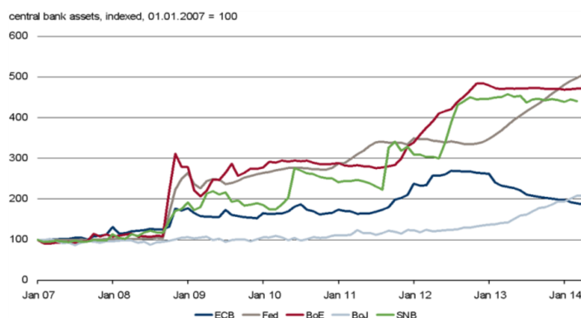
Strategic allocation musings

QE reduction by the Fed -- really? Potential strategic allocation impact if untrue or unsustainable

May 2014

Elevated monetary bases and questionable QE reductions



US dollar through 1962 (payable in silver to bearer on demand)

"Tapering" (less bond purchases) by the Fed -- really?
What could be more strategically bullish for fiat currency/dollar valuations of real money (physical gold) and scarce real assets, esp. vital dense energy and ag assets, than solid indications showing that massive, albeit it veiled, QE may be continuing apace? In this sense, please consider this link: www.paulcraigroberts.org/2014/05/12/fed-great-deceiver-paul-craig-roberts/. Excerpts:

"From November 2013 through January 2014 Belgium, with a GDP of $480bn, purchased $141.2bn of US Treasury bonds. So where did the $141.2bn come from? There is only one source. The money came from the US Federal Reserve, and the purchase was laundered through Belgium in order to hide the fact that actual Federal Reserve bond purchases during November 2013 through January 2014 were $112bn per month.

In other words, during those 3 months there was a sharp rise in bond purchases by the Fed. The Fed's actual bond purchases for those three months are $27bn per month above the original $85bn monthly purchase and $47bn above the official $65bn monthly purchase at that time. (In March 2014, official QE was tapered to $55bn per month and to $45bn for May 2014.)

Another curious aspect of the sale and purchase laundered through Belgium is that the sale was not executed and cleared via the Fed's own National Book-Entry System (NBES), which was designed to facilitate the sale and ownership transfer of securities for Fed custodial customers. Instead, the foreign owner(s) of the Treasuries removed them from the Federal Reserve's custodial holdings and sold them through the Euroclear securities clearing system, which is based in Brussels, Belgium. We do not know why or who. We know that there was a withdrawal, a sale, a drop in the Federal Reserve's 'Securities held in Custody for Foreign Official and International Accounts,' an inexplicable rise in Belgium's holdings, and then the bonds reappear in the Federal Reserve's custodial accounts. What are the reasons for this deception by the Federal Reserve?" (https://research.stlouisfed.org/fred2/series/WMTSECL1)

A different "explanation" for the ballooning of Belgium-domiciled Treasury holdings, as offered by the FT (www.ft.com/cms/s/0/4a2f3a32-db90-11e3-a460-00144feabdc0.html#axzz31tUf3S9y), boils down to this:

- "Russia's Treasury holdings have declined over the past five months from $149.9bn. In contrast, Treasury holdings for Belgium continued to expand sharply over the same period.
- Belgium added a further $40.2bn during March 2014 and its holdings have more than doubled in the past year to $381.4bn, making Belgium the third largest foreign holder of US government debt after China and Japan.
- The move is seen reflecting secret buying of top-rated sovereign debt by other countries using Brussels as a financial centre.
- This means financial centres are temporarily highlighted as large buyers, rather than the countries that are really adding to their Treasury holdings.
- Some traders believe the hefty buying by Belgium could also stem from investors utilising the clearing and securities lending services of Euroclear, the bank-owned central securities depository and custody service headquartered in Brussels."

Clearly the FT's implied explanation for Belgium's rapidly rising Treasury holdings is focused on anything but "covert QE" by the Fed above its announced monthly tally. Paul Craig Roberts, in contrast, sees the $141.2bn ballooning of Belgium held Treasuries as, in essence, undisclosed

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additional Fed-based QE of $47bn per month between November 2013 and January 2014.

Who's right, or is something else taking place?

Which is the correct take, the right interpretation, Roberts' or the FT's? And why have *both* US stock and bond markets remained in such historically elevated valuation territory if the Fed's QE punchbowl has really been sharply withdrawn (from $85bn per month in November 2013 to $45bn announced in May)?

Given the Fed's cartel-like origin and purpose (http://mises.org/books/originsoffed_rothbard.pdf), its charter's primary mandate to protect its member banks/financial elites, its questionable constitutionality, its steadfast refusal to allow Congressional audits, its history of currency debasement, and its support of Statism (the doctrine of big government) via QE, allow me to suggest that there could well be more monthly QE going on than meets the "Fed monthly reduction to $45bn" eye.

Furthermore, allow me to posit that such manipulation would be in keeping with -- and possibly in synchronization with -- the increasingly "downwards-massaged" CPI as offered by another agency, the BLS (http://www.bls.gov/cpi/). The CPI is a statistic which Bill Gross of PIMCO rightly identified as a "haute con job" some ten years ago. I am referring to the same understated/misrepresentative-of-consumption-reality CPI which also continues to result in overstated real GDP growth rates. (Can a thinking investor be forgiven for worrying about a potential pattern of disinformation and how to best allocate, at least at the satellite level, for it?) For more detail on the CPI manipulation front, please visit this link: www.europac.com/commentaries/inflation_propaganda_exposed.

(Addendum: throw in the stark possibility that the Fed's gold vaults are (near) empty and the fact that the big re-emerging nations are looking to reduce exposure to the ubiquitous dollar, and the Fed's possibly cloaked QE abatement efforts in order to support the value of the dollar while keeping yields low sound that much more plausible.)

The other obvious, yet non-mainstream "explanation" has to do with Anglo-American financial hegemony -- the Bank of England pioneered a return to money printing (QE) to sustain its debt-laced empire starting in the mid-18th century (www.xat.org/xat/moneyhistory.html) -- and the fact that these nations are steeped in how to sustain reserve currency supremacy. My point: The US and the UK have been working together to uphold the dollar's (by now) arguably ill-deserved reserve currency status simply because both countries, and especially America, hugely benefit from it in multiple ways, e.g., America's lower cost of financing, America's lower import costs, America's vast money printing to pay for imports, and both countries tremendous financial/geopolitical power -- especially when acting in concert -- thanks to this collaboration.

In addition, large dollar reserve currency parallel interests in OECD countries have been established over time -- and embellished recently, courtesy of the FATCA "rollout" (www.irs.gov/Businesses/Corporations/Foreign-Account-Tax-Compliance-Act-FATCA). As a result, money center, OECD-nation foreign banks and their "headquarters' governments" are already extending the IRS' global reach via FATCA. Implementation is superseding or upending, in certain instances, foreign nations' laws, including putting the kibosh on what remained of the erstwhile, constitutionally-based Swiss bank secrecy law (www.swissbanking.org/en/bankkundengeheimnis.htm), which was originally drafted to effectively protect solely Swiss citizens against potentially overzealous Swiss tax authorities once Swiss citizens residing in the country (in sympathy with virtually every other OECD nation, expatriates are not taxed) had paid their income taxes.

Post FATCA "implementation," one could legitimately wonder why the involved banks and the related "headquarter nation" jurisdictions would then shift dollar assets/dollar collateral to Brussels? To what effect? This is all the more true considering the huge profit foreign money center banks are making lending dollars that cost nothing to acquire (courtesy of the Fed) and easily facilitate a 200 - 300 BP spread, a financial killing that the country of foreign money center bank incorporation(s) surely wants to tax as a "quid pro quo" for accommodating FATCA.

Another assessment of how Brussels has suddenly become the world's third largest holder of Treasuries has also been offered, namely that the ECB has come to the Fed's QE reduction claim rescue and surreptitiously purchased $141.2bn (or more) worth of Treasuries and "parked them" in Brussels. Possible aim: to keep financial markets stable amidst the Fed's alleged QE punchbowl reduction, and in so doing simultaneously helping to establish and bolster new Fed Chief Jane Yellen's "hawkish" credentials (so she can "QE-ease" with more ease later).

If this is what has occurred, it raises the obvious question of what the ECB/ECB head Mario Draghi will do should the ECB be poised to (re)launch its own QE/bond buying campaign in order to weaken the euro against the dollar and to push up inflation in Europe. Given the clamoring about pronounced Eurozone economic weakness and deflationary developments in peripheral nations, the ECB is likely to revisit QE sooner rather than later. If this is indeed in the offing, how could -- or why would -- the ECB simultaneously buy Treasuries and Eurobonds? As such, one would expect any covert European "Treasury price support"

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to be short lived. Commensurately, pressure on the Fed to increase "overt QE" could rise substantially.
On another front, it is no secret that the EM countries that aren't in (benefitting from) the Anglo-American financial hegemony camp are increasingly interested in turning their dollars into real assets. And they are starting to do this, taking a page out of China's book. Plus, they are also starting to trade in non-dollar, yuan terms. So why would such nations move their Treasury holdings to Belgium? They'd conceivably rather use their dollar-based foreign currency reserves to buy gold -- real money that has held its value throughout history, particularly from EM countries' perspectives -- or scarce real assets, especially in the pivotal dense energy (Asian nations) and agricultural asset (Asian and Gulf states) realms that they are short of and need to stock up on in order to sustain or re-establish productivity-based growth and to head off potential political concerns.

Finally, and strategically much more important than any near-term "is there more to Fed QE than meets the eye" deliberations, let's consider this: with more indications that the long anemic US economy recovery may be heading for recession (Q1:2014 real GDP growth was 0.1%), i.e., assuming we truly left the last one, what precisely is in the policy makers' playbook short of addressing growing weakness with revved-up QE? Is any D.C. powerbroker in office or any leading establishment politician on either the Democratic or Republican side that may run for president in 2016 interested in revisiting constructive tax policy, sane regulatory policy, litigation reform, and therefore sound property rights so as to stimulate risk taking, investment, job creation, and ultimately robust output growth in the key free market sector of the economy? Does anyone even hear this from the Statist powerbrokers? And is it much better or constructively different in Europe or Japan?

Upshot: given the hugely outsized growth in US federal debt relative to GDP since 2008 as well as a bevy of rule of law-impeding legislation and SCOTUS decisions over the past decade in the US -- and, to an arguably lesser but still disturbing degree, in too much of the world -- the modern day Keynesian standbys, deficit spending funded by QE, continue to look like the tools of policy makers' choice going forward. We should take note. Caveat emptor.

Asset allocation conclusion:

Virtually no matter how one slices it, based on the scenario outlined above, it appears that strategic investors ought to establish or increase satellite portfolio exposure to physical gold and silver as well as to economically vital scarcity assets in the energy and ag patches. Such allocations should serve as protection against potentially accelerated and widespread currency debasement on the one hand, while positioning strategic investors to capitalize on "scarcity pricing" via the P&Ls of select global enterprises -- whose balance sheets either offer material exposure to these assets or to "harvesting" these increasingly inaccessible/costly commodities -- on the other hand.

Risks:

Clearly the advent of a US and or global recession would, initially, drive down most asset values and earnings alike. This could well result in dense energy and agriculture sector equities also coming under pressure/declining in price, possibly substantially so, short-term (a potential mitigating factor: commodity-related assets have tended to underperform the broad stock market over the past few years). That said, with growing distrust of government solvency and the lingering scarcity in both dense energy and ag realms as aggravated, at times, by fiat regulatory policy, neither earnings nor market caps in these two sectors are likely to remain depressed for long. Case in point: the rocket-like rise of the oil price from a low of $35 per WTI barrel in the spring of 2009 into an extended trading range around $100 thereafter has amply shown, in terms of the massive earnings generated by the oil majors and oil service giants since, the inherent P&L leverage.

Supplement:

For your convenience, below please find real asset and EM-centric report links, should you wish to review such allocations in view of potentially more marked QE than meets the eye either currently or possibly in the near future (this year):
http://dkanalytics.com/wp-content/uploads/2016/10/11-Gold-update-March-2014.pdf
http://dkanalytics.com/wp-content/uploads/2016/10/10-Global-ag-assets-January-2014.pdf
http://dkanalytics.com/wp-content/uploads/2016/10/9-Dense-energy-November-2013.pdf
http://dkanalytics.com/wp-content/uploads/2016/10/7-BLUE-CHIPS-with-EM-and-scarcity-exposure-August-2013.pdf

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