A Recipe for Disaster

By The Mogambo Guru

06/13/05 There's something funny going on – the Fed is creating all of this money-out-of-thin-air – but who is getting richer? Certainly not the Mogambo…and he has a strange suspicion as to whose pockets this magic money is filling…

It was a week of extraordinary excess (WOEE) everywhere you looked in the shadowy world of modern money. At least, that is the way that it looks to me, as I nervously peer out of the periscope of the heavily fortified Mogambo Bunker, cowering in abject overpowering fear.

First off, the Federal Reserve has apparently started down the dismal path to economic hell of Ultimate Money Debasement (UMD), namely the last-ditch desperation move classically known as direct monetizing of debt. They have now sunk so low that they are now engaging in the worst behavior that a central bank can engage in, namely creating money to buy government debt, which is commonly known as "monetizing" the debt.

In effect, the Federal Reserve (which is, I hasten to point out, a private bank) creates money – poof! – for itself and buys government debt with the money. It's that simple! Magically, money has appeared out of nowhere! The total, aggregate debt load has not, unfortunately, changed, but the total amount of money sloshing around is greater!

The Fed and the Money Supply: Who DOES Have More Money?

If you keep a close eye on your finances, you realize that you do not have more money. Likewise, I do not have more money. So if YOU do not have more money (I point to you) and I do not have more money (I point to myself) then, (audience shouts in unison) "Who the hell DOES have more money?"

The answer is, of course, that the BANKS have more money! I know what you are thinking: "Wow! What a racket, huh?" This brings us to today's timeless gem from the Mogambo's Famous Treasure Trove of Valuable Lessons In Life (MFTTOVLIL), and this lesson is that when you get a chance to make a wish, maybe by wishing upon a star, or blowing out the candles on your birthday cake, or rubbing a magic lamp and a genie pops out or something, you should wish to own a country's central bank. You can create money out of thin air, anytime you want, and buy anything you want with it! Cool!

But so much money has already been created, so achingly much money, so damnably impossible much money, has been created and borrowed. Reluctantly, I rise up from my chair and stagger over and look out the window, and I cry out in horror as I note that MORE money and credit are STILL being created right now, every minute of every day, all around the freaking world! And a lot of that the money is being used to buy some of everything, sometimes a LOT of everything, including stocks and bonds and houses and government, which drives prices up. And when a bond goes up in price, then that automatically means that the imputed yield goes down. Thus, interest rates are low! It's as simple as that!

And so long-term rates, which are most affected by market forces, have gone down, but short rates, which are more affected by Fed actions, stayed up. The difference in interest rates between the short and long terms narrows, and thus the yield curve flattens.

The Fed and the Money Supply: The Inverted Yield Curve

Now, if long-term interest rates keep falling and falling, and eventually fall below the interest rate on short-term debt, you get the famous inverted yield curve. That means you have achieved the absurd condition where you are getting paid less money for loaning your money for a longer term, and at higher risk! Hahahaha!

Of course, Alan Greenspan thinks that this is not necessarily bad, according to Reuters, which reported that the Federal Reserve chairman said that an inverted yield curve was not necessarily an indicator of a recession these days. He admitted that it USED to mean exactly that, back before the Federal Reserve got into Permanent Liquidity Mode (PLM), when he said, according to Reuters, "It's … certainly the case that history suggests that it's usually, or has been, an indicator – a forward indicator – of softening economic activity." See? He actually admits that an inverted yield curve always has been an indicator of what he calls "softening economic activity!"

He went on to say, "I suspect, however, that we have changed the structure of flow of funds and relationships amongst the various interest-rate tranches by maturity such that I'm not sure what such a configuration, should it occur, would mean."

You are going to be surprised that I agree with him 100%. He is exactly right. Interest rates are no longer the result of a tug-of-war between borrowers and savers. There are no savers anymore. Savings have been replaced by instant liquidity, as part of the Federal Reserve's new Permanent Liquidity Mode (PLM) philosophy and practice. What the Federal Reserve has done is to produce more "liquidity" all the time, which gets borrowed by someone like you, although not as good-looking as you, and the borrower (you) uses the money to play the spread between different pieces of debt, in effect borrowing money short-term at low rates, and lending the money long-term at higher rates. You then pocket the difference! What a racket, huh?

And when it comes time to make a payment on that first loan, you merely saunter into a bank, and borrow some more just-created "liquidity"! You then use this second, bigger loan of instant liquidity to do the interest-rate spread thing TWICE more; once to pay the interest on the first loan, and the other one to provide some more pocket money for yourself! Sweet!

And this can, theoretically, go on, and on, and on, forever. So therefore the actual interest rates are immaterial! The only important thing is that there is a difference between short-term interest rates and long term interest rates! That's it!

The only difficult thing is that it takes massive amounts of leverage to make it worthwhile when the yield curve is flat. Borrowing a million dollars at 4% to buy a bond that pays 4.0001%, resulting in a cash-flow of a measly $100 a year, is hardly worth the trouble. But let me leverage up, maybe putting up only $10 as my part of this deal, and suddenly I have made ten times my initial investment! I only put up ten stinking bucks and made a hundred! All it takes is a bank that is willing to do it.

The Fed and the Money Supply: Inflation

That, sadly, is how it is nowadays. And to everyone who thinks that this can work out in the long run, I say, "Look at my face to see my contempt for you, and hear my mocking ridicule echo in your ears as I say hahahahaha!" because, and you might want to write this down because it seems to be some big secret or something, eventually the money gets to be SO huge that it starts going into those things OTHER than stocks, bonds, houses, and government, and they start showing up as price inflation, and everybody gets all crazy, and it gets worse and worse, and people are screaming bloody murder, and the nightly news is full of people rioting because prices are so high.

Or perhaps you would rather listen to Eric Fry, of the Rude Awakening column, who writes, "For starters, throughout the ages, bond yields and commodity prices have tended to move up and down together – not at every single moment, but over long sweeps of time. Over the last few years, however, bond yields have strayed from commodity prices like an unfaithful spouse. But we expect this philanderer to return home fairly soon, in which case, bond yields would rise." Which means bond prices would fall, handing a lot of people some hefty losses, losses so big that not even Superman could lift it.

Stephen Roach, on the same subject, writes, "Real interest rates – both short and long – are still far too low for sustainable growth in the global economy and for stable conditions in world financial markets. Yet central banks – especially America's – have been reluctant to lead the charge in normalizing the rate structure. The best we have gotten from the Fed is a policy rate that has gone from negative to zero in real terms over the past year. I continue to believe this is ultimately a recipe for disaster."

Nevertheless, he reluctantly acknowledges, "At some point over the next year, I wouldn't be shocked to see yields on 10-year governments test 3.50% in the US, 2.50% in Europe, and 1% in Japan."

Whew! After all that, and notice how I am drained and winded from the ordeal, to make matters even worse, the Treasury printed up and issued more actual dollars. How much? I will wait until you are seated. Comfy? Okay, two weeks ago they printed up another $6 billion in actual cash! Where in the hell is $6 billion in cash going all of a sudden? I have no idea, personally, but I am sure that it is due to government corruption, and it also adds to the overall money supply, which will, once again, cause just that little bit more inflation down the road. It just never stops.

Regards,

The Mogambo Guru
for The Daily Reckoning