The "Repo" Fiasco; the Fed's Cash Injections Send Stocks Soaring

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A five-alarm fire has broken out in a little known, but critically important area of the financial system where high-quality bonds are swapped for cash. The "repo" market, which is short for repurchase agreements, is part of the nondeposit, shadow banking system that remains largely unregulated despite the fact that it was ground zero in the 2008 financial crisis.

On September 17, 2019, the repo market was whipsawed by a sudden spike in short-term interest rates that rose from the Fed's target rate of roughly 2% to an eye-popping 10% in a matter of hours. The incident, that put traders into an immediate frenzy, sent the Fed scrambling for the printing presses where it swiftly rolled-off $75 billion to finance additional short-term loans and to add liquidity to a market badly in need of cash. The Fed's efforts did in fact bring rates back down to the 2% target-range but at great cost to its credibility. Despite repeated assurances that the financial crisis was over, the Fed has resumed pumping $60 billion per month into a market that is liquidity-starved and dangerously out-of-whack. In truth, the only thing preventing another spike in rates followed by an excruciating debt cascade, is the Central Bank's ability to bury the problem under a mountain of freshly-minted dollar bills. Absent that, another cataclysmic crash would be unavoidable. Check out this excerpt from an article from Wall Street on Parade:

> "According to the data made available on the public website of the New York Fed, since September 17, 2019 it has funneled a cumulative total of $6.6 trillion to some of the 24 trading houses on Wall Street that are known as its "primary dealers." The giant sum has been sluiced to Wall Street in the form of repurchase agreement (repo) loans without any details being provided to the elected representatives in Congress as to which firms are getting the money or what it's being ultimately used for." ("Fed repos have plowed $6.6 trillion to Wall Street in 4 months", Wall Street on Parade)

The Fed is swapping cash for collateral of unknown quality. The public doesn't know the terms under which these agreements have been made nor do they know whether the banks are concealing their own insolvency as they did following the collapse of Lehman Brothers in September 2008. What we do know, however, is that the Fed has provided a "cumulative total of $6.6 trillion" at the discounted rate of 1.55% to the most distrusted institutions in America without any congressional oversight, without any independent review of the process, and without the American people having the slightest idea of the risks that are involved in blindly rolling over trillions of dollars of short-term loans to these thoroughly corrupt and totally unreformable financial institutions.

The Fed has no intention of allowing the public to know what's really going on behind the scenes. Remember, the Fed "battled in court for more than two years to keep the details of its loans a secret from Congress and the American people", so they're certainly not going to do an about-face and open up today. No, what they are going to do is push the envelope as far as they can, operate far beyond their legal mandate, and conceal their inappropriate or illegal activity behind an iron wall of obfuscation and denial. Keep in mind, no one knew the extent of the Fed's lavish handouts until years after the dust had settled. Check it out:

> "When the nonpartisan investigative arm of Congress, the General Accountability Office (GAO), tallied up the cumulative total that the Federal Reserve had secretly sluiced to Wall Street from December 2007 through July 21, 2010, it came to $16.1 trillion. But the GAO did not include all of the programs that came out of the New York Fed. When those other programs are added, the Levy Economics Institute, using the Fed's own data, arrived at the tally of $19.559 trillion to the Wall Street trading houses and another $10 trillion in central bank liquidity swaps, bringing the bailout figure to over $29 trillion." ("Fed Repos Have Plowed $6.6 Trillion to Wall Street in Four Months", Wall Street on Parade)

So "over $29 trillion" was shoveled into the banking system without congressional approval and without the American people having any idea of how they were being finagled. We should probably expect the same underhanded goings on in the current crisis, in fact, that looks to be the case. The Fed is not going to acknowledge what it is doing and the media is not going to publish the details. It's a conspiracy of silence.

Some readers may remember the $700 billion Troubled Asset Relief Program (TARP) that was created to purchase the "toxic assets" that were supposedly "clogging" the financial system and dragging the Wall Street banks towards insolvency. Originally, that program was rejected by Congress which triggered a panic on Wall Street sending stocks into a steep 700-plus point nosedive. Following that bloodletting, the Fed decided to bypass Congress in the future and, instead, usurp extraordinary powers it was never intended to have. And since the Fed has never been challenged on the matter, it has made the brash assumption that it can meddle in the markets whenever it chooses printing as much money as it likes.

The results of the Fed's chronic interventions, its uber-accommodative policy, and its perennial low interest rates, are plain to see. Stock and bond prices have gone through the roof soaring to record highs on an almost daily basis. To appreciate the magnitude of this unprecedented 11 year bull market, it helps to know where it all began, that is, with the first round of Quantitative Easing (QE) that was launched in December 2008 when the Fed purchased $600 billion in mortgage-backed securities(MBS) and $100 billion in other debt. Naturally, when hundreds of billions of dollars are pumped into the financial system, prices rise. And rise they did. Take a look at the "highs and lows" of the three main indices since the end of the Great Recession in 2009:

> On March 6, 2009, the The Dow Jones Industrial Average (DJIA) touched a low of 6,547. Today, (January 28, 2020) the Dow is 28,722 points, more than 4 times higher. On March 9, 2009, the S&P 500 hit a low of 676 points. Today it is 3,276 more than 4 times higher. As for the NASDAQ which dropped to 1,268 on March 9, 2009. Today, the index has climbed to 9,269 nearly 7 times its 2009 value. At the same time, business investment remains at historic lows, personal consumption is flat, wages have stagnated, and the economy is still in the throes of the weakest expansion in the post WW2 era. Bottom line: The

> stock and bond markets have not thrived because of a strong economy but because the Fed is engaged in the greatest bubble-blowing experiment in history. The $60 billion per month infusions into the repo market just adds more helium to the bubble.

So, what impact have the Fed's capital injections into the repo market had?

By boosting liquidity and acting as lender of last resort in the daily swapping of cash for collateral, the Fed has been able to calm the markets and keep interest rates where it wants them. But the additional flood of cash has also ignited a stock market rally similar to earlier incidents when the Fed used QE to increase reserves. So, what impact have the Fed's injections had on stock prices? Check out this clip from market analyst Jim Bianco at Mish Talk:

> "There is no such thing as a one-factor model to explain the stock market. Metrics such as the Fed's balance sheet, repo, etc. cannot explain the stock market's movements in isolation.
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> That said, when the Fed injects money, funds generally flow to the best-returning market. During the financial crisis, it was the bond market. Today, as was the case in 1999, it is the stock market..... a big part of this year nearly 30% stock market gain has come on the heels of Fed moves, much like last year's 20% decline was coincident with the Fed's hawkish rhetoric." ("Jim Bianco Says This Is QE, Like Y2K", Mish Talk)

For more clarity on this point, we turn to a brief clip of an interview with economist David Rosenberg who explains that, when the Fed pumps liquidity into markets, stocks rally.

> "This is a liquidity and momentum driven market. It's been that way for the past four months where **the correlation between the S&P 500 and the Fed's balance sheet has expanded to a 95% relationship.** This is a case of a very accommodative Fed policy. The double-digit growth in the money supply is bypassing the real economy and has entered into asset markets broadly, and specifically into equities. So as long as the Fed is in the game priming the monetary pump, shorting stocks is going to be a very dangerous game to play….
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> The power of the Fed has become so acute that it has replaced the economy as a principle influence over the stock market to the point where **there is only a 7% correlation between GDP and the S&P 500.** Historically, in any given cycle that relationship was anywhere between 30% and 70%." ("David Rosenberg Warns "We're Going To Have Helicopter Money"", Zero Hedge)

The scale of the Fed's manipulation is truly breathtaking. Stocks are not rising on the strength of the economy, but on the jet-fuel from digitally-generated money produced with the flip of a switch in the basement of the Eccles Building. Has there ever been a bigger fraud perpetrated on the American people?

But what are the downside risks of such an operation?

Once again, Wall Street on Parade helps to answer this question in a recent article. Here's an excerpt:

> "On Monday, a member of the New York Fed's own Investor Advisory Committee on Financial Markets, Scott Minerd, published a critique which he headlined as follows: "Global Central Banks Fueling a Ponzi Market," with this scary subhead: "Ultimately, investors will awaken to the rising tide of defaults and downgrades."

The thrust of the article is that central banks (which include the New York Fed's Wall Street money spigot that was launched on September 17, 2019) are creating a Ponzi scheme of liquidity that is hiding the true state of risk in both the stock and bond markets. The implication is that without the Fed's cheap money flooding markets, interest rates on questionable debt would be much higher, thus providing a red flag for investors. Minerd develops his thesis as follows:

> "The disturbing trend is that despite the rally in risk assets in the prior year, the number of defaults rose by approximately 50 percent, according to data compiled by J.P. Morgan. Additionally, the number of distressed exchanges increased by 400 percent.
>
> "This correlates well with our observation that the number of idiosyncratic defaults has been increasing. … However, that day of reckoning when spreads rise is being held off by the flood of central bank liquidity and international investors fleeing negative yields overseas." ("The Man Who Advises the New York Fed Says It and Other Central Banks Are "Fueling a Ponzi Market" Wall Street on Parade)

Defaults are rising because corporations and financial institutions can no longer roll over the prodigious pile of debt they've accumulated in the last few years due to the Fed's easy money policies. So even though stocks continue to steadily climb higher, the rot at the foundation of the system is becoming more and more apparent. As defaults increase, more liquidity will be sucked from the system, deflationary pressures will build, the economy will stall, and stocks will fall back to earth.

But the greatest threat posed by the Fed's reckless "repo" policy is not the threat of another giant asset bubble but the possibility that US Treasuries will lose their exalted role as the world's preeminent "risk free" asset of choice. Keep in mind, that the way the Fed finances these repos, is identical to the way it conducted QE, by buying U.S. Treasury bills and other high-rated securities from the banks for cash. These securities serve as collateral for the underlying loan, and the banks buy them back with interest. This unconventional expansion of the Fed's balance sheet calls into question the true value of USTs which are increasingly used as a tool for preventing crises. Former Fed governor Kevin Warsh pointed out the pitfalls of the Fed's strategy in an article in the Wall Street Journal titled "The New Malaise". Here's what he said:

> "The Fed's increased presence in the market for long-term Treasury securities also poses nontrivial risks. **The Treasury market is special. It plays a unique role in the global financial system. It is a corollary to the dollar's role as the world's reserve currency. The prices assigned to Treasury securities–the risk-free rate–are the foundation from which the price of virtually every asset in the world is calculated. As the Fed's balance sheet expands, it becomes more of a price maker than a price taker in the Treasury market**. And if market participants come to doubt these prices–or their reliance on these prices proves fleeting–risk

premiums across asset classes and geographies could move unexpectedly. The shock that hit the financial markets in 2008 upon the imminent failures of Fannie Mae and Freddie Mac gives some indication of the harm that can be done when assets perceived to be relatively riskless turn out not to be." ("The New Malaise", Kevin Warsh, Wall Street Journal.)

With the National Debt hovering at $23 trillion, one would think the Fed would be more cautious in its misuse of USTs to shore up transactions in the repo market. If present trends continue, it's only a matter of time before foreign central banks trim their stockpiles of USTs and seek a more reliable source of value. Any significant shift away from risk free US debt will send shock-waves through the global economy. It would portend an abrupt changing of the guard and the onset of a new order.

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