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A GREEN SHOOTS REALITY CHECK: PART I of II
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A bewildering series of economic events over the past 12 months has put a large question mark over the global economy. Many have interpreted the recent stock market rally as a sign of recovery: the so-called "green shoots" concept. But this optimism ignores four looming problems, all centered in the US, that threaten a new round of pain this year. The four problems are: the diluted balance sheet of the US Federal Reserve; Obama's deficit binge; the growing wave of "Option-ARM" mortgage resets in US real estate; and the California state budget crisis. We need to watch how these issues develop over the summer to know whether a recovery later this year will be possible.

The first issue is buried in some seemingly arcane numbers in the balance sheet of the US Fed. The total US money supply is the product of two variables: the monetary base times the velocity of circulation. The expansion of the monetary base must be matched to the growth of real economic production, so as not to debase the currency. With few exceptions, annual increases are kept to a few percentage points. But from last August to the present, as the Fed scrambled to finance a massive bailout of the banking system, it more than doubled the US monetary base, increasing it from $870 billion to about $2 trillion.

This has not led to inflation, however, because the money is not circulating. Banks are merely leaving it on deposit at the Fed. This too is unusual. The US banking sector, despite its size, normally keeps very little on reserve at the Fed over and above what the law requires. From 1959 to 2008, excess reserves at any one time ranged from a few hundred million to about $2 billion. But since last August, excess reserves have soared to $844 billion. One analyst recently likened this to a giant pile of kindling threatening an inflationary bonfire.

But in this case the kindling is soaking wet. Normally, the release of new money into the banking system gets multiplied because of the way fractional reserve banking works. The so-called money multiplier has always been above 1.5 or so, meaning that every dollar of new money from the Fed expanded the money supply by at least $1.50. But in December 2008 something unprecedented happened: the multiplier collapsed to 0.91. New liquidity is causing the money supply to shrink, not grow. During the "green shoots" April stock market rally, the money multiplier actually fell further, hitting 0.862, its lowest level ever. Banks are hoarding money, perhaps afraid for their own solvency, or that of the households and firms to which they would otherwise lend.

There are now two great financial forces precariously balanced, exerting equal and opposite pressure on the US economy. The expansion of the monetary base has created an inflationary risk. But the collapse of consumer wealth has shrunk investment and lending, creating a deflationary vacuum. No recovery, no inflation. But if a recovery starts, all those excess reserves will flood the banking system, setting off inflation.

At this point the ability of the Fed to manage the money supply becomes critical. The Fed injects or withdraws money from the base by buying or selling assets. To ensure its ability to do so, it is only authorized to hold liquid, risk-free securities such as Treasury Bills. But last year, the Fed bailed out crumbling US banks by swapping its T-bill holdings for assets the banks were unable to sell. This helped bank stocks to recover and kicked off the stock market rally. But it left the Fed with a balance sheet full of trash.

As of December 2007, the Fed owned $800 billion in T-bills, and another $50 billion equally split between repos (overnight loans guaranteed against T-bill collateral), and currency swaps with other central banks. As of today the Fed lists about $2 trillion in assets, but only $640 billion are Treasury securities. Over $1 trillion is a mix of stocks and bonds nobody else was willing to hold, much of it listed at book value rather than market value. For instance, $455 billion is in mortgage-backed securities from failed lenders Fannie Mae and Freddie Mac. $100 billion is loans to troubled insurance giant AIG as well as other financial basket cases. The list goes on.

What is this stuff actually worth? Fed officials have long insisted that the assets are rock solid, but those assurances may soon be tested. US Congressmen Ron Paul and Alan Grayson now have 237 cosponsors for HR 1207, a bill to audit the Federal Reserve balance sheet. Any such audit will likely reveal that the Fed lacks the assets to cover the US monetary base.

This matters because, if a recovery gets going, the Fed must quickly draw the monetary base down from $2 trillion to about $900 billion, otherwise inflation could cut the value of US dollars in half. If the Fed can't get face value for its holdings, it will fail to draw the necessary amounts of currency out of circulation, and US currency will be debased.

Ironically, the Fed is safe as long as the credit system remains frozen. But then again the economy cannot recover. The Fed seems to be hoping for a miracle of timing. If the economy starts to grow, the assets it is holding might appreciate quickly enough to be sold at their face value before inflation breaks out. But if they gain in value only after bank excess reserves start hitting the market, the US will face an inflationary crisis comparable to the 1970s.

The second problem looming over the US economy is the Obama Administration's massive deficit. The Congressional Budget Office (http://www.cbo.gov/budget/budproj.shtml) predicts that US government spending will jump from $3 trillion to $4 trillion this year, even as revenues fall to $2.2 trillion. Nearly half of US government spending is now borrowed money, and the deficit will hit 13 percent of GDP this year. In order to raise all this money, the US Treasury is holding a series of record-breaking note auctions this summer. This week alone the Treasury must sell over $160 billion in notes with maturities ranging from 3 months to 7 years, and there are many more such auctions to follow. We will learn over the next few weeks how high interest rates will have to go to sell all those notes.

As with the perilous Fed balance sheet, Obama's deficit plan creates a problem that worsens if a recovery begins to appear. Growth in the stock market increases the competition for investor funds. The only way the Treasury can sell all those bills is to offer sufficiently high interest rates to compete with equities. As the interest rates on Treasury bills rise, money will flow out of the equity market, depressing stock prices. Rising interest rates will be avoided only if the stock market drops over the next few months and people look for low-return government bonds as a safe haven.

But if the stock market remains attractive to investors, interest rates will have to rise to meet Obama's borrowing needs. And that will impair the ability of homeowners to cope with the next wave of mortgage refinancing. In the next part I will look at this issue, as well as the California budget crisis.

A GREEN SHOOTS REALITY CHECK: PART II of II
Ross McKitrick

There are four looming threats to the US economy. The first two, which I described yesterday, are national in scope, concerning the Federal Reserve balance sheet and the government budget deficit. The others are centered in California. One is what we could call Sub-Prime Round II. So-called “Option-ARM” mortgages gave borrowers an interval during which they paid no equity, and less than the full interest, with the unpaid amount accumulating on the principal. When the reset date hits, borrowers must start making full payments, with payment increases often reaching 50 percent or more. These mortgages were popular at the height of the property bubble. 75 percent were written in four states: California, Florida, Arizona and Nevada. Many borrowers expected that house prices would just keep rising, so when the reset date approached they could simply sell the house, pay off the mortgage and pocket the difference.

But housing prices in places like California have collapsed. Homeowners are now facing payments hikes on houses worth far less than the loan principle. According to a recent Credit Suisse analysis, by fall 2011 the volume of Option-ARM (and related Alt-A) resets will have risen from $2 billion per month to $25 billion per month, dwarfing the size of the sub-prime wave. And according to data from T2 Partners, 30 percent of Option-ARM mortgages are already 60 days or more in arrears. A new wave of defaults could bring a new wave of bank failures.

The best hope is that continuing low interest rates will help many Option-ARM resets go through without default. But this is where the threat of rising interest rates due to the US deficit begins to matter. On May 27 the Treasury conducted an auction of $35 billion in 5-year bonds, with a plan to auction $26 billion in 7-year bonds the next day. The market reacted by dumping longer-term bonds, sending mortgage rates from 5 to 6.5% in one day. While this spike tapered off over the next few weeks, it sent an early signal that large-scale government borrowing will raise long-term mortgage rates. In California, foreclosures and Notice-of-Trustee sales are already back to levels observed during last year’s sub-prime crisis, and the trend is up, not down.

This brings us to the fourth harbinger of trouble ahead: the California state budget. California accounts for ten percent of the US economy. Its state budget is about $125 billion, and the deficit is about $25 billion. By law, California must balance its budget each year, and the fiscal year ends June 30. Back in February the Democrat-controlled legislature could not agree with Republican Governor Arnold Schwarzenegger on spending cuts, but they did agree to put a series of tax increases and borrowing schemes before the voters in a referendum. On May 19 all were defeated. California treasurer Bill Lockyer appealed to Washington for access to bank bailout funds, but he was turned down. He has since warned that the state only has enough cash to meet payrolls until mid-July.

California matters because of its sheer size in the US economy, and because 49 other governors are watching to see how Washington reacts to its budget crisis. Data released in mid-June by the Nelson Rockefeller Institute of Government showed state-level income tax revenues from January to May were down 26 percent across the country. New York, Massachusetts and Oregon each get over half their revenues from income taxes and collections were off by at least 27 percent in each. The revenue shocks are national in scope and unprecedented. Regardless of whether Washington is able to scrounge up some assistance, state governments are contemplating layoffs, program cuts, tax hikes, facility closures and other such measures, all of which will cut into US employment and consumer spending in the third quarter.

Over the summer we will learn how these four issues play out. In the meantime, policymakers should realize that this recession is not a simple business cycle, it is more akin to the aftermath of a giant earthquake. It began with worldwide destruction of wealth as a result of bubbles in commodities, housing and other assets. Some profited, many lost, and the money is gone. Borrowing or printing money to paper over the damage is not the answer. Starting the slow process of rebuilding private sector wealth through entrepreneurship and profitable enterprise is the answer.

The US is putting forward daily examples of what not to do. It is borrowing heavily to prop up money-losing industries like wind energy and automobiles. Alternative energy boondoggles destroy more jobs than they create, and they are unsustainable without taxpayer subsidies. The massive auto bailouts merely rewarded parasitic unions and incompetent managers who had steered Detroit into unviable cost structures. Workers in other sectors, many earning far less than unionized auto workers, will now pay higher taxes for a decade to subsidize this misadventure.

Government efforts should focus on personal income assistance, not subsidies to businesses. The financial collapse leaves retirees especially vulnerable, as pension funds have fallen deeply into deficit, and newly-retired individuals suddenly find themselves with far less capital than they expected. Where is their bailout? Instead of "stimulus" spending on hastily-conceived construction projects, funds should be used on an as-needed basis to help elderly persons whose investment income collapsed through no fault of their own, but who can no longer work to make up the losses.

Help people through income support, not corporate bailouts. Let investors find the next crop of profitable ventures, by putting their own money at risk. Governments that try to pick winners inevitably end up subsidizing losers. They end up paying to prolong the recession.

Government should also resist the one-size-fits-all notion that all public spending is expansionary. Today's problem is wealth destruction, and deficits cut into future wealth. Cutting non-essential spending will help keep borrowing needs to a minimum, thereby keeping us on track for lower personal and corporate taxes. The US will soon have to ramp up its tax burden, giving Canada a historic opportunity to become a haven for North American entrepreneurial talent and investment. But failure to cut the bloated Ottawa budget now will condemn us to higher future taxes as well.

Canada must also resist Obama's crisis-driven expansion of the state, which is manifesting itself in nationalized industries, environmental-overregulation and the suspension of financial contract law. Real backbone will be needed in the future to resist misguided energy sector intervention (including attempts at extra-territorial greenhouse gas regulation), nationalization of manufacturing and banks, and other Obama initiatives. Unfortunately the Harper government has so far adopted a supine, Yes-sir approach to copying Obama's environmental policies, regardless of the costs to Canadians.

As we move into the summer, four economic storms are converging, and it will take an extraordinary miracle of timing to avoid all of them breaking together. The famous words of Chesterton bear quoting at this point: "I tell you naught for your comfort/ Yea, not for your desire/ Save that the sky grows darker yet/ And the sea rises higher."

A GREEN SHOOTS REALITY CHECK: PART III
Ross McKitrick

Earlier this year I wrote a two-part column that questioned whether the “green shoots” of recovery were as promising as they then appeared. I pointed to four potential problems that needed to be monitored: the state of the US Federal Reserve balance sheet, the US government deficit, the wave of option-ARM mortgage renewals in four southern US states, and the California budget deficit problem. This is an update on how those issues have played out over the past six months.

The recovery thus far has had a split personality. If you only followed the stock market and ignored all other news, you might think we are in a golden age of prosperity. Beginning last Spring the US market, and most others around the world, exploded higher by some fifty percent. Those positioned on the long side of the market have had a very successful year.

But if you ignored the stock market and followed the news, you would have formed a very different view. US unemployment blew past all expectations, and is now in the double digits. Corporate earnings are weak, over 150 US banks have failed since fall 2008, major industries continue to shed jobs, and government deficits are still expanding. The green shoots of recovery looked more like a dustbowl-era crop failure.

Which is the true picture? Many bearish observers dismissed the stock market rally as a mirage created by massive government spending and computerized trading programs. But while the explosive phase of the rally ended in the summer, share values held firm through the fall, belying any notion that it was a computer-driven bubble. Investors seem confident that the economy is growing again and corporate earnings are going to recover over the coming quarters, justifying an advance run-up in equity values.

So how did the four looming problems play out? Here again, the stock market rally conceals the surprising fact that all four seem to have gotten worse, not better.

The first issue was the inability of the Fed to shrink the monetary base should inflation reappear. The kindling for an inflation bonfire was the banks’ stockpile of $844 billion in excess reserves on deposit at the Fed. If a recovery were to get going and banks decided to lend those reserves out, the Fed would suddenly need to shrink the monetary base by selling assets on its balance sheet. As of last June the Fed had more than doubled the monetary base, but most of it was backed, not by liquid Treasury bills but by mortgage-backed securities (MBS) and other unwanted garbage. An inability to get 100 cents on the dollar for its holdings would leave the Fed powerless to stop inflation.

But the Fed now has a Plan B: they obtained from Congress the authority to pay interest on bank excess reserves. In principle they can set the rate high enough to prevent a flood of new credit should banks decide to start lending.

However there is no sign of new lending. Last spring I noted that the US money multiplier had fallen to 0.862, its lowest level ever, indicating that for every dollar by which the Fed issued credit, the banks only lent out 86 cents, rather than $1.50 or more, the historical norm. The money multiplier briefly rose in the summer, but over the past two months has fallen to a new low of 0.809. Meanwhile the banks’ stockpile of excess reserves has gone from $844 billion to nearly $1.2 trillion.

Why are banks hoarding cash? One theory relates to a second of the four issues, the perilous state of US mortgages. The US Treasury estimates that a quarter of all mortgages are now 60 days or more in arrears. At the start of 2008, 5 percent of option-ARM mortgages were 60 days behind: today the number is

nearly 40 percent. House prices and sales have held up because of government interventions—foreclosure moratoriums, home buyer tax credits, etc. But these are only band-aid strategies. Eventually the rate of distressed mortgages needs to return to its historical norm of under 5 percent for banks to be able to lend to home buyers. For that to happen many of the option-ARM mortgages need to be defaulted and written off or renegotiated. The rock-bottom interest rate environment is crucial for getting homeowners through the mortgage reset process.

Will low rates continue? The biggest threat comes from US state and federal borrowing rates. Most US states report continued declines in revenue. Arizona reported its revenues were down 40 percent in the past 3 years, during which time spending doubled. Despite supposedly solving its budget crisis last summer, California has already accumulated $21 billion in new debt, and its credit rating is lower than Greece's. In September it had to issue IOUs to pay its bills. Last week it appealed (again) for federal assistance. Quite simply, California is running out of money, and in 2010 it will either default on its debt or stop paying its bills, or both.

Meanwhile the situation in Washington is so bad that the influential Treasury Borrowing Advisory Committee (TBAC) projects debt service costs will become "unbearable" over the next decade without massive spending cuts. The US federal deficit reached nearly $1.9 trillion this year, and Treasury projects deficits of more than $1 trillion per year through 2020. Most of the recent borrowing took the form of very short term bills, with the result that 40 percent of all marketable US government debt matures in the next 12 months. Treasury wants to roll it over into long bonds in order to increase the average maturity from under 50 months, its current rate, to over 70 months, its historical norm.

Can the market absorb all those long bonds? According to the Treasury, a total of $1.37 trillion in net new fixed income securities were issued in the US last year without pushing up interest rates. But the Fed acquired $1.44 trillion, implying that all other US bond buyers actually reduced their fixed income holdings last year. The Fed has indicated it too plans to stop buying securities in the first quarter of 2010, while Treasury plans to issue even more new debt than it did last year and projects total economy-wide issuance of $3 trillion next year. Without the Fed's participation as a buyer, this is bound to force up interest rates.
http://www.zerohedge.com/article/brace-impact-2010-private-demand-us-fixed-income-has-increase-elevenfold-or-else

They were helped by the Fed's decision to buy $290 billion in US bonds, the so-called called "Quantitative Easing" program. This is scheduled to end in March. Foreigners purchased about $700 billion, and Americans purchased about $200 billion. As Eric Sprott has recently pointed out, this leaves $500 billion in purchases of Treasury securities unaccounted for. Where did they go? This has yet to be determined, but one crazy rumour suggests that the Fed is secretly purchasing bonds off its balance sheet.
http://www.zerohedge.com/article/sprott-calls-fed-ponzi-scheme-half-trillion-treasury-purchasers-are-unaccounted

The other thing that helped the auctions go smoothly was the disproportionate reliance on short-term notes, maturing in under a year. Relatively little long-maturity debt was sold, and as a result, the continued demand for safe short-term notes helped finance US federal borrowing. But this reliance on short-term borrowing means that 40 percent of outstanding US debt matures by the end of next year. Next year the Treasury must roll over close to $2.9 trillion in debt, plus borrow whatever amount is needed to fund the government deficit, likely another $2 trillion.
http://www.zerohedge.com/article/observations-us-governments-escalating-near-term-funding-mismatch