Gordon T Long
Global-Macro Tipping Points

www.GordonTLong.com
Market Research & Analysis

MMC

LIQUIDITY IS NEITHER WEALTH NOR COLLATERAL

The Fed Can't Create Wealth & Only Temporary Collateral

Gordon T Long
7/15/2014

LIQUIDITY IS NEITHER WEALTH NOR COLLATERAL

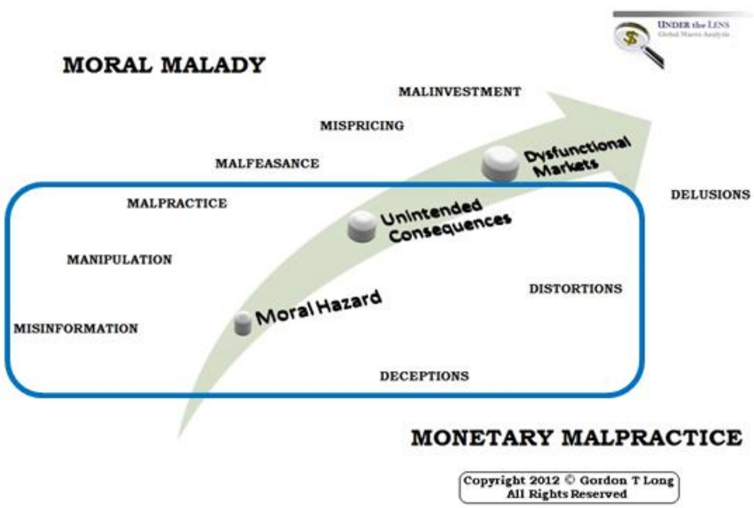
The Fed Can't Create Wealth & Only Temporary Collateral

JULY MONTHLY MARKET COMMENTARY

LIQUIDITY IS NEITHER WEALTH NOR COLLATERAL – *The Fed Can't Create Wealth & Only Temporary Collateral*

I spent a lot of time in 2012 and 2013 talking about Monetary Malpractice and where it would lead. I discussed extensively the consequences of Moral Hazard and Unintended Consequences and how they could lead to Dysfunctional Financial Markets.

I additionally showed how Misinformation & Manipulation of CPI Inflation measures, GDP deflators and Labor Statistics was Monetary Malpractice and how it would lead to Malfeasance, Mispricing and Malinvestment as the Price discovery process was corrupted. The Mispricing of Risk would be a logical consequence.



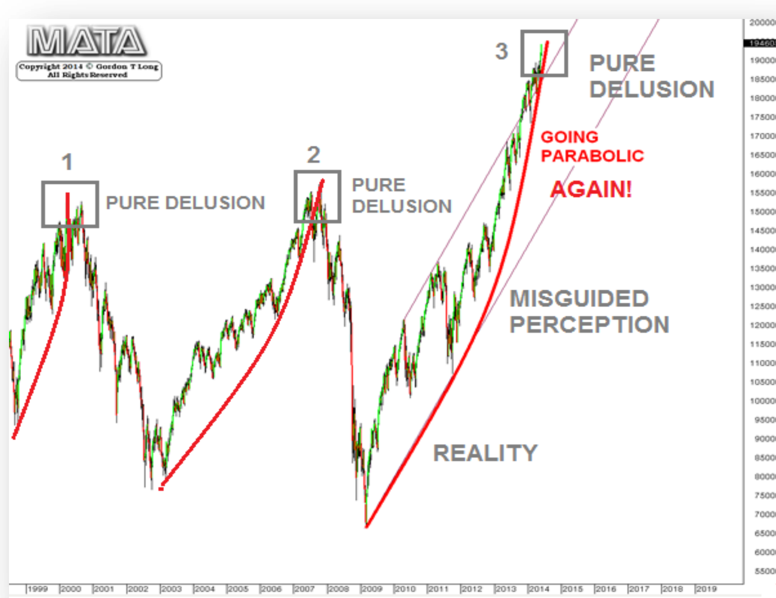
I just published an Analytic Insights paper entitled "[The Delusional High - *When Reality, Misguided Perceptions & Delusion Intersect*] "which can be linked to from our commentary page of GordonTLong.com.

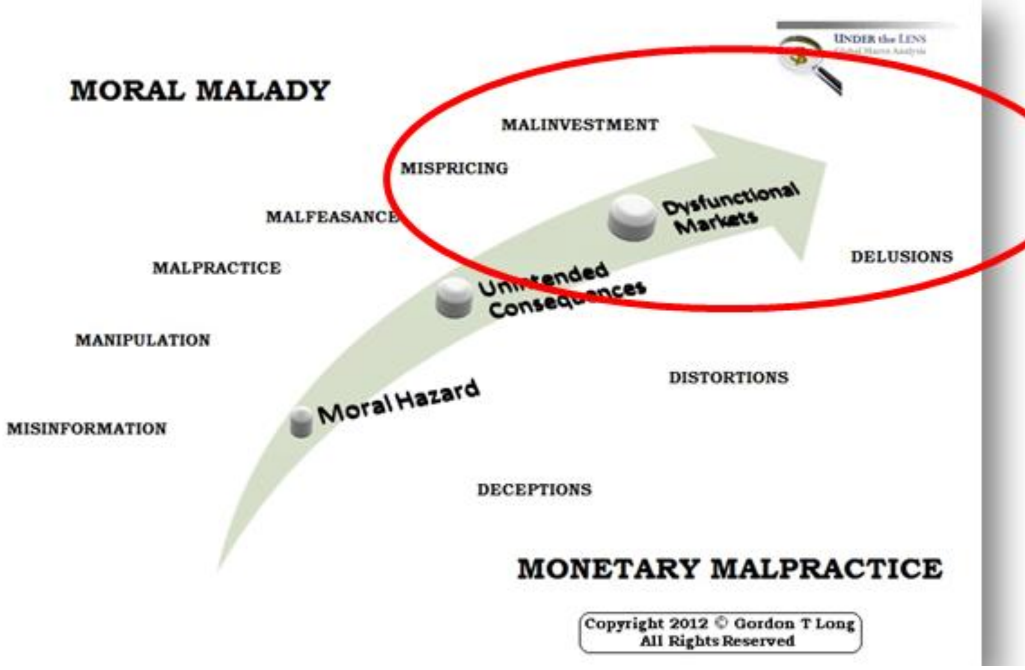
I illustrate that Deceptions of all types, if sustained over longer periods of time, usually lead to Distortions which in turn lead to Delusional expectations.

Specifically, how Reality moves to Misguided Perceptions which inevitably results in Pure Delusion.

This is exactly where we said we would eventually end up when we talked about Monetary Malpractice.

This is precisely where we are now! -With Dysfunctional Markets, Malinvestment and Pure Delusion.





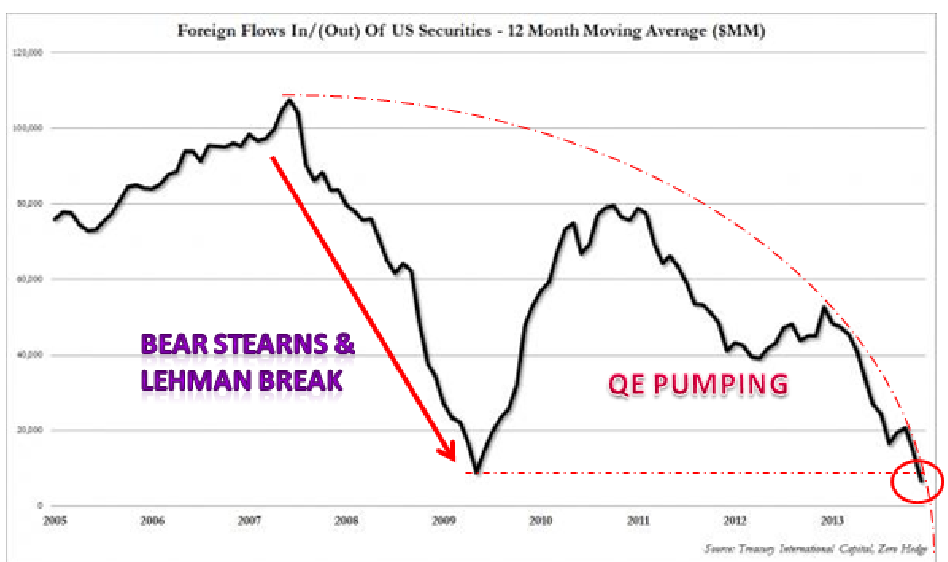
These are pretty harsh statements, so let me back them up with the facts.

Let's talk specifically about the US Treasury Markets, and Global Equity Markets, but this list could be quite easily expanded to include Global Residential and Commercial Real Estate, the Chinese Metals Markets, the $700T SWAPS market to name a few.

WITHOUT THE FED US TREASURIES WON'T' SELL (AT LEAST AT THIS PRICE & YIELD)

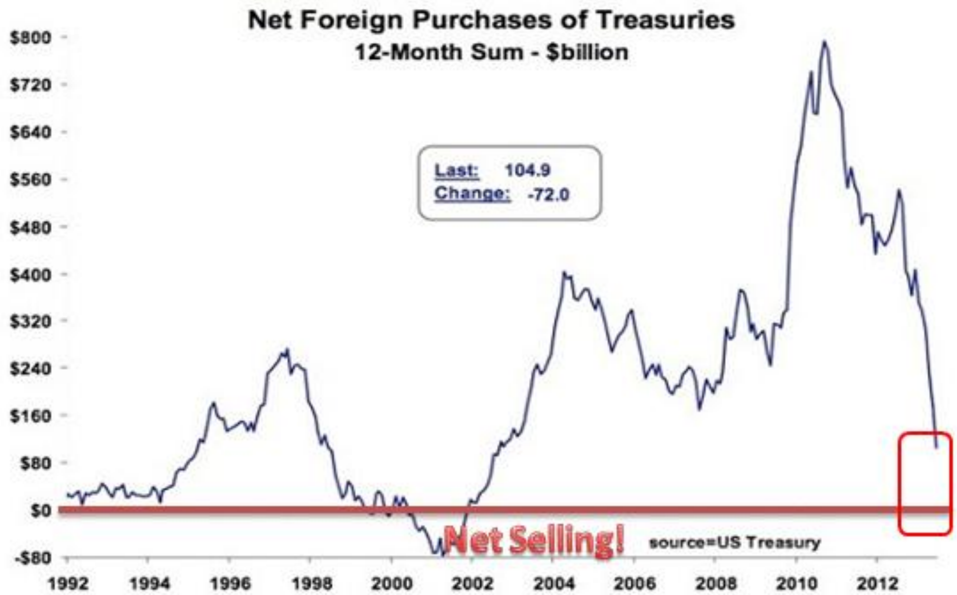
Consider that Foreign Direct Investment in the US has been falling steadily since the 2007 Financial Crisis and Quantitative Easing has done nothing to change that. As a matter of fact it has made an already bad problem worse!

GLOBALIZATION TRAP – Slowing Global Aggregate Demand = Less FDI



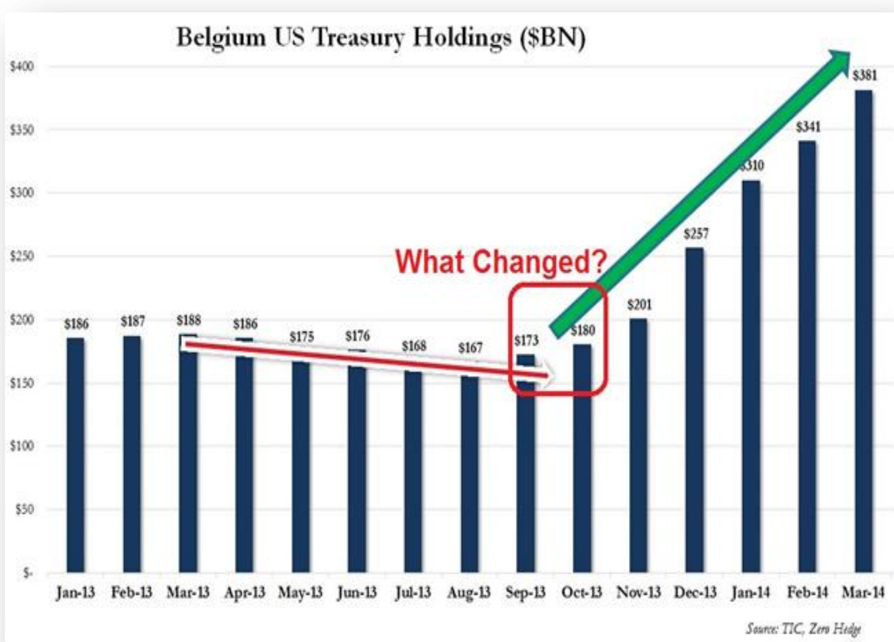
general@GordonTLong.com

US Treasury sales are no longer being bought by foreign buyers to the degree required by the size of the US government debt, ongoing budget deficits or Current Account deficits. We are approaching net selling.

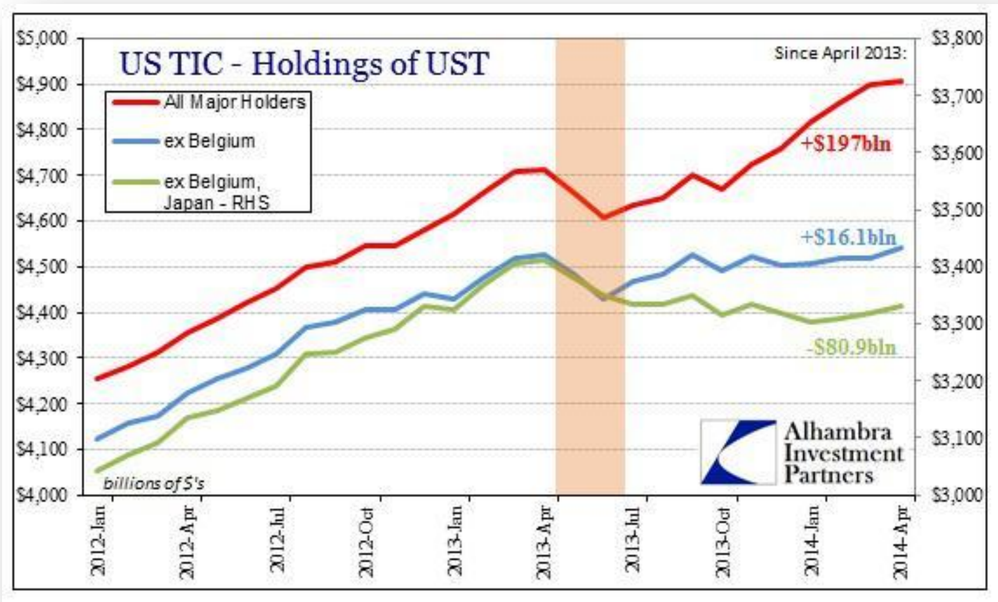


Clearly there is a loss of confidence in the US Treasury notes and bonds being of sufficient 'store of value' to merit investment.

When the Federal Reserve announced its TAPER intentions last fall there was suddenly a mysterious buyer that appeared in Belgium that began buying unprecedented amounts of US Treasuries that made up for the lack of buying that was occurring and additionally covered the amounts that Russia (as one example), was selling.



If this “White Knight” hadn’t suddenly started buying US Treasuries the market would have gone into freefall, with rates spiking dramatically. Rates that the US government could not afford to pay now, ever mind what is going to be required to finance 75M baby boomers retiring at 10,000 a day and expecting social benefits. Social entitlements which are unfunded and now facing retirees no longer paying the payroll premiums used to mitigate an already blotted US budget deficit.



The suspects for this mysterious buyer who apparently can’t be indentified through Euroclear in Belgium (if you can believe the ridiculousness simplicity of the media reporting on it) were speculated to be:

- FEDERAL RESERVE
- US TREASURY
- ECB
- PBOC (Gross Fixed Capital Formation 45% versus 16% for US)
- BIS/IMF (keep things balanced on a short term quarterly basis)

All have motivations, all had reasons to keep it quiet and all had sources of funds to orchestrate it.

	US TREASURY	FEDERAL RESERVE	ECB	CHINA - PBOC	BIS / IMF
MOTIVATION	Their Product (Bills, Notes, Bonds) Keep Yields Down Keep Gov't Borrowing Costs Down	Their Product (Federal Reserve Note ie $) Keep Dollar Strong Protect Bank Treasury Collateral Values	Devalue the Euro Currency Improve Exports Stop Recessionary Cycle	Stop Yuan from Rising Capital Investment Requirements Mercantile Strategy	Keep Global Settlements Working and Stop Possible Implosion
WHY HIDE IT?	Issuing Bonds Yet Buying Them? Seen As Clearly Manipulative	Maintain Credibility of TAPER Policy	No Legal EU Mandate	Don't Want to Inflame Congress further as 'Currency Manipulator'	Raises Alarm Flags
SOURCE OF FUNDS	Off Balance Sheet SWAPS	Off Balance Sheet SWAPS	Off Balance Sheet SWAPS	Off Balance Sheet SWAPS	Off Balance Sheet SWAPS

The fact that we are even speculating on this sort of deception shows the level we have sunk to.

With the advantage of hind sight in June 2014 we can see some things much more clearly.

- The Belgium buying increased from $180B in October to $366B in April. This was an increase of $186B,
- The announced Federal Reserve Taper Reduction program which actually began in January has resulted in $160B in reductions YTD in June.

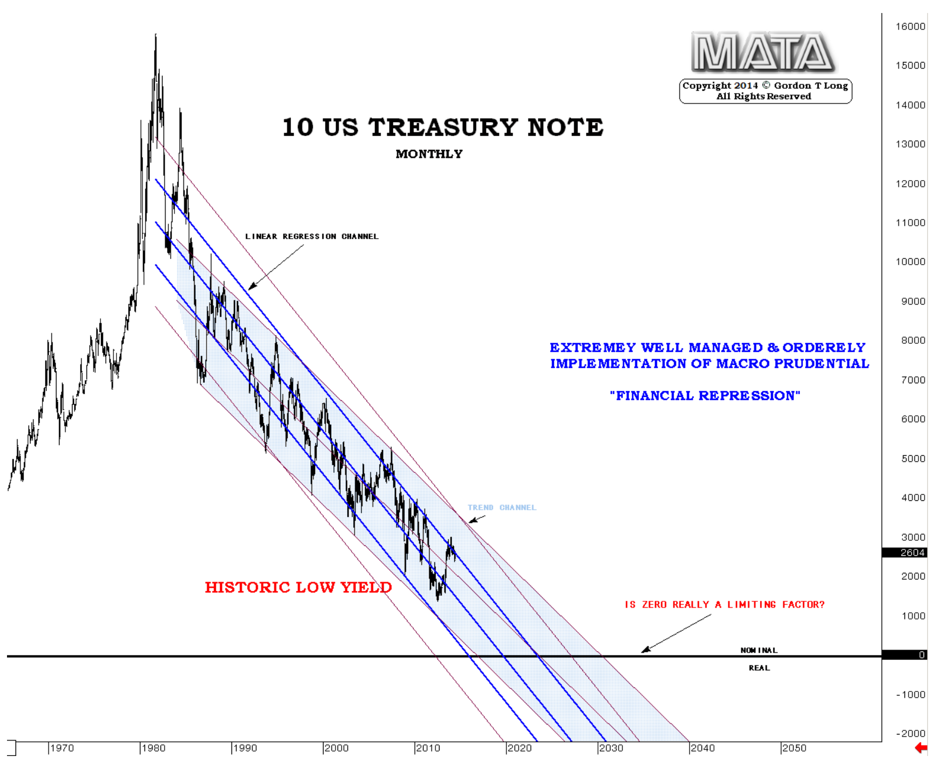
This is so close as to suggest that the US Treasury in fact orchestrated this buying to front run the Fed TAPER program and to ensure stable bond markets as TAPER was rolled out.

All of this is deception and manipulation no matter who the party and motivation. It means the mispricing of risk and dysfunctional markets.

THE TAPER SCHEDULE

US$ billions

2014	QE per month	QE per Quarter	Cumulative	REDUCTION
January	75		75	
February	65		140	
March	65	205	205	
April	55		260	
May	45		305	
June	45	145	350	160
July	35		385	
August	25		410	
September	25	85	435	
October	15		450	
November	5		455	
December	0	20	455	



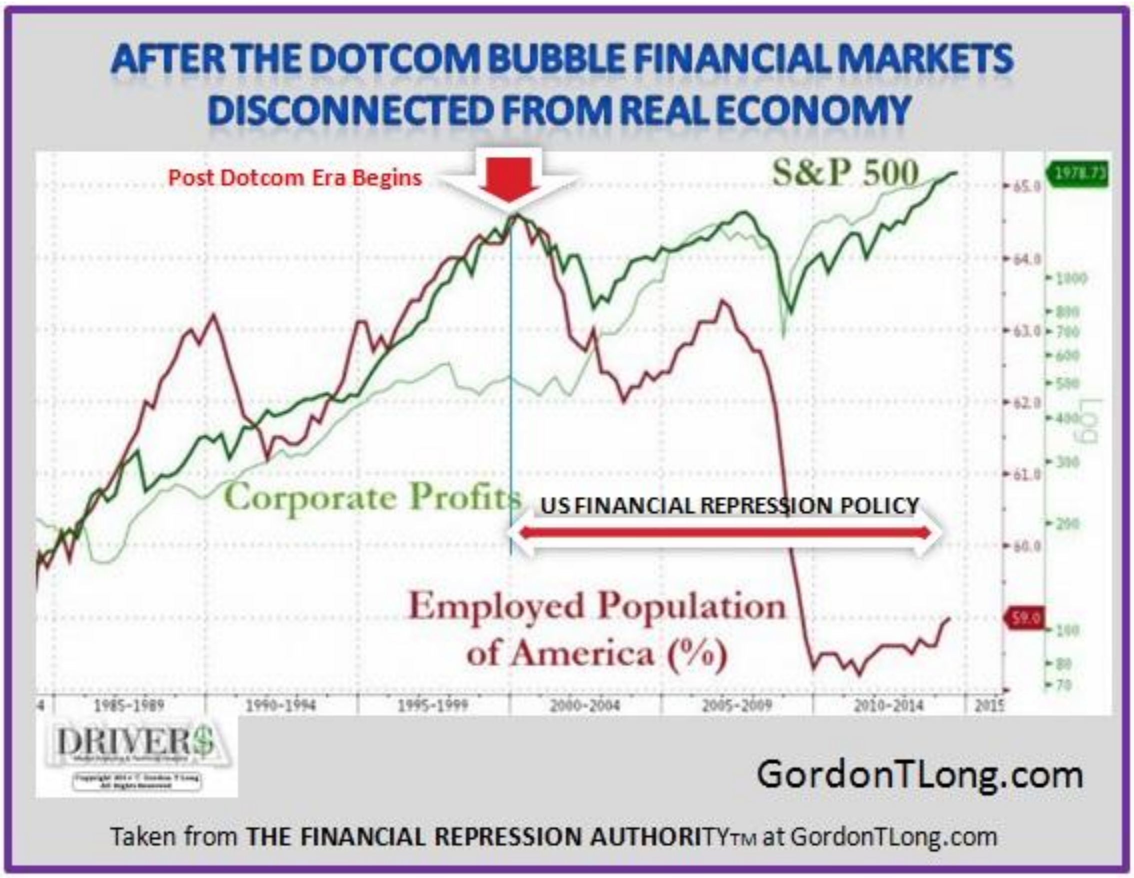
- The Federal Reserve now owns over 1/3 of US Treasury Market
- It Now Controls Long End Inventory in addition to Shorter End

Since the Federal Reserve now controls the Bond Market, it means we no longer have a free market system where debt is priced based on market pricing. The Fed now effectively dictates that price.

This means that with continued policy of Financial Repression we should expect US Treasuries yields to continue to fall thereby making it easier to pay the US debt. This in concert with real negative rates means the existing debt will be paid back on the back of savers and pensioners. Additionally, lower yields will keep bond prices higher and protect the collateral value of these instruments owned by financial institutions.

This is where we said in our 2011 Financial Repression Thesis paper was where we were going and this appears to be exactly what is now unfolding.

Let's now switch from the debt markets to the Global Equity markets.



ARTIFICIAL MONEY THE ONLY THING KEEPING EQUITIES AFLOAT

The FT reports that "A cluster of central banking investors has become major players on world equity markets."

The report, by the Official Monetary and Financial Institutions Forum (OMFIF), confirms that $29.1T in market investments, held by 400 public sector institutions in 162 countries, has been purchased.

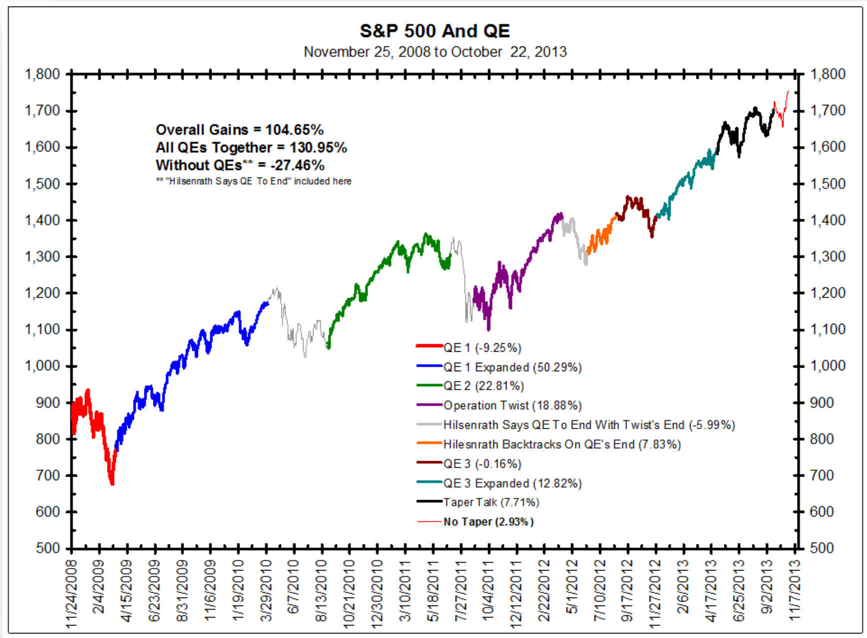
In fact it appears that China's State Administration of Foreign Exchange has become "the world's largest public sector holder of equities", according to officials.

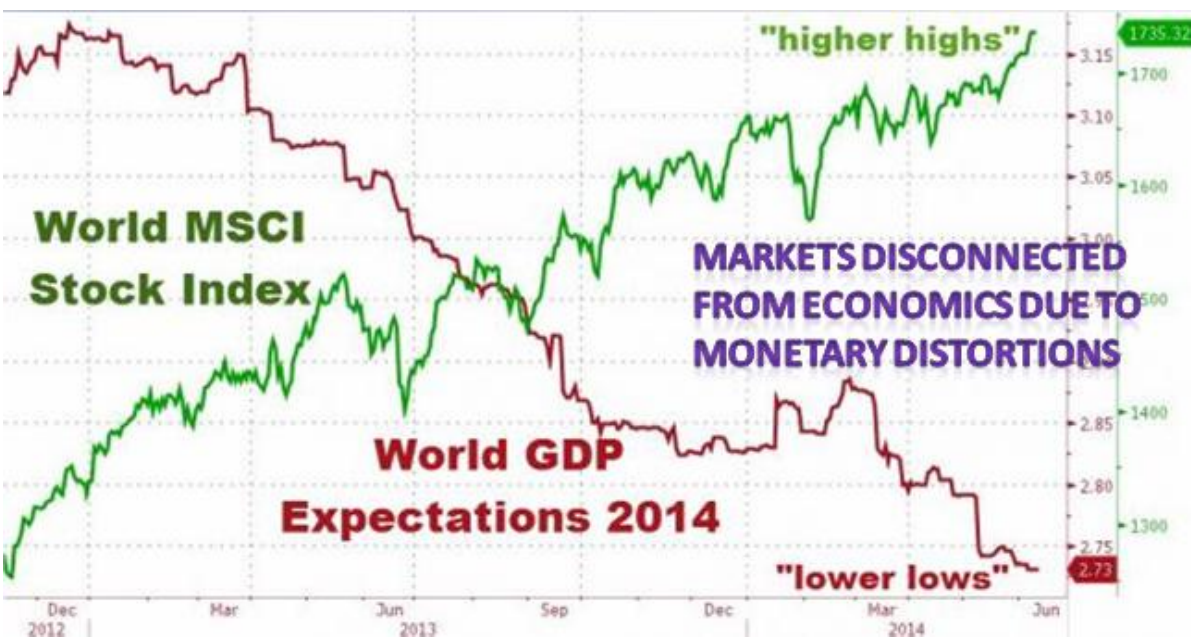
Central Banks such as China's PBOC, Denmark and Switzerland are now reportedly openly buying equities.

I read recently that Norway is going to increase its holdings of European equities to 5% of ALL European companies by using its $888B Sovereign oil fund.

The Financial Times reports, "Yngve Slyngstad, chief executive of Norway's sovereign wealth fund, is hiring aggressively to manage its real estate portfolio and **while the oil fund already owns 2.5% of every listed European company on average, it plans to go above 5%"**

Zero Hedge suspects the Fed is close behind (courtesy of more levered positions at Citadel), as the world's banks try to diversify themselves and "counters the monopoly power of the dollar." Which begs the question: Where are the central banks 13Fs?



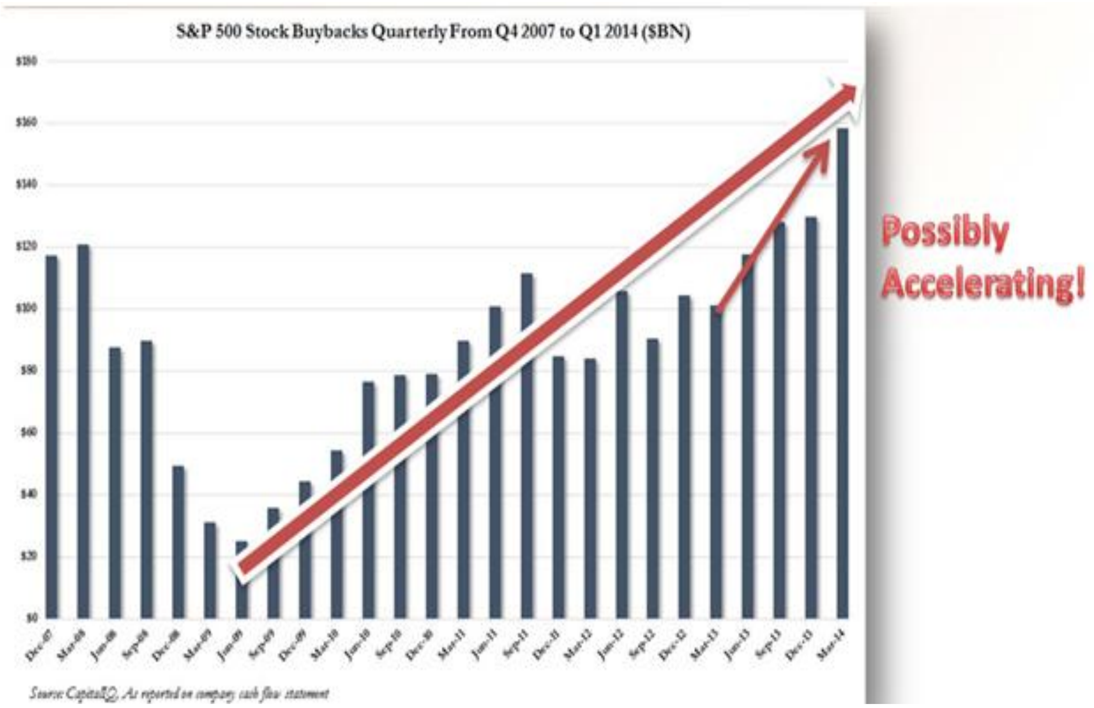


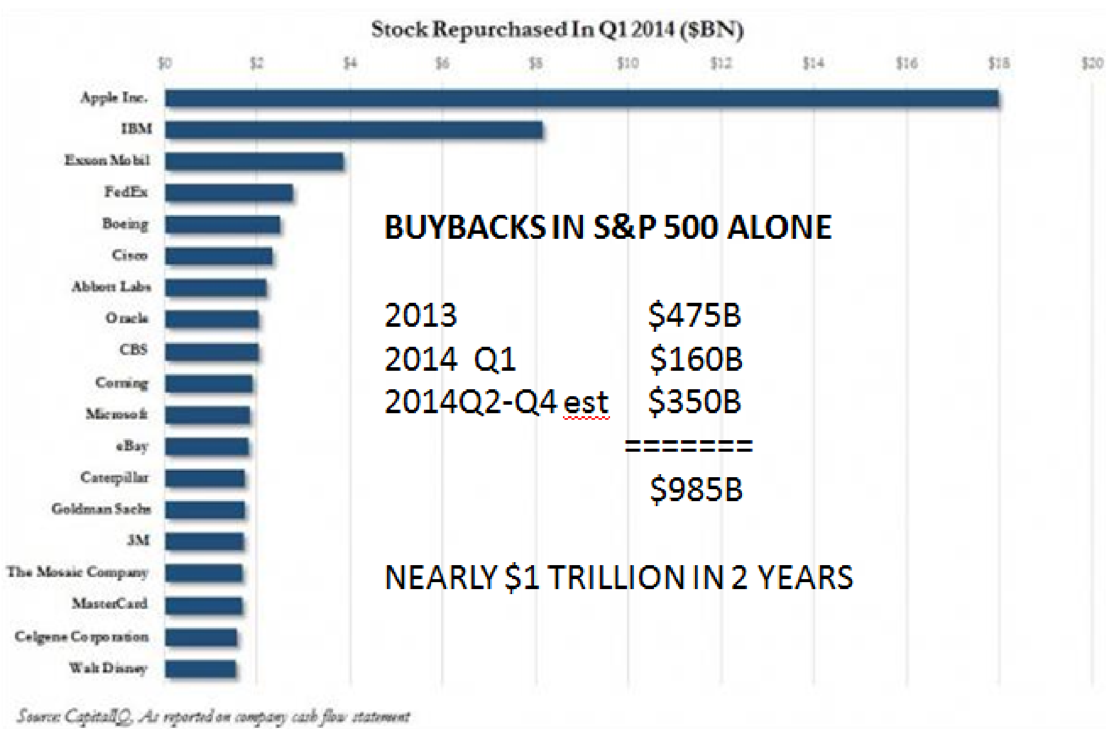
The protracted period of the untested policy of Quantitative Easing and near Zero Interest Rates has lead to this, whether as unintended consequences or intended – the result is the same. I will leave it to the reader to conclude which it is.

Let's talk about Private Buyback of stocks versus public institutional buying using tax payer money.

380 of S&P 500 have aggressive repurchase programs and it appears to be accelerating. If you want to know why the markets are going up, you need not look any further than this. It is unprecedented and is a direct result of US Monetary Policy and its cheap money policy. The policy incentives are such that it is

better for corporations to buy back their stock than make investment in plants and people. I lay all this out in my paper: “THE BUYBACK TAX RUSE - It’s a Free Tax Ride for Corporations”.





- OVERALL

2013	475B	
2014	160B (up 50%)	
	350B Q2 –Q4 (Q2 now seen to be over 200B)	
	====	
	985B ~ 1T in 2 Years	

- APPLE

2014	18.6B in Q1

- IBM

2013	13.9b (Q4 5.8)	Taxes	
Debt	+6.4B	2012	2013
CAPEX	-0.5B	25.5%	11.2%

- ORACLE

Q4	2B
2014	10B YTD
2 Yr	21B

- CATERPILLAR

2013	7.5B
2014	10.0 ANNOUNCED

This buyback activity is outpacing EBITDA which is nearing contraction or burn.

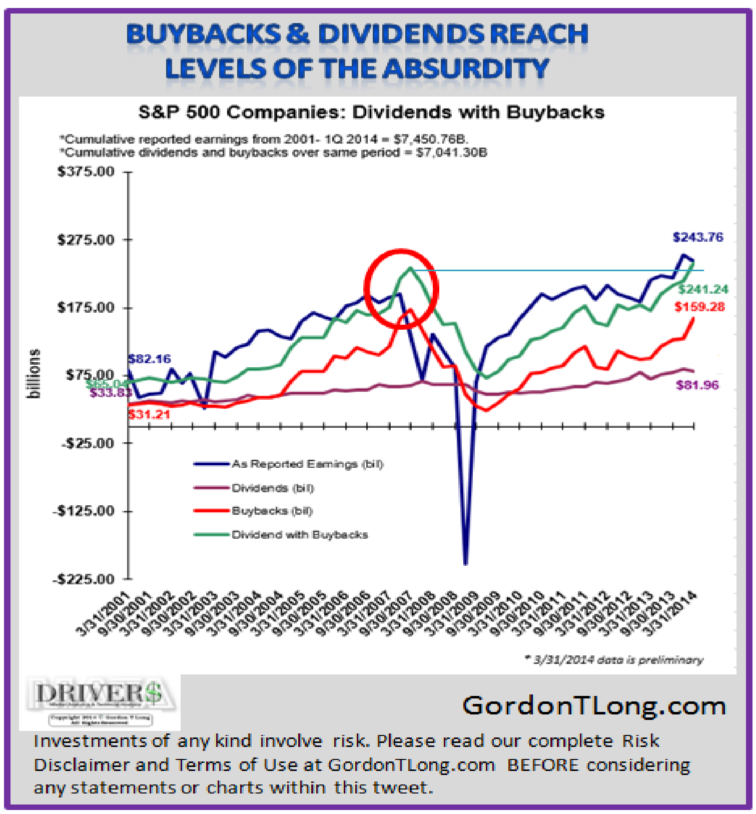
80-90% of all profits are going into Buybacks and Dividend.

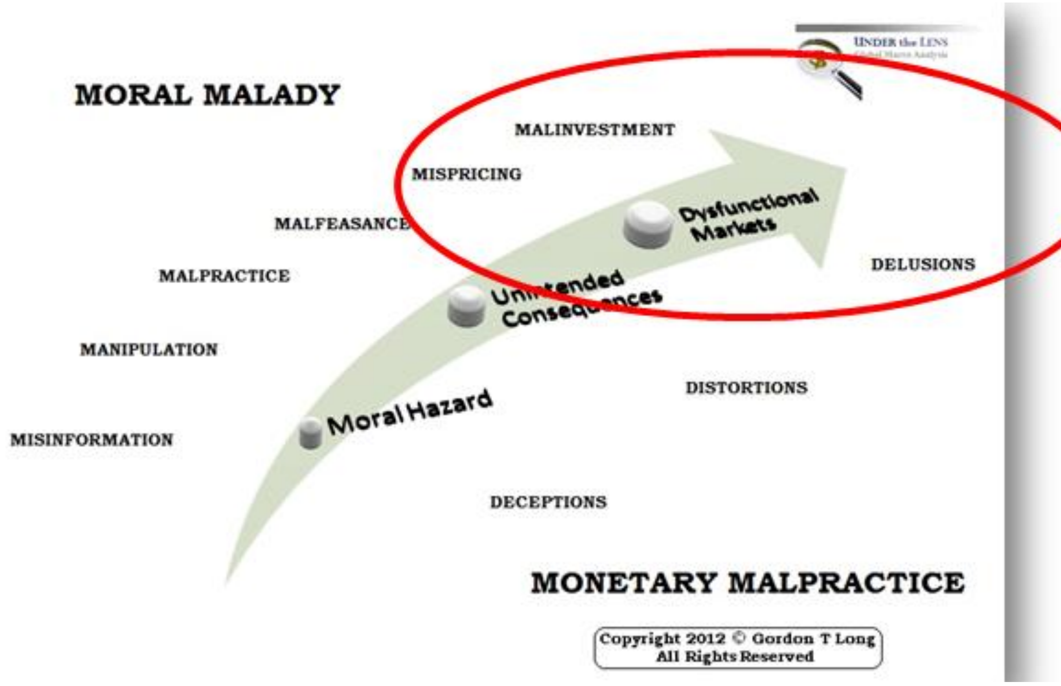
Think of what this means when:

- 2/3 of World's Market Cap in 5 Markets w/ US & Japan Dominating,
- Only 3 Countries in MSCI EM with Total Market Cap > Apple.

THE PROBEM: LIQUIDITY IS NOT WEALTH NOR COLLATERAL

I would suggest it is safe to say we have arrived where we said we were headed and wrote about two years ago.





The questions are:

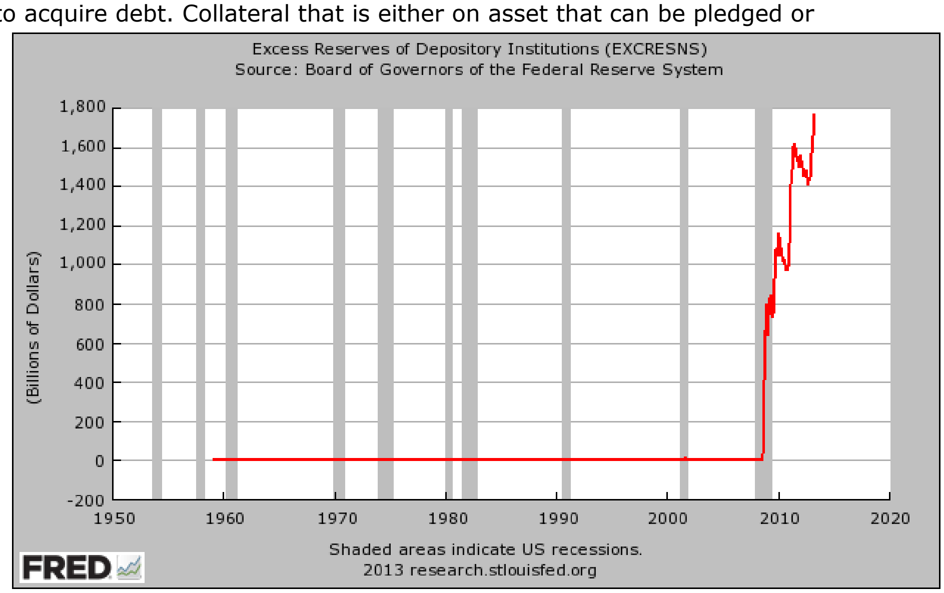
1. "Will it keep going"?
2. For How Long? And
3. What would derail it?

This is impossible to answer. However, there are things to watch for that will help.

Few seem to appreciate that the liquidity the central banks create is neither new wealth nor new collateral.

Liquidity only has a real impact on growth when it becomes someone's debt and that debt is used productively to create wealth.

It takes collateral for someone to acquire debt. Collateral that is either on asset that can be pledged or prospective free cash flows that can be collateralized.



The problem today is collateral is disappearing, is losing value or is over pledged through the rehypothecation process.

This is one reason the banks hold approximately $2T of excess reserves at the Federal Reserve. The simple truth is they can't find loans that they feel comfortable that the loan and collateral supporting it are sufficient to take the risk.

This tells us that we have reached markets that can only be described as

Dysfunctional and Delusional

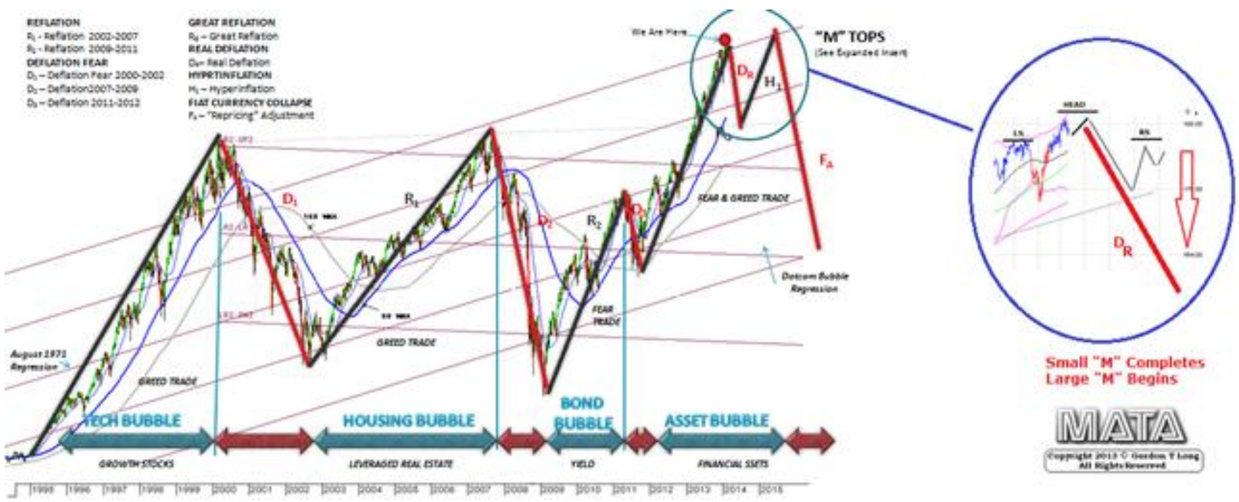
We expect the markets to soon adjust with an attendant flight to safety.

This will force yet another round of central bank programs and political actions.

Don't ever underestimate central bankers' and politicians' creativity under pressure.

The central bankers may be getting very concerned (as they should be) but they haven't yet reached the point of outright panic.

That day is coming and the new policies that will come with it **will seem as preposterous as the chart we showed two years ago** on what to expect with Monetary Malpractice.



Gordon T Long
Publisher & Editor
general@GordonTLong.com