Weekly Market Comment

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Vanishing Act - Are the Fed and the ECB Misleading Investors about "Liquidity"?

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I'll begin with a brief note about the stock market here. Suppose you're considering riding a unicycle on a high-wire that by most evidence is not secure, but it's possible that the wire might hold up for a while. If you keep riding, people will throw small bills at you until the moment the wire breaks. Once the wire breaks, you will be injured and will probably lose whatever you gained initially. Would you keep riding?

A risk-averse investor (or even a risk-neutral one) would decline that bet, even though there's some potential for lost short-term gains if the wire doesn't break immediately. A myopic risk-seeker will ignore the risk and keep speculating, assuming that some spontaneous impulse will move them to quit just before the wire snaps.

Needless to say, our investment strategy is averse to those risks that have, on average, produced no return. We avoid such risks even though continued risk taking may produce further gains for a while, sometimes until those gains are abruptly forfeited. Currently, the combination of valuations and market action (not to mention recession probability) is one that has historically been associated with negative average returns. That doesn't mean that investors who keep riding the unicycle can't make a few more small bills, but it does mean that *repeated* risk-taking in conditions like the present has not been rewarding, on average, and has frequently involved significant and abrupt losses.

The high-wire act in the center ring is only part of the three ring circus here. In the other two rings are a couple of magic acts by the Fed and the ECB, where entirely mundane and inconsequential tricks are being delivered with great flourish as if they are extraordinary.

When I was a kid, it was entertaining to do entirely obvious magic tricks, like raising the index finger of each hand, bumping the hands together and making a finger “jump” - so that one hand suddenly had two fingers up while the other had none, or making a loop with the thumb and forefinger of each hand, putting the hands behind our heads, and bringing them back over with the loops suddenly linked. What's fascinating is that the recent moves by the Fed and the ECB *should* be equally obvious.

Simply put, contrary to the impressions they attempt to create, neither the Fed nor the ECB have "injected" material amounts of "liquidity" into the international banking system in recent months. This is *not* a call for them to do so - to some extent their hands are tied by inflation pressures, currency risks, and profigate government spending (particularly in the U.S.). The problem is that by creating the illusion that they are doing something material - when the problem in the global financial system is *not* confidence, or liquidity, but *solvency* - the Fed and the ECB misdirect the attention of investors, provide false hope, and will ultimately do a great disservice to investors and to their own credibility.

The eagerness of Wall Street analysts to hail the moves by the Fed and ECB as important, without even examining or understanding the data, is a discouraging reminder of how willing many investment professionals are to parrot common misconceptions rather than thinking for themselves. We should not be so alone in pointing out these issues.

Let's look at the data.

The Fed – “Hocus Pocus – it's the same money!”

Last week, the Fed executed the first of its highly publicized “term auction” transactions. As I noted in A Little Acid Test for Fed “Liquidity” last week, the Fed had $53 billion in repos outstanding on Friday December 14, fully

$39 billion of which were due to expire last week. This ensured that the Fed would initiate new repos of a similar amount. The acid test was whether the term auction repos would represent a) new liquidity, or b) just a different way of rolling over the same money. Last week, we learned the answer to that question is b.

You can follow along using the Fed's actual data using this link:

http://www.ny.frb.org/markets/omo/dmm/temp.cfm?SHOWMORE=TRUE

Here's last week's play-by-play

Monday (12/17): the Fed holds a $20 billion auction through its “term auction facility.” Unlike typical open market operations, which settle the same day, these would settle on Thursday 12/20 (which happened to be when the bulk of the expiring repos would come due). The Fed does, however, initiate a $9.5 billion 1-day repo, which pushes the amount of outstanding repos to $62.5 billion.

Tuesday (12/18): A $5 billion 4-day repo from 12/14 comes due, along with the $9.5 billion from Monday. The Fed replaces these with a $10.25 billion 1-day repo, for a net withdrawal of $4.25 billion in repos, bringing the total outstanding repos down to $58.25 billion.

Wednesday (12/19): The $10.25 billion from Tuesday's action comes due, and the Fed initiates a $9.75 billion 1-day repo to replace it, for a net drain of $0.50 billion in “liquidity.” Even though the $20 billion from Monday's auction hasn't settled yet, you'll notice from the Fed Funds chart (http://www.ny.frb.org/markets/openmarket.html) that the actual rate briefly slipped to 4%, below the Fed's 4.25% target. Total outstanding repos: $57.75 billion.

Thursday (12/20): And now the acid test. The $9.75 billion 1-day from Wednesday comes due, along with a $10 billion 7-day (from 12/13), a $20 billion 8-day (from 12/12), and a $4 billion 14-day (from 12/6). Total expiring repos: $43.75 billion. Now remember, this is the day that the $20 billion from Monday's auction settles. If the Fed initiates less than $23.75 billion in new repos, the “term auction facility” fails to “inject” any new liquidity at all.

On Thursday 12/20, the Fed initiated just $20 billion in new repos: A $10 billion 14-day, an $8 billion 7-day, and a $2 billion 1-day. So given $43.75 billion in expiring repos, the Fed replaced $20 billion through standard means, and $20 billion through the term auction facility. **Overall, the Fed *drained* $3.75 billion of “liquidity” on the very day its first "term auction" transaction settled.**

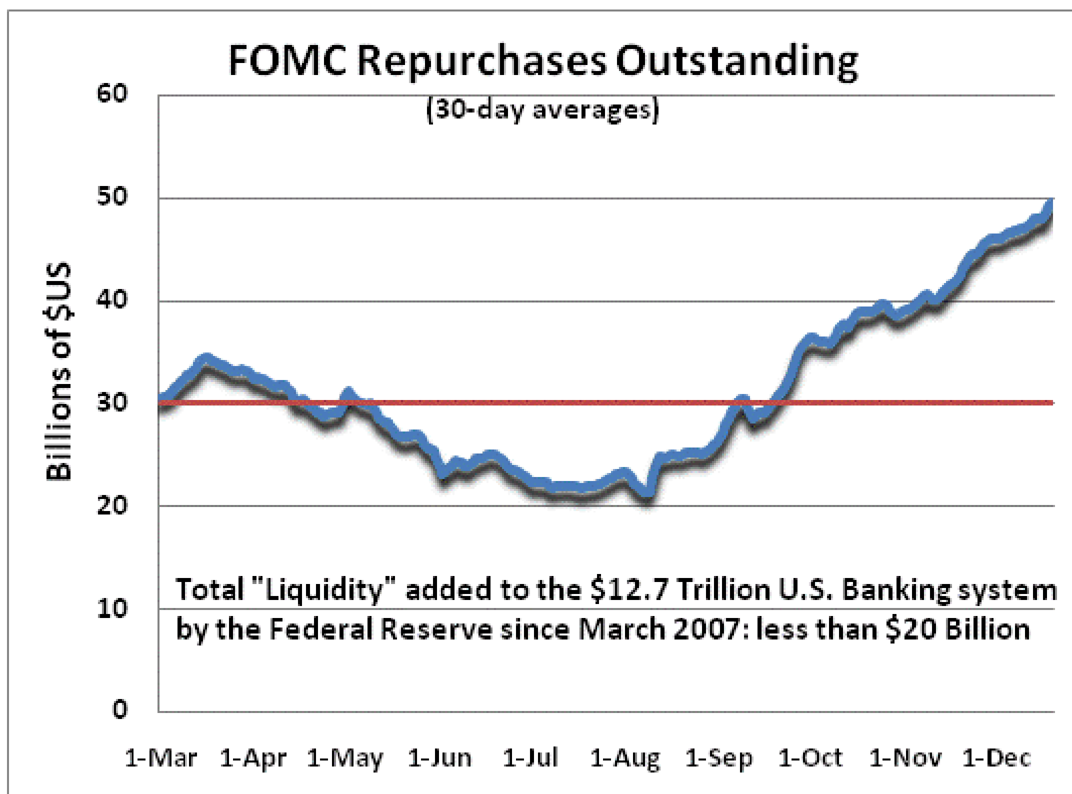
Also on Thursday 12/20 – the Fed auctioned off another $20 billion through its “term auction facility.” Those will settle on 12/27. So let's continue.

Friday (12/21): the $2 billion 1-day repo from Thursday expires, which the Fed replaces with a $6.75 billion 3-day repo. Total outstanding repos as of last week: $38.75 billion in standard repos, plus $20 billion in term repos that expire in late January.

This week, $6.75 billion in repos expire on Monday 12/24, which we can guess will most likely be replaced with a 3-day or shorter repo. Why? Because on Thursday 12/27, two other repos also come due: the $8 billion 7-day from 12/20, and a $6 billion 14-day from 12/13. Assuming that the Fed rolls something close to Monday's $6.75 billion out until Thursday, there will be a total of $20.75 billion in “standard” repos expiring on Thursday 12/27, which is precisely when the next $20 billion batch of “term auction” repos will start. Very convenient.

As a side note, we can already predict that at least one of the “term auction" repos that will be announced in January will have a settlement date of January 17. Why? That's when the first term repo expires.

At present, the Fed has injected *less than $20 billion* in total “liquidity” since March – nearly all of which has been *withdrawn from the banking system* as currency in circulation. Normally, the Fed would have done a “permanent” open market operation by now, to finance this increase in currency demand (which predictably grows by $30-50 billion annually). But by constantly rolling over temporary repos every week or two instead, the Fed can act as if it is “doing more.”



As an additional remark, as I noted in mid-October, “we're likely to observe a growing amount of what will wrongly be viewed as 'cash on the sidelines' and 'money creation' in the banking system. The problem is that the commercial paper market has dried up. If savers are not buying those securities as the proceeds come due, and a good portion of the borrowing is still somehow being rolled over, then it must be the case that the savers who used to own commercial paper are now saving in another form, and the borrowers who used to issue commercial paper are now borrowing in a different form. Most probably, banks will be the chosen intermediary, because savers view bank deposits as insured and somewhat safer than unsecured commercial debt.” This is a very predictable outcome, so be careful not to interpret, say, increases in M3 as being the result of “Fed liquidity.”

In short, the Fed is doing nothing more than predictably rolling over its repos, but with great flourish as if something more is going on. The fact is that current economic risks are not the result of a shortage in liquidity or confidence, but reflect a fundamental *solvency* problem among homeowners who borrowed more than they could afford, on the expectation that rising home prices would *provide* that affordability through “cash out” refinancing.

It may make people feel good that the Fed looks like it's doing something, but these actions are being misrepresented to investors as being far more than they actually are. Misinformation simply creates false hope, and directs attention away from real problems. This is a disservice to investors.

Over the years, the misperceptions of investors have tended to be a source of periodic frustration for us (the 1999-2000 tech bubble being a good example), but avoiding those misperceptions has also generally been a great source of *long-term* returns. I don't have any reason to believe that this instance will be much different.

ECB Liquidity – “Now you see it, now you don't!”

Last week, the market shot higher on reports that the European Central Bank was injecting *348.6 billion* euro (the equivalent of US$500 billion) of liquidity into the European banking system. The truth is that the ECB actually *drained* liquidity last week.

If you're a regular reader of these weekly comments, my hope is that your first thought in response to that $500 billion headline was “Wow - that sounds like a lot of money,” your second thought was “I wonder whether it's a repo,” and your third thought was “I probably should look at some data before I jump to any

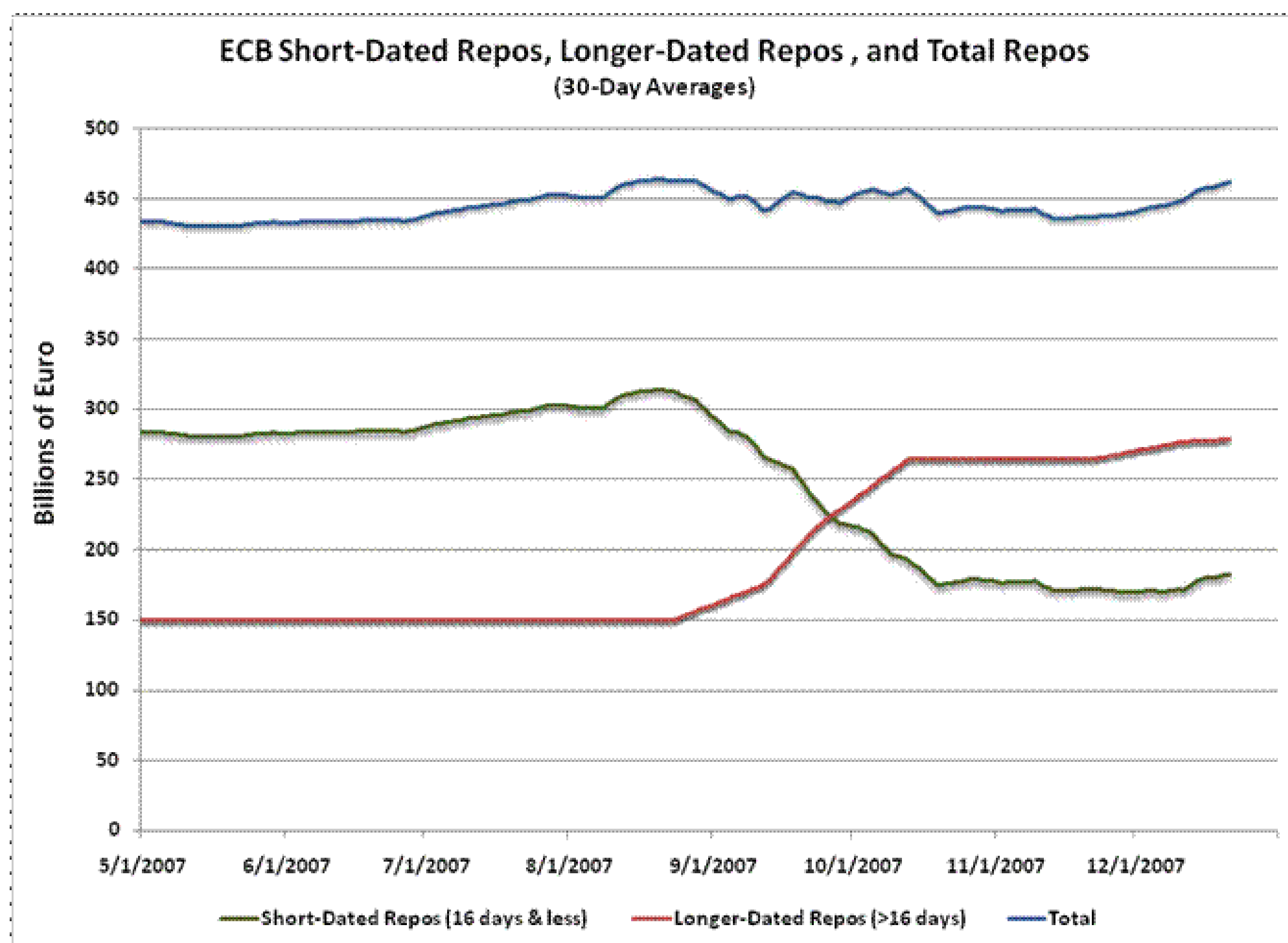
conclusions."

For background, the ECB typically has two types of operations: "reverse transactions" (liquidity providing) which are essentially just repos by which the ECB temporarily buys securities from banks and provides reserves for a fixed period, and "fixed-term deposits" (liquidity absorbing) where the ECB accepts deposits of funds *from* banks for a specific length of time, thereby "mopping up" unused liquidity. The ECB data is a little less transparent than the Fed's but they also do their rollovers less frequently (typically one "main refinancing" each week and a few other fine-tuning transactions).

Again, if you want to track these, here's a link to the source data. About half-way down the page is a link to a data file of historical ECB operations (note that the amounts reported are in thousands of euro):

http://www.ecb.int/mopo/implement/omo/html/index.en.html

Let me start by thanking Bill Hester, who did the careful (and I'm sure unpleasant) job of sorting through all of the transactions and tying out one refinancing with the next. The following chart summarizes how the ECB has operated in recent months:



Just as in the U.S., the bulk of the reserves in the European banking system are financed by the continuous rollover of repurchase agreements. In the Euro-zone, the total outstanding amount of these repos has been fairly steady around 450 billion euro. Also, as in the U.S., the ECB has moderately increased the amount of repos outstanding to cover the holiday period through January 4. Still, this increase has only had only minor effect on the 30-day average, and even measured daily, represents only about 38 billion in additional euro to cover the holiday currency demand for the entire Euro-area.

Despite the apparently enormous amount of last week's 348.6 billion euro "main refinancing," the fact is that it was a *rollover* of existing repos, not a "new injection" of funds.

What's more interesting is what *didn't* get reported. If you examine the ECB's own data, you'll find that as of Friday, December 14, the ECB had a total of 488.5 billion euro in outstanding “liquidity,” 268.5 billion euro of which was set to expire on Wednesday, December 19. If you look carefully at the source data, you'll find the following transactions last week, in chronological order (even if you hate numbers, stick with me and just read each one before moving on, even if the picture isn't clear at first – this is fascinating):

12/17/2007 FIXED_TERM DEPOSIT / LIQUIDITY_ABSORBING:
36.6 billion EUR, maturing 12/19/2007

12/19/2007 REVERSE_TRANSACTION / LIQUIDITY_PROVIDING:
348.6 billion EUR, maturing 01/04/2008

12/19/2007 FIXED_TERM_DEPOSIT / LIQUIDITY_ABSORBING:
133.6 billion EUR, maturing 12/20/2007

12/20/2007 REVERSE_TRANSACTION / LIQUIDITY_PROVIDING:
48.5 billion EUR, maturing 03/27/2008

12/20/2007* REVERSE_TRANSACTION / LIQUIDITY_PROVIDING:
10.0 billion EUR, maturing 01/17/2008

12/20/2007 FIXED_TERM_DEPOSIT / LIQUIDITY_ABSORBING:
150.0 billion EUR, maturing 12/21/2007

12/21/2007 FIXED_TERM_DEPOSIT / LIQUIDITY_ABSORBING:
141.6 billion EUR, maturing 12/27/2007

[Geek's Note: you can ignore transactions that were both initiated and matured last week. What you have left is: 488.5 less 268.5 expired, plus 348.6, plus 48.5, plus 10.0, less 141.6 = 485.5 billion euro]

At the beginning of the week, the ECB had *488.5 billion* euro in net liquidity outstanding. By the end of the week, the ECB had *485.5 billion* euro outstanding.

So here's the blunt truth: the ECB *drained* 3 billion euro of liquidity last week!

The story reported and repeated ad nauseum on the financial channels was that the ECB “injected” the equivalent of US$500 billion of “liquidity” into the international financial system last week. The slightly more refined version was that Wednesday's 348.6 billion EUR refinancing was dramatically higher than the 268.5 billion EUR refinancing that was expected.

The *real* story is that on Wednesday December 19, the same day the ECB did that 268.5 billion refinancing (isn't it interesting that at prevailing exchange rates, it translated into a “headline number” of almost exactly US$500 billion?), the ECB also did a massive 133.6 billion EUR “liquidity absorbing” operation, which it then rolled over the next day and then into next week.

We can fully expect that on December 27, the ECB will enter yet another “liquidity absorbing” transaction to extend this “mopping up” of Wednesday's misleading repo. It will be no surprise if that enormous mopping-up operation expires on January 4, 2008, which is when the much-vaunted 348.6 billion EUR repo expires (and will no doubt be replaced with great fanfare by another rollover).

Internationally coordinated liquidity "injections"? Hardly

The final items to note are the transactions on 12/20/2007. First, the 48.5 billion “liquidity providing” transaction that day was a rollover of a long-dated 50.0 billion EUR repo from September. Next was the 10.0 billion EUR transaction on 12/20/2007, which I've marked with an asterisk. The ECB reference code on that transaction is “TAF07001.” This was the much publicized U.S. dollar “term auction facility” transaction coordinated with the Federal Reserve.

But look closer. That *same* day, the ECB entered a *liquidity absorbing* transaction of 150.0 billion euro. The net result was 48.5 + 10.0 provided, plus the 133.6 expired "absorbing" transaction, minus 50 billion expiring from September, minus the new 150.0 billion absorbing transaction = -7.9 billion euro.

So on the very day that the ECB engaged in a "coordinated injection of liquidity" through the new term auction facility, the end result that day was to *drain* 7.9 billion euro from the international financial system.

As a final observation, in the above chart, Bill Hester broke the ECBs repos into short-dated and longer-dated (greater than 16 day) categories. He observed that following the August turmoil in the financial markets, the ECB shifted the maturity of their repos from short-dated toward longer-dated transactions. Evidently, the ECB has been trying to provide somewhat more predictability to the banking system as to the availability of funds. This is an indication that they are at least trying.

Well, it's Christmas - I thought at least we could end on a positive note.

Market Climate

As of last week, the Market Climate for stocks remained characterized by unfavorable valuations and unfavorable market action, holding us to a fully-hedged investment stance. The market moved back toward an overbought condition last week, which was accompanied by a surge in the Investors Intelligence sentiment figures, to 56.5% bulls and just 22.4% bears. Despite the lament by analysts on CNBC about pervasive bearish sentiment, the fact is that we've rarely seen higher bullish sentiment in recent years. Though the market tends to enjoy somewhat favorable seasonality about this time, through about the first week of the New Year, there is little room before the market is again overbought in an unfavorable Market Climate. Given high bullish sentiment and the continued likelihood of an oncoming recession, I remain concerned about the potential for steep and abrupt losses (particularly as we move into the New Year).

Regardless, our defensive stance is not driven by any forecast of steep losses, but by the *prevailing* condition of valuations and market action, which remain unfavorable for now.

In bonds, the Market Climate was characterized last week by unfavorable yield levels and moderately unfavorable market action. While dollar risks and import price pressures threaten further near-term pressure on inflation, I continue to believe that widening credit risks and defaults will ultimately exert a moderating effect on inflation as we move through 2008.

Over the near term, the dollar has nearly "cleared" the oversold condition that it developed a few weeks ago. As I've noted before, a yen/dollar rate of about 115 is about where I would consider the dollar particularly vulnerable to fresh weakness, but that figure is just an impression – not a hard number that we would use as a trading guideline. In the next few months, I would expect that downward pressure on the U.S. dollar will tend to create upward pressure on inflation (historically and contrary to popular belief, inflation and GDP growth tend to move in opposite directions as the economy weakens, until a recession has firmly taken hold). At that point, credit fears tend to drive investors toward the safety of government liabilities like currency and Treasury securities (economists refer to this as a decline in "velocity"). The safe-haven demand for these liabilities tends to absorb the supply, so ultimately inflation pressures decline. Generally speaking, the decline in inflation that typically accompanies established recessions is not driven by slower economic growth but instead by slower velocity as the result of credit concerns.

For now, we're likely to continue observing a gradual and persistent downward pressure on bond yields because of the generally weak economic tone, but also periodic spikes in interest rates in response to specific inflation reports. That's likely to hold the bond market in something of a trading range, but again, with the yield spikes occurring primarily in response to inflation surprises.

In precious metals, the Market Climate remains quite favorable overall, with the gold/XAU ratio reaching an unusually favorable 5.0 last week, while downward pressures on real interest rates continue. On the combination of positive factors and a nice pullback in gold shares last week, we bumped our precious metals exposure to just under 20% of assets in the Strategic Total Return Fund.

Wishing you a very Merry Christmas, with peace and God's blessings in the New Year

- John

Prospectuses for the Hussman Strategic Growth Fund and the Hussman Strategic Total Return Fund, as well as Fund reports and other information, are available by clicking "The Funds" menu button from any page of this website.