constitutes credit-market stress, but we are pretty sure cranking up the interest rate on $350 trillion of financial obligations at a pace two-and-a-half times the speed of FOMC tightening is the ***dictionary definition*** of financial-market stress! We believe Libor's unruly ascent is an important signal that the Fed's delicate attempts to vacate the zero bound have finally triggered a domino sequence of evaporating market liquidity.

Figure 3: Libor Interest Rate (9/2/15-4/13/17)



Source: Bloomberg.

QT: Quantitative Tightening – A Dose of Hope from the Fed?

It is never popular to suggest Fed Governors and Regional Bank Presidents are a bit over their skis in believing they can unwind a $4.5 trillion balance sheet without collateral damage to the U.S. economy. At the risk of hubris, we believe the Fed is failing to recognize, or even worse, deliberately ignoring, mounting evidence that telegraphed Federal Open Market Committee (FOMC) policy – three-to-four rate hikes and $420 billion in QT balance sheet reduction during 2018 – is straining global liquidity. Further, should the Fed follow through with 2018 policy as advertised, we suspect groundwork is being laid for a potential deflationary episode.

Since the Fed's first rate hike in December 2015, it has been clear the post-QE tightening cycle would bear little resemblance to any prior cycle. During the past two years, financial markets have learned to differentiate between Fed "rate hikes" and Fed "tightening." If the Fed had truly wished to tighten, just one 50-basis-point, intra-meeting hike would have accomplished the task in the span of about 15 minutes. Instead, the Fed has navigated a painstaking two-year course specifically designed to ***avoid*** tightening of global liquidity, while surreptitiously gravitating from the dreaded zero bound (to gain wiggle room for future policy action).

Our proof that markets have clearly understood the Fed's duplicitous policy objectives stems from the fact that, despite four FOMC rate hikes through the fall of 2017, U.S. financial conditions continued to loosen, with junk bond yields declining 150 basis points. Now, that is a neat trick!

Poof! The QE-Era Officially Ended

All of this changed, however, with the final two lines of the Fed's 9/20/17 FOMC statement, which simply noted that beginning October the Committee would begin the "balance sheet normalization program described in the June 2017 Addendum to the Committee's Policy Normalization Principles and Plans." Poof! Just like that, the QE-era officially ended. Chair Yellen subsequently emphasized that the size of the Fed's balance sheet was no longer in play as FOMC policy tool. Balance sheet reduction would be scaled, automatic and, other than clarifying the minor detail of an eventual downsized target, not subject to further debate or review.

We occasionally marvel at the Federal Reserve's capacity for misdirection. After unprecedented accumulation of the world's two most important financial assets – U.S. Treasuries and mortgage-backed securities (MBS) -- in a six-year gambit specifically calibrated to inflate these securities' prices and depress global interest rates, the Fed adopted an "awe shucks" attitude in declaring that reversal of the QE-program-to-save-the-world would amount to no particular biggie. In fact, to avoid unnecessary attention, Fed stewards simply flipped the switch to autopilot on their $3 trillion liquidation of the world's most high-powered monetary base.

How could such a simple and transparent policy upset any financial apple carts?

Well, to us, liquidity warning-signs from the Fed's 9/20/17 QT switchover are flashing. A timeless adage suggests fixed-income managers are more reliably sensitive to evolving market fundamentals than their equity-focused colleagues. Expanding our earlier Libor analysis to Treasury markets, we plot in Figure 4, five-year histories of both 2-year and 5-year Treasury yields. We find it especially telling that the Fed's 9/20/18 QT announcement completely altered the slopes of both 2-year and 5-year Treasury yields, while none of the Fed's four pre-QT rate hikes (12/16/15, 12/14/16, 3/15/17, and 6/14/17), nor either of its two post-QT hikes (12/13/17 and 3/21/18), had much discernible impact.

Bond investors seemed to have shrugged off telegraphed rate hikes as incremental and incidental but interpreted QT as a game-changing signal that the Fed might be getting serious about tightening.

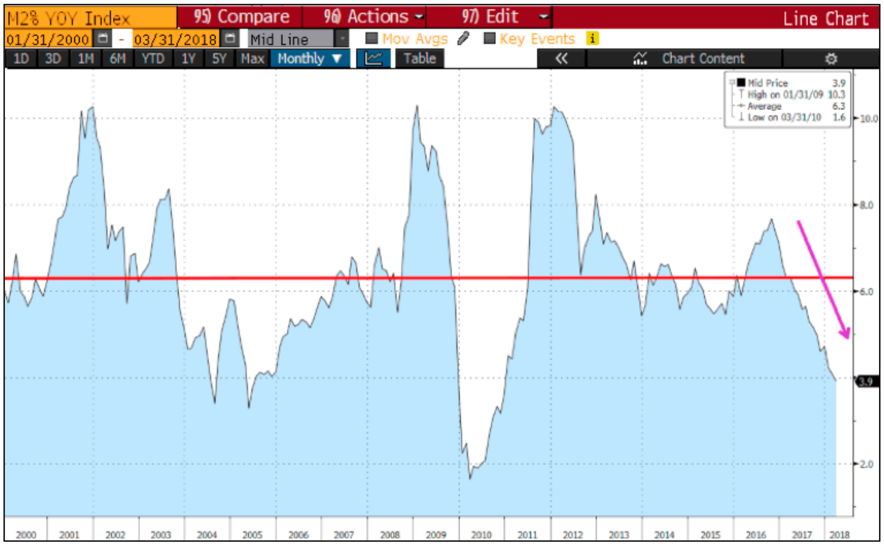
Figure 4: U.S. 2-Year and 5-Year Treasury Yields (4/15/13-4/16/18)

Source: Bloomberg.

Perhaps we are jaded, but we perceive in the Fed's plan to execute its QT program within passive parameters the same dose of hope that has become a hallmark of Fed communiques during the past decade. As hard as the Fed may try to maintain a nothing-to-see-here profile with respect to its balance sheet rundown, we would cite two deteriorating market fundamentals we believe would give the clearest signals as to when the Fed will cry uncle and suspend or reverse its tightening agenda.

First, we plot in Figure 5, the Fed's proprietary calculation for growth in U.S. M2 money supply. Since 2000, monthly year-over-year M2 growth has averaged 6.3%. Furthering a trend beginning with October 2016, implementation of new money-market regulations, however, M2 growth slipped to 3.9% in March. Outside the GFC and Chairman Greenspan's 17 consecutive FOMC rate hikes (June 2004-June 2006), this is the first sub-4% reading since 2000. With $68.6 trillion in U.S. credit market debt, we do not expect the Fed to tolerate much further erosion in M2 growth rates. ***Stay tuned!***

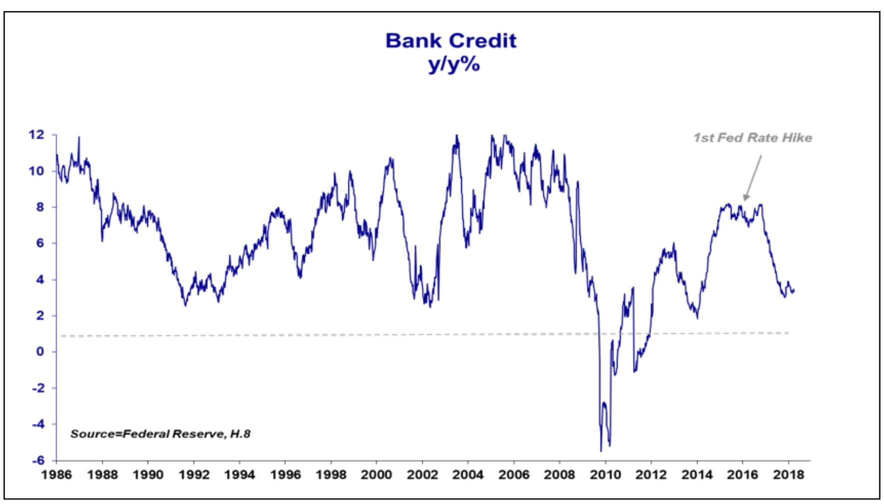
Figure 5: M2 Money Supply Year-over-Year % Growth Rate (Monthly; 2000-3/31/18)



Source: Federal Reserve.

A closely related economic series of equal importance to FOMC participants is the Fed's weekly H.8 report on commercial bank activity. MacroMavens plots, in Figure 6, weekly year-over-year growth in commercial bank credit. As one might have expected, Fed rate hikes reversed the post-crisis rebound in commercial bank lending. However, post-QT loan growth is now slipping towards what the Fed has generally viewed as a danger zone for healthy economic expansion. We suspect the Fed is watching closely for signs that recent fiscal stimulus translates into a pickup in loan growth. If not, the Fed is likely to put further rate hikes, or QT, or both, on ice.

Figure 6: Year-over-Year % Growth in U.S. Commercial Bank Credit (Weekly; 1986-Q1 2018)



Source: MacroMavens; Federal Reserve.

Looking Forward

Following seven years of ZIRP and QE, the Fed has endeavored during the past two-plus years to separate U.S. monetary policy from the zero bound. After global tremors emanating from the first hike in December 2015, the Fed has methodically ratcheted fed funds up to 1.75% without much (lasting) impact on financial asset prices. This past October, the Fed initiated a long-contemplated process of reducing its $4.5 trillion post-QE balance sheet. The Fed's scheduled QT program will pare its Treasury and MBS holdings on a graduated scale beginning with $10 billion-per-month in Q4 2017, up to a monthly peak of $50 billion-per-month by Q4 2018.

Given the sheer scale of these dual undertakings, it is not surprising the Fed is attempting to get started on both projects at the same time. However, we are skeptical the Fed can continue the simultaneous pursuit of its policy goals without inflicting significant damage on U.S. financial markets.

Importantly, we believe the liquidity destroying implications of the Fed's proposed QT schedule are almost completely being ignored by consensus. According to Chairman Bernanke, every $200 billion-or-so in QE asset ***purchases*** equated to a functional 25-basis-point ***rate cut***. It is textbook wishful thinking that equivalent QT balance-sheet ***reductions*** will amount to anything other than functional tightening equivalent to 25-basis-point ***rate hikes***. We do not believe outstanding debt levels in the U.S. financial system can withstand this type of blunt force monetary tightening, especially in concert with the FOMC's telegraphed schedule of fed-fund hikes.

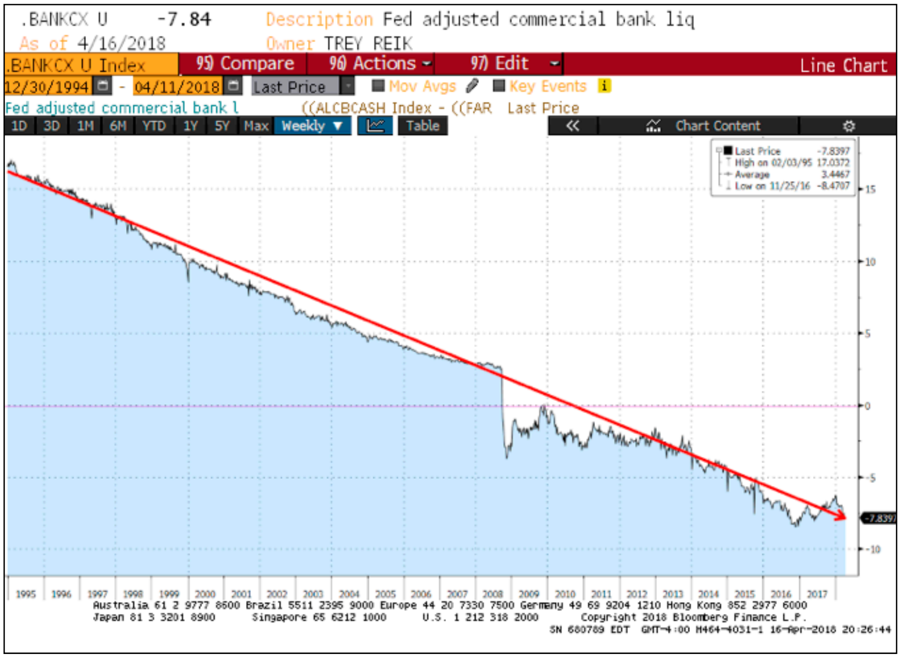
We interpret the Q1 2018 explosion in Libor-OIS as tangible evidence the Fed's dual policy objectives are straining global USD liquidity. U.S. bank credit and M2 money supply are slumping towards unacceptable growth rates. The Fed's scheduled Q4 2018 QT amounts to 4.4% of U.S. M2 outstanding, exceeding the aggregate's 3.9% growth rate in Q1 2018. We find it implausible the Fed will permit its QT program to inflict outright contraction on U.S. money supply.

Got Gold?

In Figure 7, we offer final food-for-thought on how instrumental the Fed's expanded balance sheet remains in supporting U.S. commercial bank liquidity. As of 4/4/18, bank cash balances ($2.196 trillion) equaled 13.23% of bank assets ($16.596 trillion). Were the Fed to withdraw from the banking system an amount equal to its net balance sheet growth during the QE-era (now $3.497 trillion), it would immediately kneecap U.S. commercial bank liquidity to ***negative 7.84% of total assets***. Of course, this is simply never going to happen.

Got gold?

Figure 7: U.S. Commercial Bank Cash Liquidity Excluding GFC-Growth of Fed Balance Sheet (Measured as % of Commercial Bank Assets) (12/30/94-4/11/18)



Source: Andy Lees; Bloomberg.

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[1]The S&P 500® Index represents 505 stocks issued by 500 large companies with market capitalizations of at least $6.1 billion; it is viewed as a leading indicator of U.S. equities and a reflection of the performance of the large-cap universe.

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