

January 19, 2009



### **Keeping it Clean**

Some continuing e-comments of SKadvisors - By: [J. Roger Shealy, CPA](#)  
[www.skadvisors.com](http://www.skadvisors.com)

Last month we took a look at the Commercial Paper Funding Facility, LLC. This LLC was established by the Federal Reserve to provide liquidity to the financial markets ([a copy of that email is linked here](#)) through the outright purchase of commercial paper (though technically the Fed loaned money to the LLC, and the LLC then purchased the paper).

In this letter we will take a step back and look at overall lending by the Fed and the efforts they, and the U.S. Treasury, have made to prevent this lending from flooding the economy with cash. If you thought last month's missive was technical, well ... I'm sorry, but here we go again.

To begin, consider how the Fed effects changes in the money supply. To increase the money supply, the Fed can purchase securities on the open market (sellers deliver an asset in exchange for cash) and/or it can make loans to financial institutions (the Fed accepts some form of collateral from a bank and increases that bank's reserves). To decrease the money supply, the Fed can sell securities on the open market (buyers deliver cash in exchange for an asset) and/or it can call in previous loans extended by not rolling them over.

### **Purchasing and Selling of Securities – Federal Funds Market**

The purchasing and selling on the open market traditionally occurs in the Fed's System Open Market Account (SOMA). As [stated by the Fed](#), the securities in this account serve three primary purposes:

- Collateral for U.S currency in circulation and other reserve factors that show up as liabilities on the Federal Reserve System's balance sheet
- A tool for the Fed's management of reserve balances (**open market operations**)
- A store of liquidity in the event an emergency need for liquidity arises

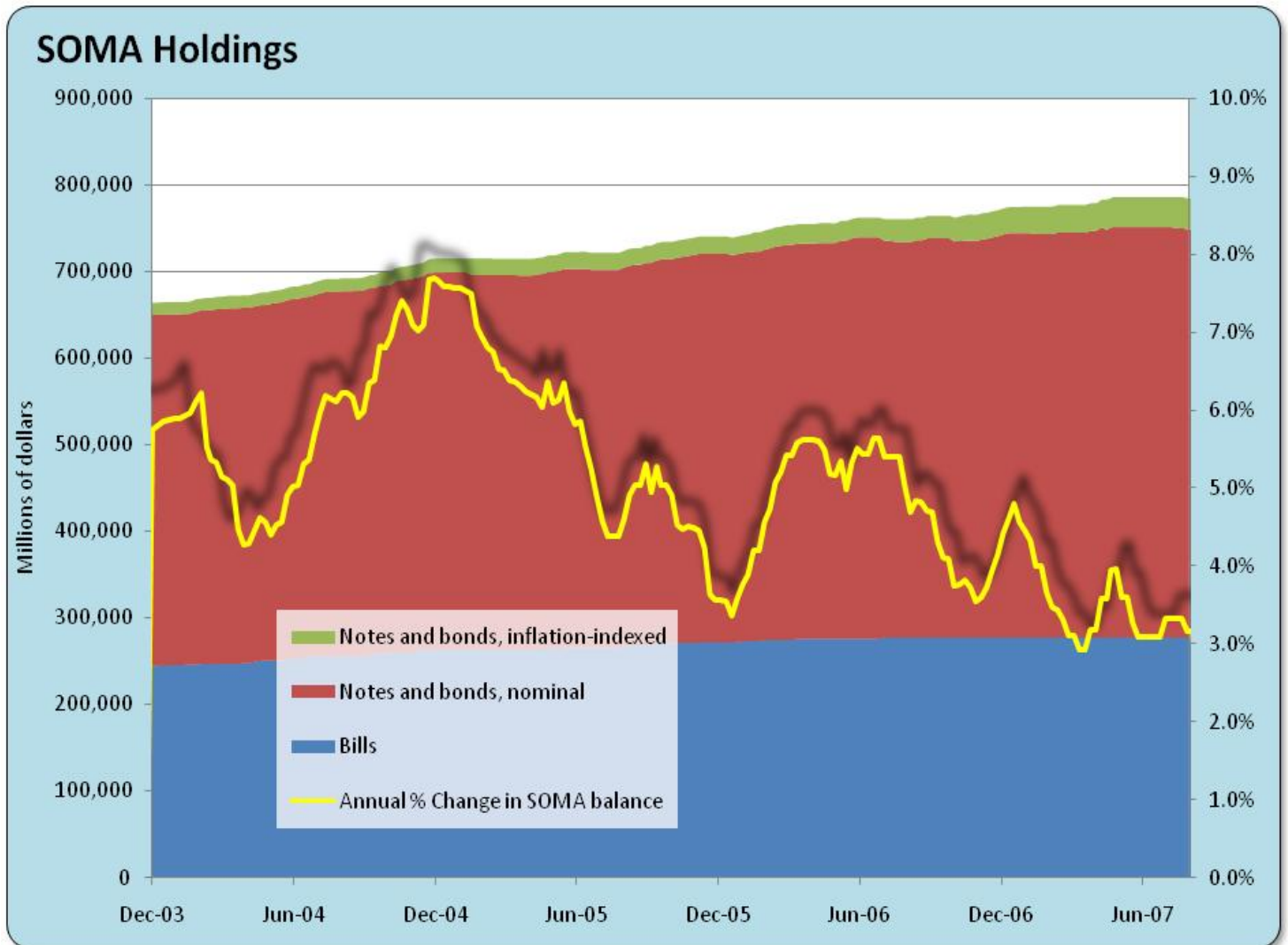
Normally, the SOMA balance remains rather constant. Constant in real value and in the maturity of the securities held, i.e. Treasury bills, notes, and bonds. Since it serves as collateral for currency in circulation, it slowly grows over time just as the economy grows and the supply of money grows. To ensure its ability to buy and sell with ease and to avoid disrupting free markets, the securities need to be liquid and the market for the securities very large – hence, the Fed normally trades in the Treasuries market. *More about this at a later date.*

The following shows the composition of the SOMA and its growth from December 2003 to August 2007. During this time, the balance has grown 18.2%, or \$120,634 million, and the composition of Treasury bills, notes, and bonds has remained roughly the same.

## SOMA Holdings

millions of dollars as of:

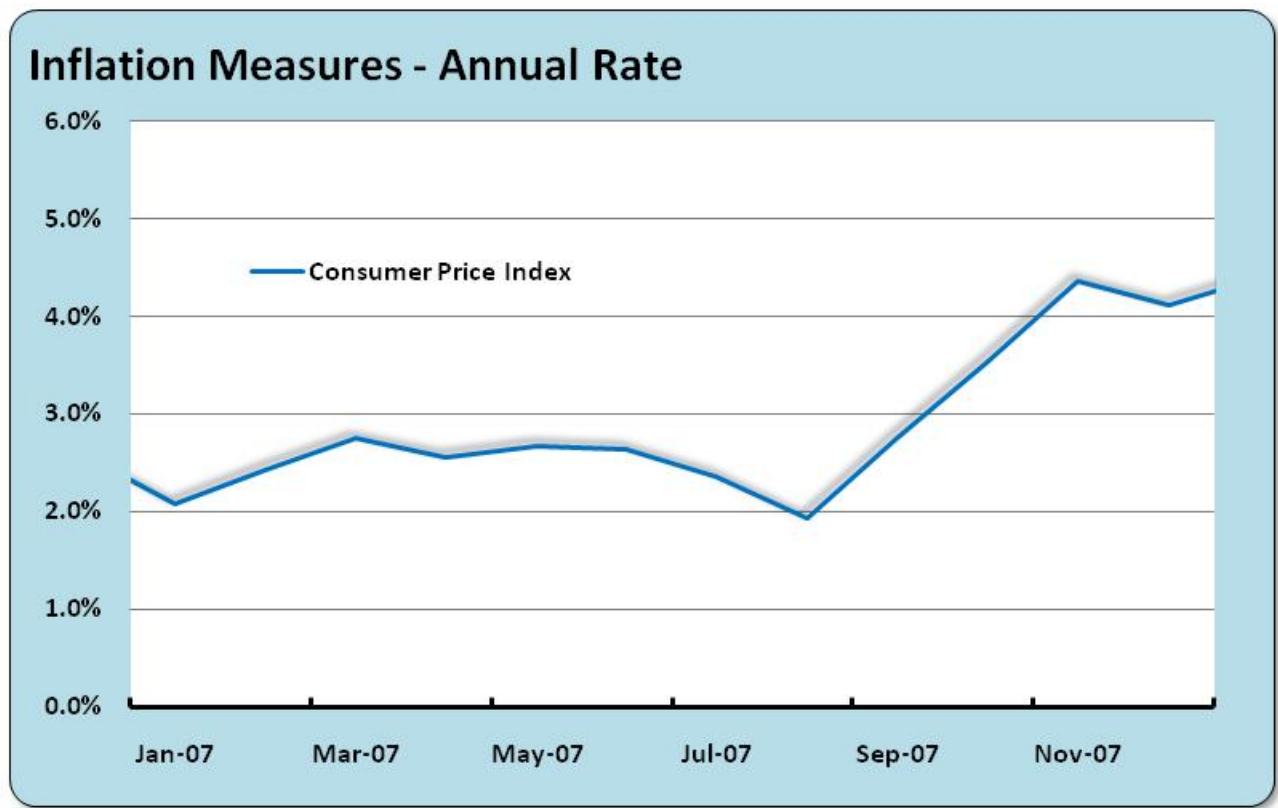
	Dec-03	% of Total	Aug-07	% of Total	Change	% Change
Bills	244,113	36.7%	277,019	35.3%	32,906	13.5%
Notes and bonds, nominal	406,173	61.1%	472,142	60.2%	65,969	16.2%
Notes and bonds, inflation-indexed	13,994	2.1%	35,753	4.6%	21,759	155.5%
Total	664,280	100.0%	784,914	100.0%	120,634	18.2%



As discussed last month, the commercial paper market seized up in August 2007 as lenders refused to “roll-over” the loans. So to provide much needed liquidity, the Fed’s response was to make loans. Indeed, over the six months following August 2007, the balance of loans made by the Fed increased from \$423 million to \$60,264 million, an increase of 14,247% (note: Lending by the Federal Reserve has historically been accomplished through the Discount Window, however, over the past two years a number of new and controversial “lending facilities” have been created to provide loans – these were listed in last month’s email).

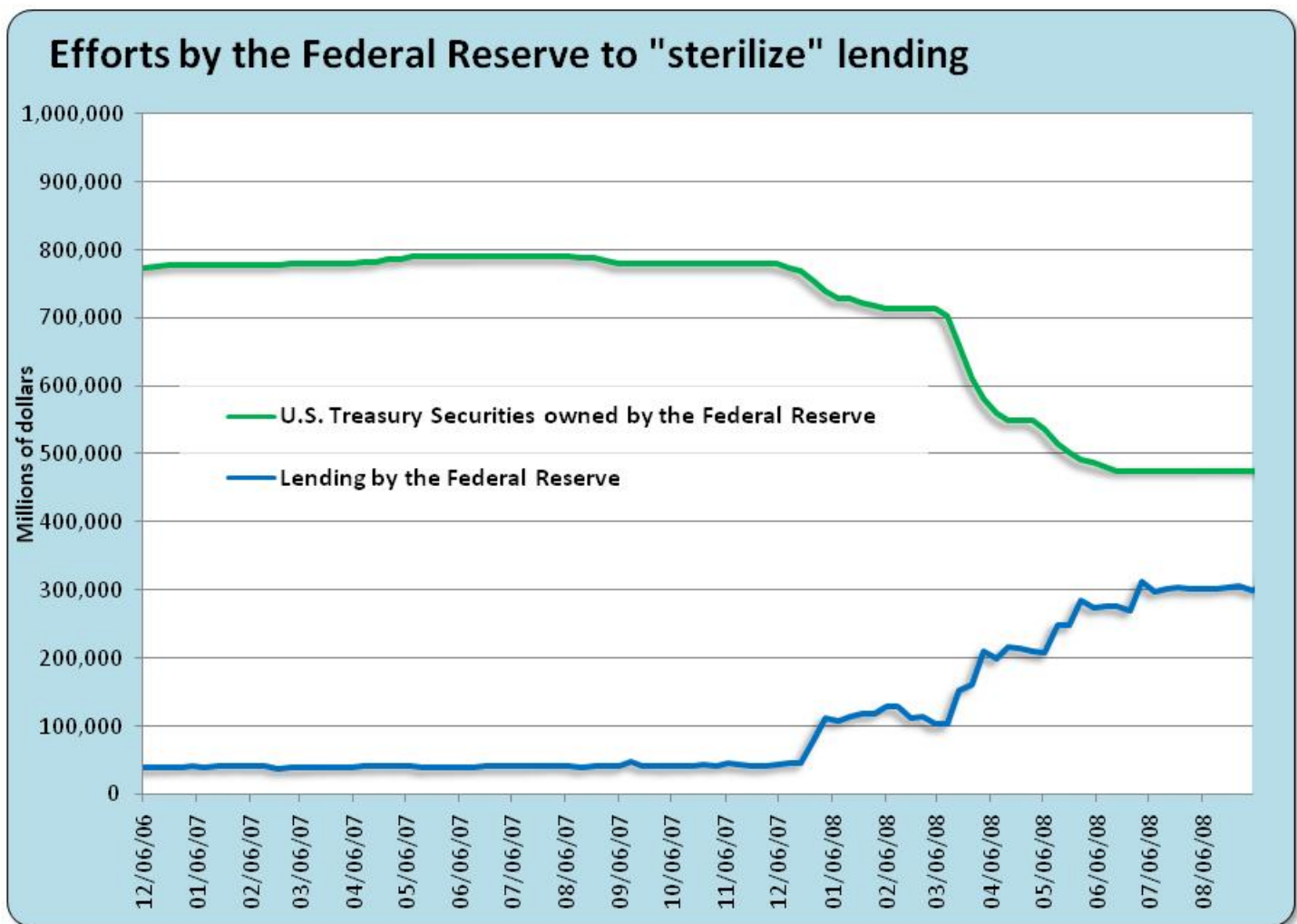
The problem facing the Fed, as it began making loans, is the corresponding risk in money creation. Loans provided to borrowers (banking institutions) create reserve balances which could then be lent and compounded throughout the

economy. Remember, in the late summer of 2007, we were watching the Consumer Price Index increase rapidly, and increasing the money supply, when price inflation expectations are increasing, is not good monetary policy.



To mitigate the risk of inflating the money supply (in this case, lending by the Fed) and further adding to an already uncomfortable level of price inflation, the Fed began to sell Treasury securities it held in the SOMA (a decreasing of the money supply). By “sterilizing” the loans it was making, the Fed could simultaneously meet the urgent liquidity needs of banks while preventing this stimulus from increasing the money supply.

The following chart shows the lending by the Fed and the amount of Treasury securities held in the SOMA. Notice, that as lending increases, an equal (and offsetting) amount of Treasury securities are sold.



So far, so good. Had the liquidity crisis, caused by the run on commercial paper, been solved, then the Fed could begin to slowly decrease its outstanding loan balance and repurchase Treasury securities back into the SOMA.

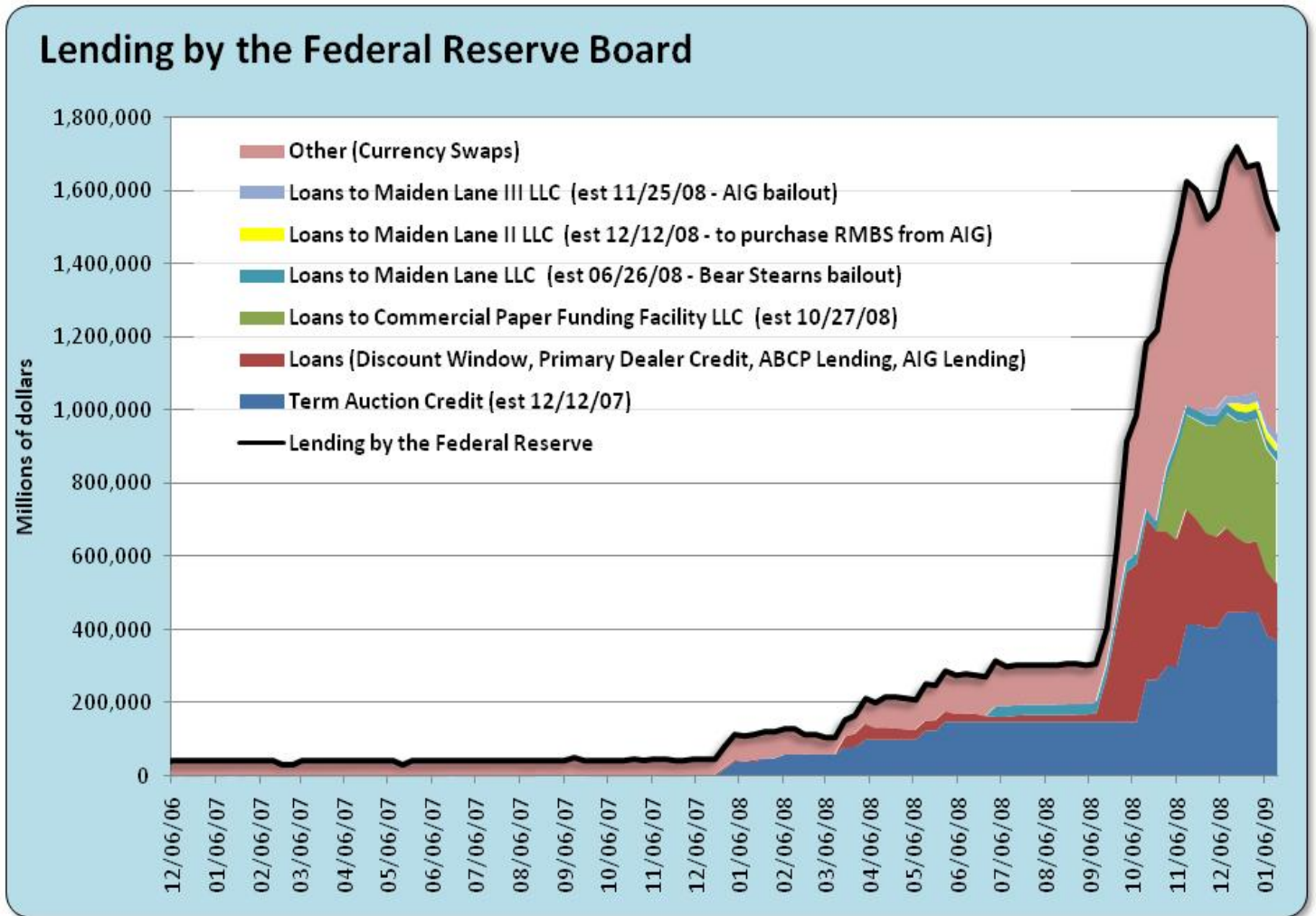
As we now know, however, the crisis did not end in August 2008. In fact, the crisis had only just begun. By now, investors were coming to grips with the bursting of the housing bubble and significant write-downs in asset values were underway. The subprime mortgage contagion had spread throughout the world markets and debtors were deleveraging as quickly as possible to cover their obligations.

Then, in September 2008, Lehman Brothers failed. The Fed had already bailed-out Bear Stearns so all were watching to see what would happen with Lehman. Similar in business operations, but bigger than Bear Stearns, Lehman had amassed more than \$768 billion in debt and held assets worth \$639 billion, yet the Fed decided that Lehman could not offer adequate collateral for a loan of the size needed and Lehman was turned away from the trough.

Since then, actions taken by the Fed and the U.S. Treasury have been fast and furious. Congress passed the Emergency Economic Stabilization Act of 2008, commonly referred to as a bailout of the U.S. financial system, in October 2008. This Act established the \$700 billion Trouble Asset Relief Program (TARP), increased FDIC insurance on bank accounts from \$100K to \$250K, and permitted the Fed to pay interest on reserves. At the same time, the Fed began to shift from open market operations to quantitative easing (or ["credit easing" as described by Chairman Ben Bernanke](#)).

Back to our review of overall lending and sterilization. After the failure of Lehman Brothers, the demand for liquidity intensified. Banks were unable to tap into the commercial paper market, as a run was underway in the shadow banking system, so they began to borrow from the Fed at an unprecedented level.

The following charts the overall lending and the various channels the Fed has used to make loans. The black line traces the total amount of lending and corresponds to the blue line in the graphic above. Notice the spectacular increase in lending that occurs on September 17, 2008, as markets and investors react to Lehman’s failure.

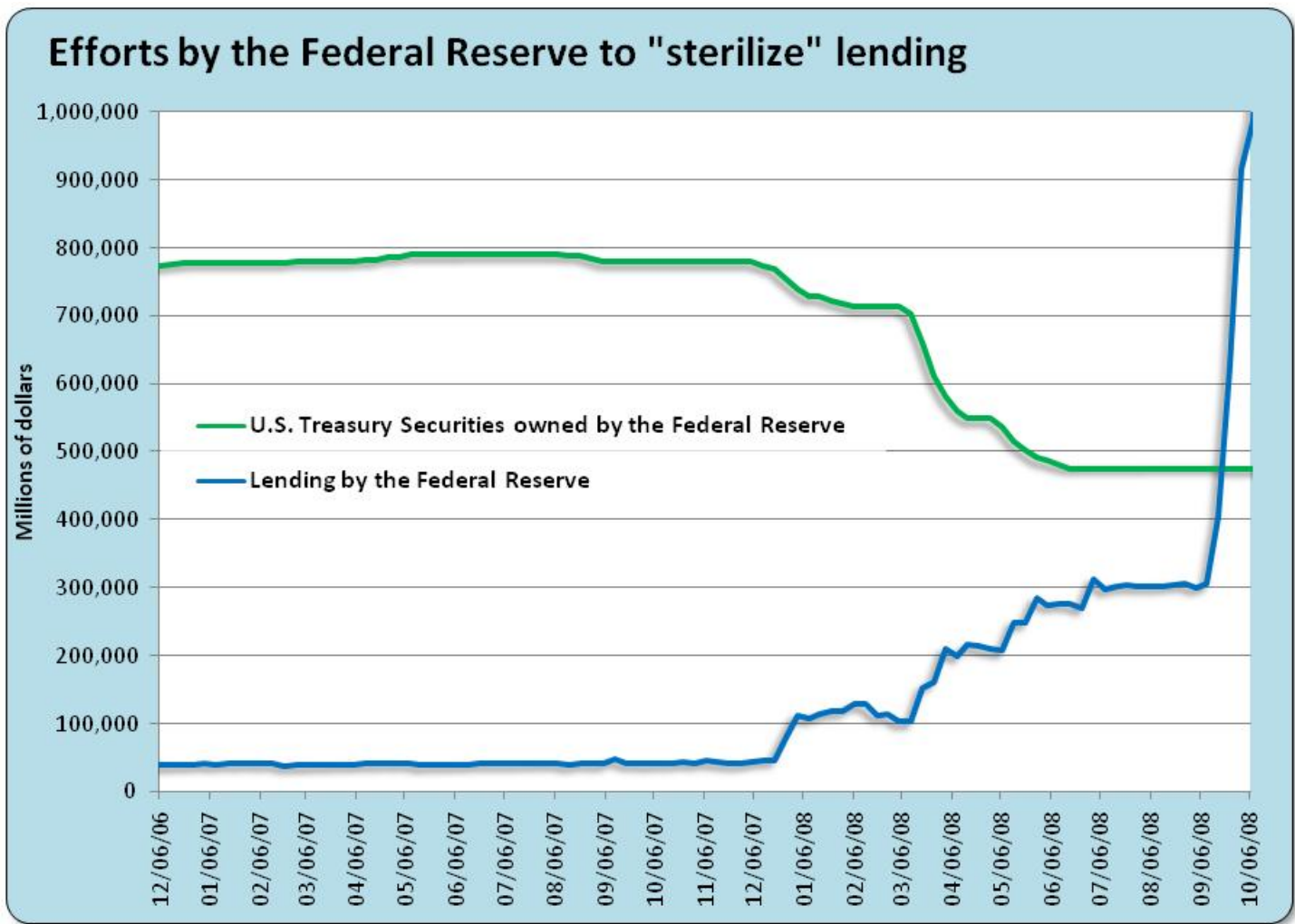


It is at this point we begin to wonder just how the Fed will continue its efforts to “keep it clean” as it now must sterilize more than **THREE TIMES** its SOMA balance.

Writing for the Congressional Research Service, in October 2008, Marc Labonte comments, “some have worried that, if this trend continued, the Fed would eventually hold too few Treasury securities to be able to conduct open market operations.” He continues, “this threat is not imminent – as of October 2008, the Fed still held about \$480 billion in Treasury securities...” Well, a lot can change in just one month as shown above.

*Not to add confusion, but I would like to point out that under the Term Securities Lending Facility (est 03/11/08), the Fed can lend securities from its SOMA for up to twenty-eight days. So in reality, the amount of Treasury securities held in the SOMA is actually less – based on the amount they have lent (as of January 14, 2009, the Fed has lent \$130,950 billion of its Treasury securities).*

Following is the chart showing the Treasury securities owned by the Fed and the lending by the Fed updated through October 2008.



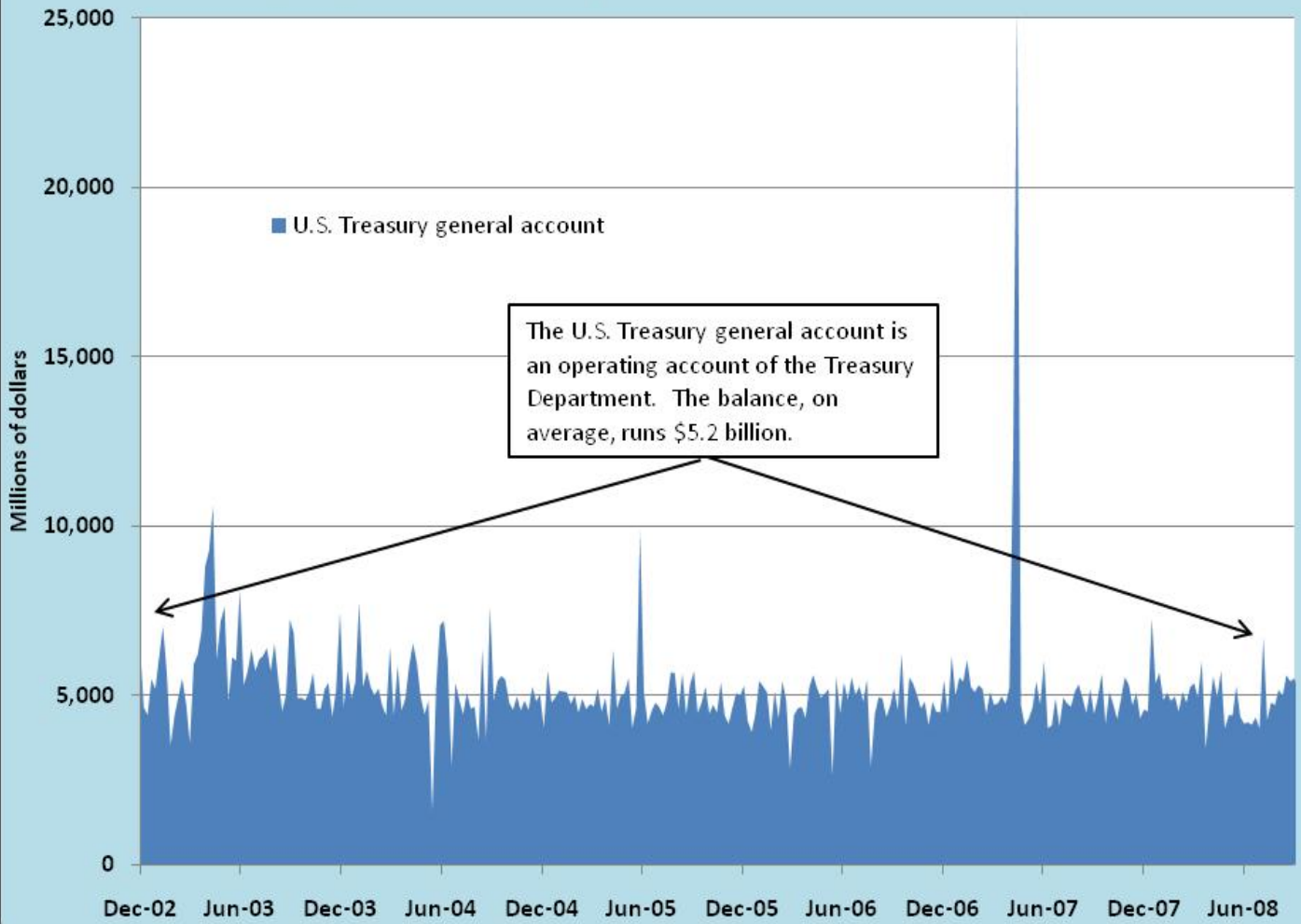
Again, it was September 15, 2008 when Lehman Brothers failed and as you can see, the demand for loans goes vertical. In their ongoing desire to sterilizing loans, the Fed had to find an alternative method for removing cash circulating in our economy.

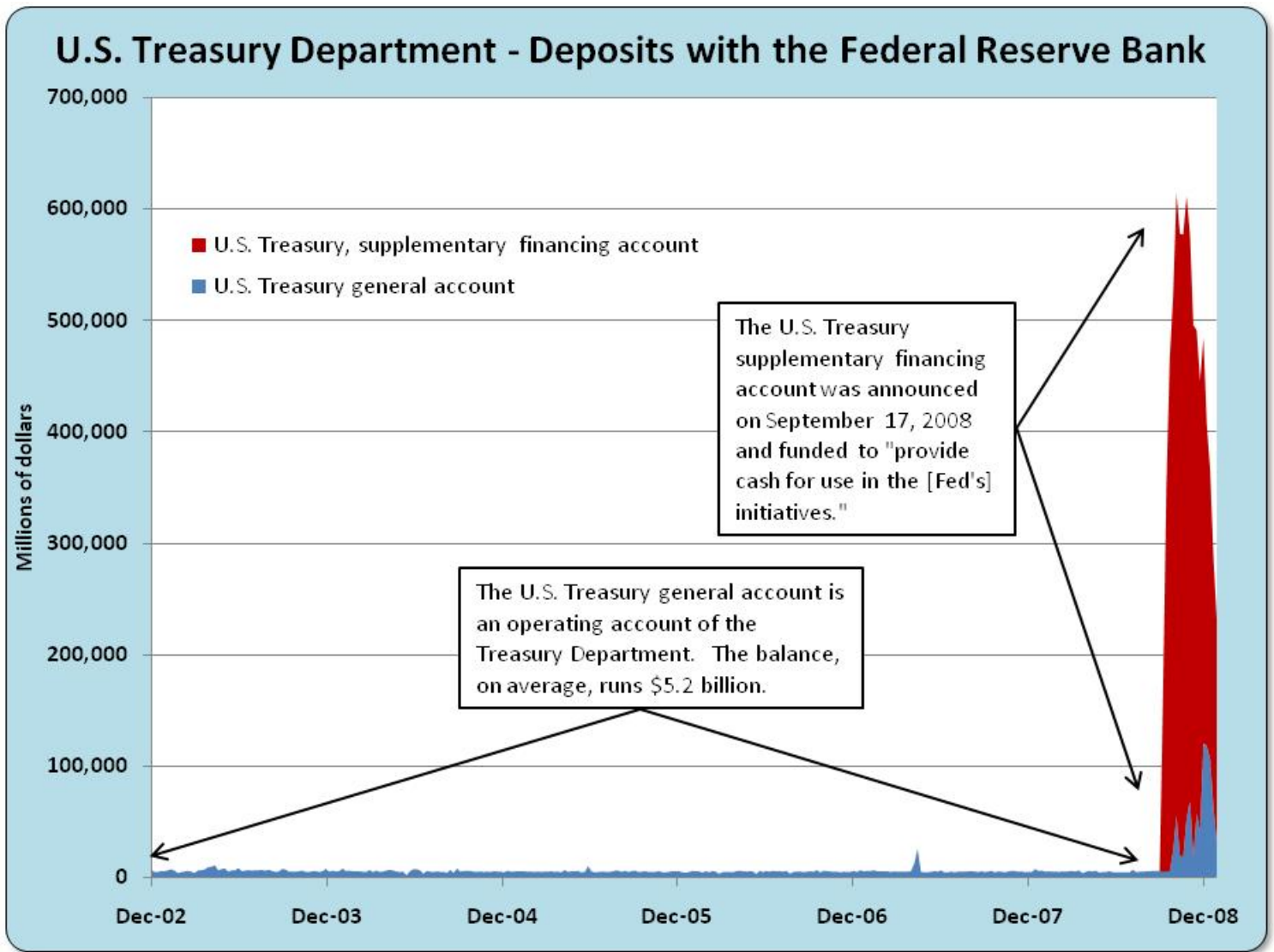
Enter the [Supplementary Financing Program](#) established by the U.S. Treasury on September 17, 2008. At the request of the Fed, the U.S. Treasury auctioned more new securities than it needed to finance government operations and deposited the proceeds with the Fed (the Federal Reserve acts as a "bank" to the U.S. Treasury Department). By selling these securities (bills), cash is removed from circulation as investors give their cash in exchange for securities. When the proceeds are deposited with the Fed, the cash is "locked-down" and effectively distills the loans being made by the Fed.

This supplementary financing account opened at the Fed is in addition to the general account the U.S. Treasury has with the Fed. The general account is used to make payments for day-to-day activities of our federal government.

I have posted two separate charts so we can see the effect of the new supplementary financing account.

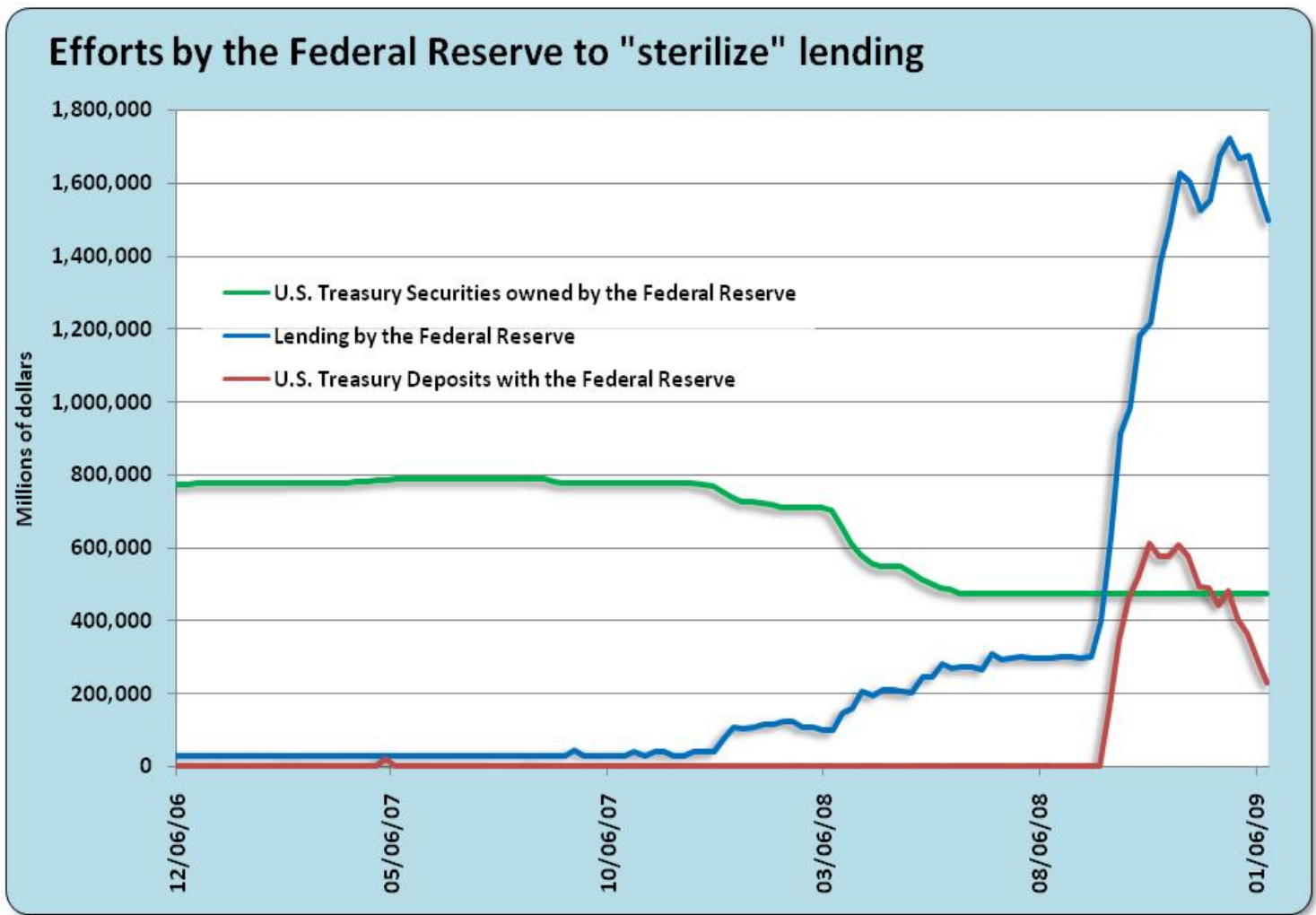
# U.S. Treasury Department - Deposits with the Federal Reserve Bank





As you can see the U.S. Treasury deposited nearly \$600 billion in "excess" funds to assist the Fed in its "initiatives."

Despite the proceeds received from the U.S Treasury under the Supplementary Financing Program, the amount of lending by the Fed has continued to exceed their ability to "keep it clean." To get a visual perspective, let's go back and look at the chart of Treasuries owned by the Fed and the lending by the Fed. We will add the deposits by the Treasury (the Supplementary Financing Account) and bring the chart up to date.



While the Fed has done what it can to sterilize the lending, by the end of November the amount of lending simply overwhelms their efforts – ...but the Fed catches a break.

#### **Breathing room for the Fed**

As the crisis in the financial markets moved its way into the overall economy, we saw unemployment begin to increase and consumer spending slow significantly as individual's preference for consumption moved from current demand to future demand. *Generally, this decrease in demand for final consumer goods, and the corresponding increase in savings (loanable funds,) serves as a signal to businesses to shift its focus away from final goods to early stage product development. Additionally, as loanable funds increases, interest rates decline providing the financial resources for businesses to deploy the capital for early product development. We will discuss this more thoroughly in coming issues as conflicting signals are currently being sent.*

As a result of this decreased consumption, the price of goods and services has fallen at an incredible rate.

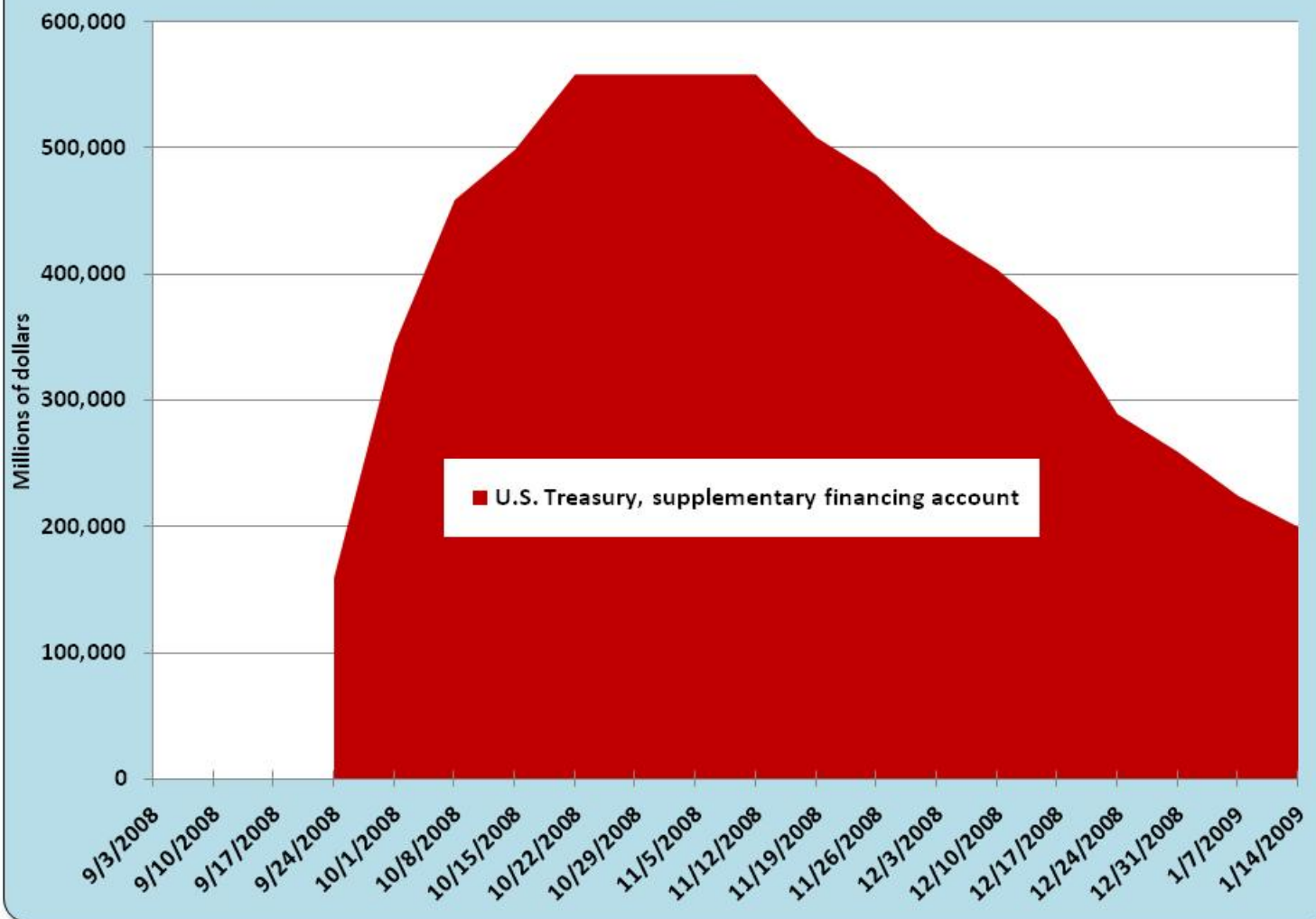
## Inflation Measures - Annual Rate



This has provided some much needed breathing room for the Fed as their concern of price inflation has eased. In the minutes from their December 2008 meeting, the Fed took note of the decrease in consumer prices and against this backdrop; they changed their targeted interest rate (the Federal Funds Rate) from 1% to a “target range” of 0% to 0.25%. They also noted that the U.S. Treasury “would not roll over bills related to the Supplementary Financing Program in order to preserve flexibility in the conduct of debt management policy, and uncertainty about supply reportedly exacerbated poor liquidity conditions in the bill market.”

So instead of this nearly \$600 billion being locked-down, it is leaking its way into the economy. The following shows the balance in the supplementary financing account held at the Fed.

## U.S. Treasury, supplementary financing account



Over the next months we will take a look at money supply to try and determine the economic effect this increase in unsterilized lending may have. Though it should certainly result in an increase in money supply, the significant impact on the overall economy is realized when the monetary base (currency plus reserves) is compounded through fractional lending.

We have discussed the concept of inflation on numerous occasions. While our attention seems to be always focused on the overall change in the price of goods and services, this “change in price” is actually the symptom of inflation. Inflation is at all times a monetary phenomenon.

Though our nation’s monetary policy should not be directed toward inflation or deflation, the reality of a fiat currency requires one or the other... and there is NO question which is worse. If America’s (individually, corporately, and fiscally) balance sheet consisted primarily of cash, then deflation is not too bad as the dollars you hold increase in purchasing power. However, if America’s balance sheet is highly leveraged, i.e. demasiada deuda (too much debt to equity), then **deflation is poison**. It requires debt holders to repay the principal borrowed with dollars more valuable and harder to come by.

Consider the following. I was recently speaking with a banker who went on and on about decreasing interest rates on mortgages. How 4.5% will soon be on the horizon. As I thought about the potential impact on home purchases I quickly calculated the “real” interest rate in my head (the real interest rate is equal to the nominal interest rate less expected

inflation). If inflation for homes is running at 3% and my interest rate quote is 6%, then the real interest rate is 3%. But what if I expect deflation in home prices of around 5.5% and I am quoted a “fantastic rate” of 4.5%? Well, 4.5% less a negative 5.5% equals a real interest rate of 10.0%! Now we can see why cash is piling up on the sidelines. **Even if you are earning a paltry 1% on your money market account, when you consider the effects of price deflation, that 1% is more like 5 or 6%, and soon could be more.**

### **Conclusion and some expectations**

Through its quantitative easing, the Fed has begun to target a certain portfolio of assets. They have moved from the norm (Treasury securities) and are now buying commercial paper, federal agency bonds, mortgage-backed securities, etc., all to provide liquidity and push down interest rates. One area where they have not yet ventured is corporate bonds. With the interest rate spread being extraordinary high and with commercial businesses also reeling from a lack of liquidity, I would not be surprised to see the Fed offer up a new facility to acquire corporate bonds.

Additionally, municipal bonds may also become a target purchase of the Fed as local and state governments work to balance their budgets under the strain of decreased taxable sales and property values.

In spite of the massive efforts of the Fed and U.S. Treasury, the financial sector is still in turmoil. Though the Fed has temporarily accepted their impaired assets as collateral for loans, the longer-term problem still exists as these assets are still deteriorating. The banks and financial institutions need to remove the assets permanently and/or increase capital immediately. Through the TARP, some \$200 billion worth of private preferred stock in financial institutions has been purchased by the public. Yet as reported last week, Bank of America is still in need another “fix.” I expect the concept of an aggregator bank, or “bad bank”, to gain steam and ultimately be funded with a portion of the TARP funds. This bad bank will be a banker’s bank to unload non-performing assets. Though the government is working to stabilize the banking system, the financial sector is still too risky for long positions. The dividend argument is quickly fading as dividends are being cut or eliminated to manage cash flow. Further, should more government ownership be required, common stock dividends may soon be an afterthought.

[Forty banks and credit unions failed in 2008](#), and [two banks have already failed this month](#) as we move our way through this correction. The crisis began with the bursting of the housing bubble, and it will not end until housing prices find their bottom and all the associated debt and derivatives have been cleared out. I have long pointed out that though the focus each month is on the quantity of new and existing homes sold, the focus should instead, or at least equally, be on the price. Though it takes sales to move inventory, the assets haunting bank balance sheets are mortgage derived securities – and as each month brings further declines in value, more taxpayer funded debt will be required to keep them afloat. *(If you know the basics of accounting, then you may appreciate the humor of Janet Yellen, the president of the San Francisco Fed. She recently joked that when looking at the balance sheets of consumers, banks, or many other companies these days, nothing on the left is left and nothing on the right is right)*

In conclusion, cash (in Treasuries) is king and preservation of principal is more important than return on principal. This current recession will likely be the deepest and most protracted recession of our lifetimes. Patience is in order, and the few that exercise it will be properly positioned when our business cycle changes from trough to expansion.

Next month we will take a look at the money supply and study the rate at which it is multiplying. This will likely serve as a good indicator of incoming price inflation or a continued path of price deflation.

Best regards,  
Roger

PS: I received a number of replies from last month’s missive - thanks for the comments and questions! Feel free to pass this around and let me know if you have any questions. Also, in advance of the next letter regarding money supply, let me know your thoughts on the topic.

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PAST RESULTS ARE NOT INDICATIVE OF FUTURE RESULTS. THERE IS RISK OF LOSS AS WELL AS THE OPPORTUNITY FOR GAIN WHEN INVESTING IN MANAGED FUNDS. WHEN CONSIDERING ALTERNATIVE INVESTMENTS, INCLUDING HEDGE FUNDS, YOU SHOULD CONSIDER VARIOUS RISKS INCLUDING THE FACT THAT SOME PRODUCTS: OFTEN ENGAGE IN LEVERAGING AND OTHER SPECULATIVE INVESTMENT PRACTICES THAT MAY INCREASE THE RISK OF INVESTMENT LOSS, CAN BE ILLIQUID, ARE NOT REQUIRED TO PROVIDE PERIODIC PRICING OR VALUATION INFORMATION TO INVESTORS, MAY INVOLVE COMPLEX TAX STRUCTURES AND DELAYS IN DISTRIBUTING IMPORTANT TAX INFORMATION, ARE NOT SUBJECT TO THE SAME REGULATORY REQUIREMENTS AS MUTUAL FUNDS, OFTEN CHARGE HIGH FEES, AND IN MANY CASES THE UNDERLYING INVESTMENTS ARE NOT TRANSPARENT AND ARE KNOWN ONLY TO THE INVESTMENT MANAGER.

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