The Wall Street Examiner

Be prepared. Stay ahead of the herd.

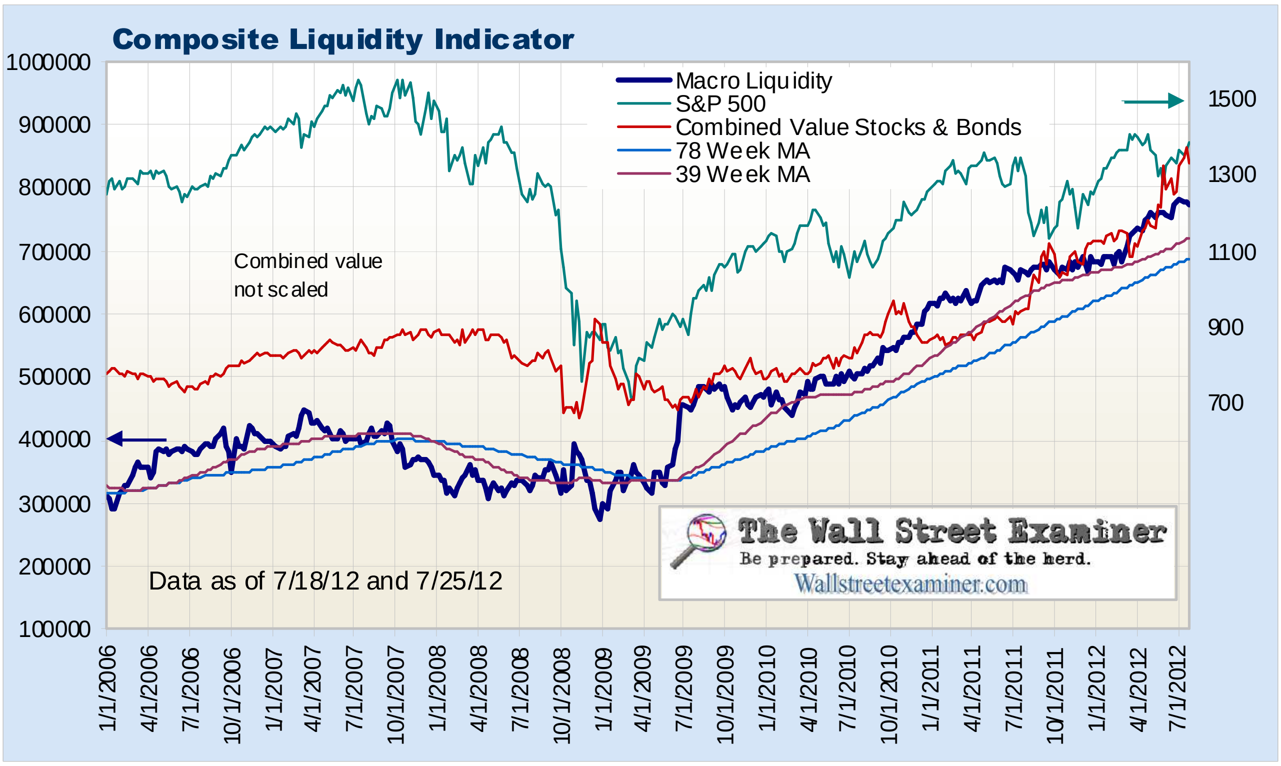
Professional Edition

Fed and Treasury Update – Tuesday, July 31, 2012 [1]

Reports on the Treasury auctions, Federal tax receipt trends, the 10 year Treasury yield, and the US Dollar Index are reported in a separate report posted here: http://wallstreetexaminer.com/money/treasury072812.pdf Housing data is posted in a separate report that is updated whenever relevant data is published. Click the Housing category tab on the Wall Street Examiner home page or this link for the latest report. http://wallstreetexaminer.com/category/housing/

	Short Term	Trend
Fed Cash To Primary Dealers	Bullish	Bullish
FCB Net Purchases Treasuries and Agencies	Bullish	Neutral
Net Bank Inflows	Bullish	Bullish
Bank Trading	Bullish	Bullish
Change in Deposits at Fed	Bearish	Neutral
Bank Net Treasury/Agency Purchases	Bullish	Neutral

The composite liquidity indicator had a tiny downtick last week. The indicator has remained essentially flat for most of July, but is still firmly entrenched in a strong uptrend.



[1] **Format notes** - Currently updated sections are in this font. Material that was updated recently and due to be updated weekly or monthly is in this brown font. Material in this font is infrequently updated background information for review or for the benefit of new subscribers. [1]

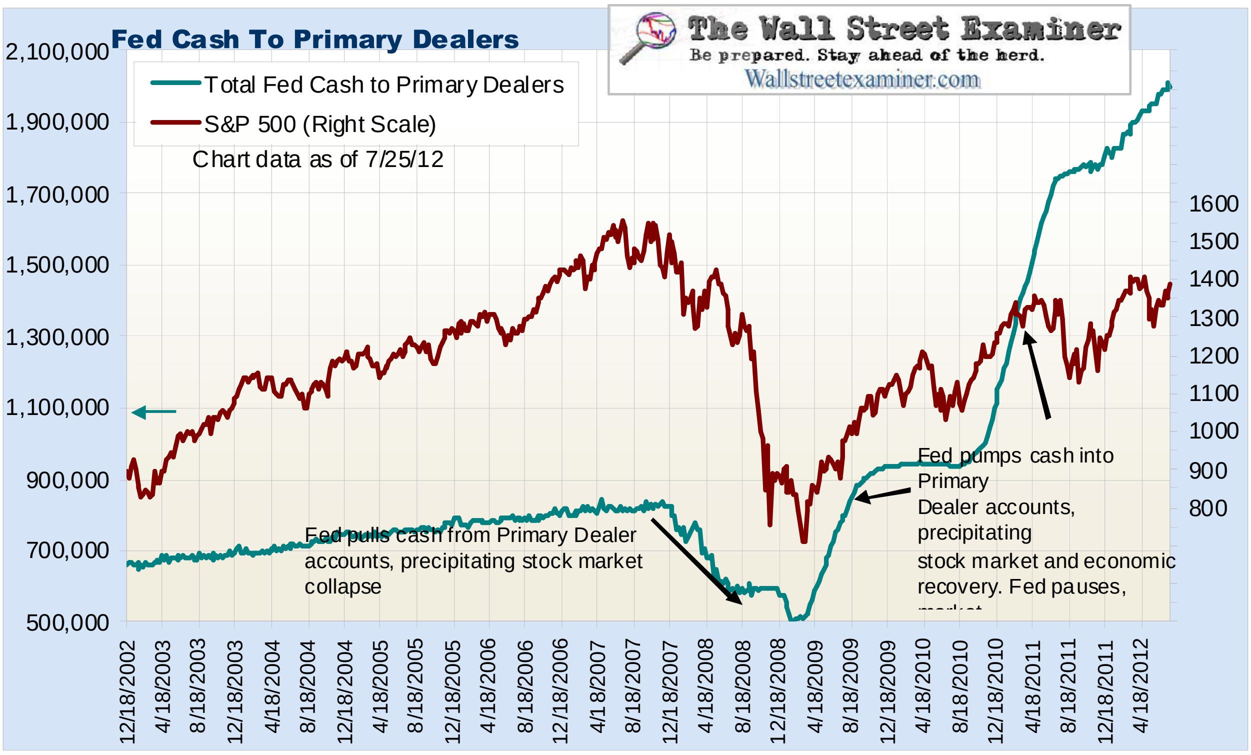
The Fed's buying of MBS and the slight tilt of Operation Twist toward more purchases from Primary Dealers than sales to them, will remain a bullish influence at least until year end. Large bank trading account patterns are still bullish while bank net Treasury purchases are back to a neutral pattern. Net bank inflows are in a slightly bullish intermediate trend, while reserve deposits at the Fed remain in a neutral pattern. Foreign central bank purchase patterns have improved from bearish to neutral.

Taken as a whole, that should be enough to keep Treasuries at very low yields and to continue to give stocks a boost. It's too soon to tell if there's a sentiment shift under way away from Treasuries. All else being equal, that would work in favor of strengthening equities, but if yields head to new lows, stocks should roll over. Liquidity, while bullish, still seems insufficient to support bull moves in both investment classes.

Macroliquidity Component Indicators

The Fed continues to pump cash into Primary Dealer trading accounts via its MBS purchases. The trend of this indicator remains bullish and will continue to be bullish under the extension of the MBS purchase program through the end of 2012.

This indicator has the heaviest weighting in the composite. The correlations have held remarkably well since I began tracking this in 2002. It is a proprietary indicator composed of the cumulative value of operations which the Fed conducts directly with Primary Dealers.

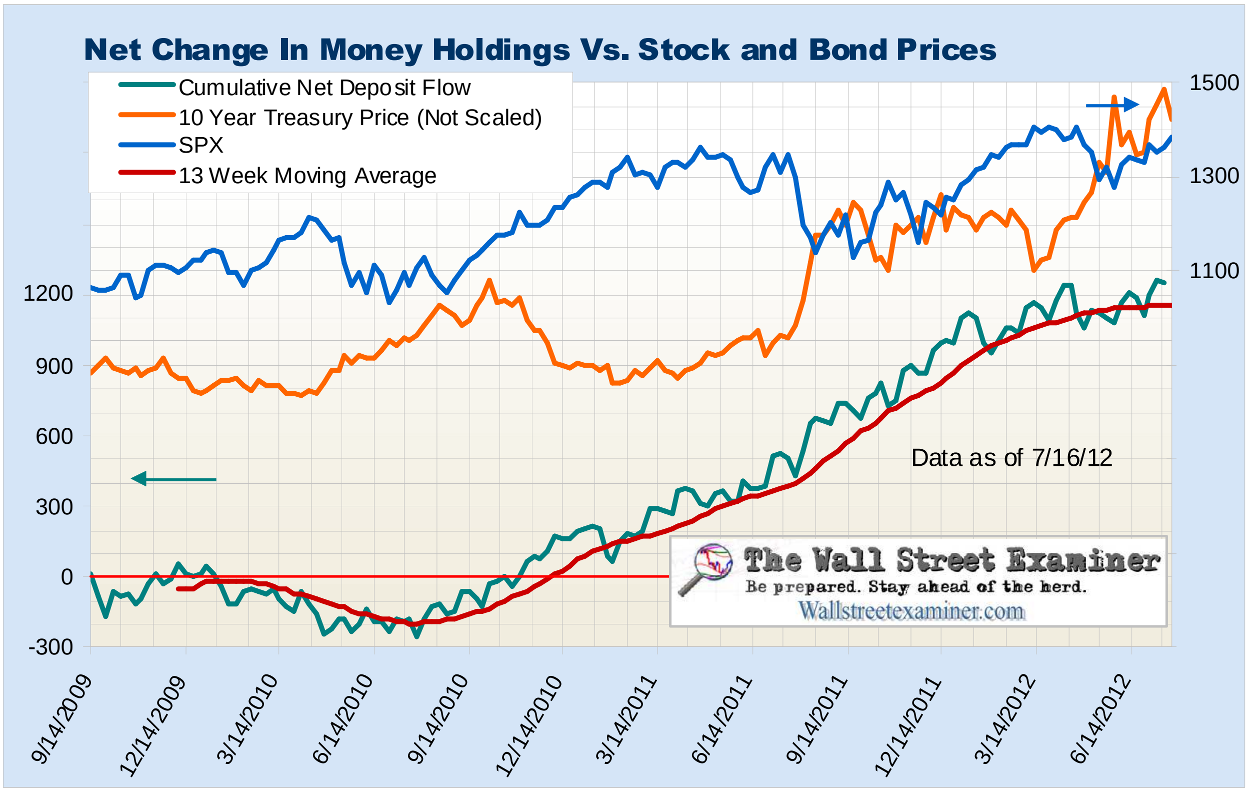


\

Continued on next page

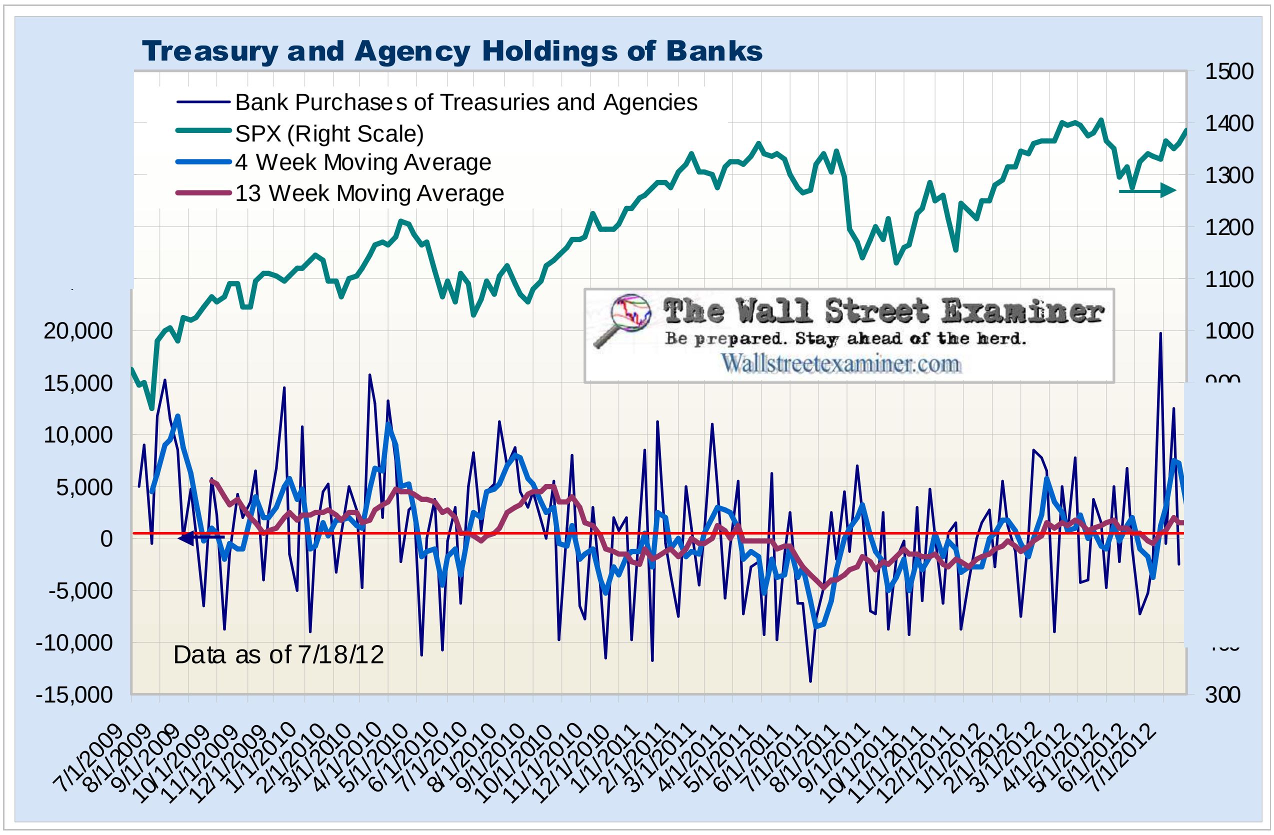
An important measure of market liquidity is US banking system net deposit flows. Banking system net money flows showed an outflow of $13 billion in the week ended July 16, pulling back from a nominal new high, while the 4 week moving average upticked slightly from being flat. None of these changes seem material yet. The indicator has barely emerged from the range it has been in since March. Stocks have gone nowhere during this time.

A downturn from this point would be a bearish indication. If the indicator breaks out to a new high, the trend would be bullish.



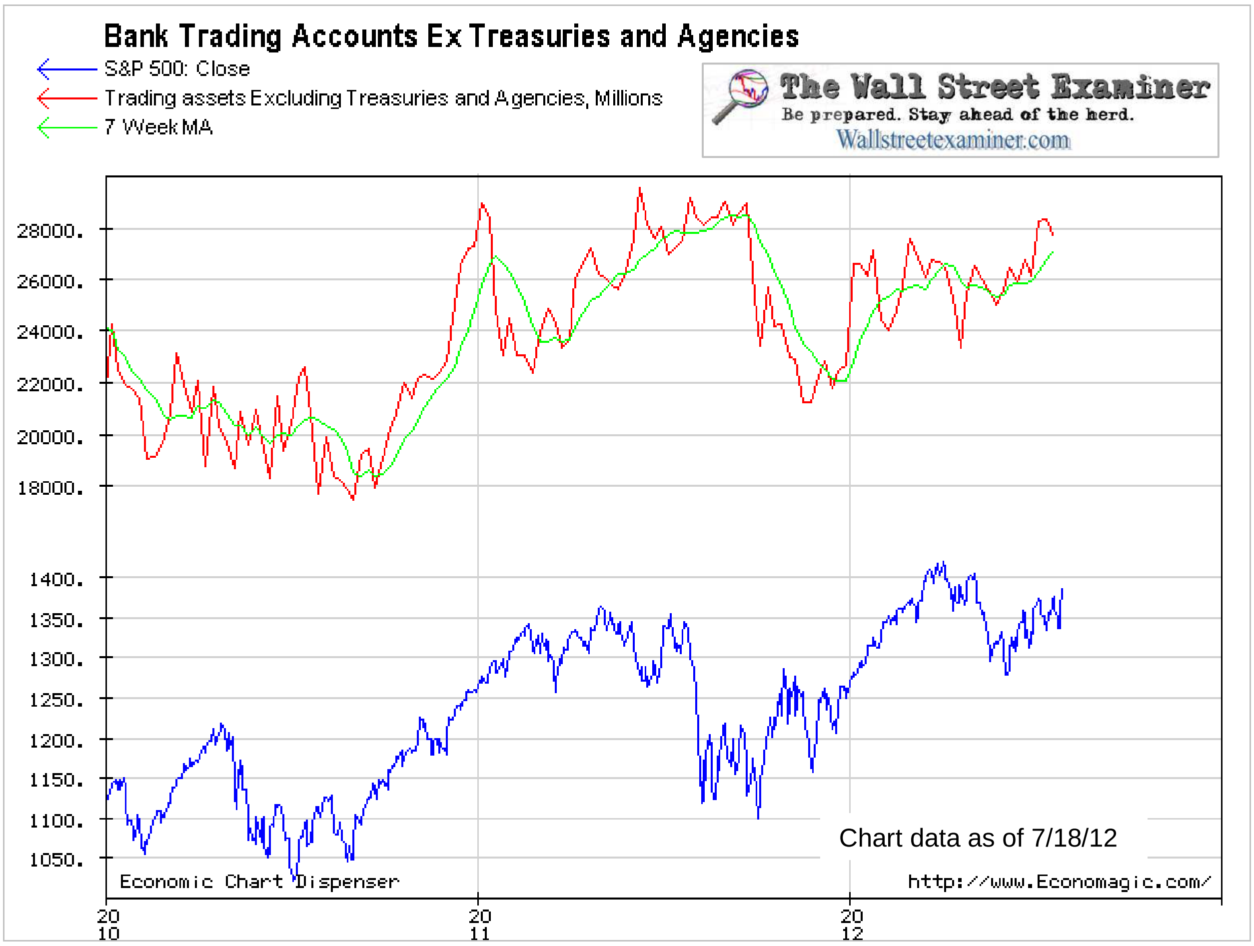
Continued on next page

Bank Treasury purchases are another key measure of market liquidity. Commercial banks' Treasury and Agency (GSE) holdings dropped by $2.5 billion in the week ended July 18. That followed a jump of $12.5 billion the previous week, and a record surge of $19.8 billion in the week ended June 27. The sudden wild volatility has made this indicator a wild card, but due to the selling in the most recent week, I'd call the trend neutral for now.



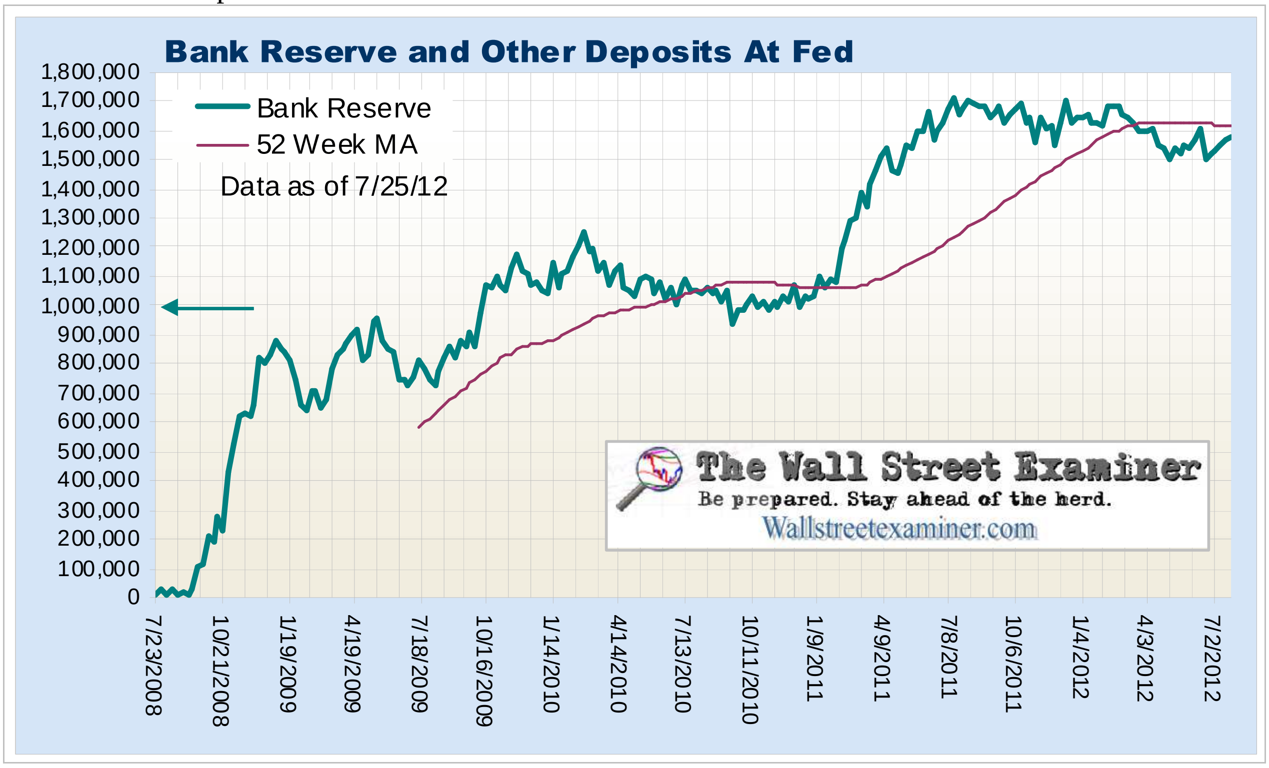
Continued on next page

The behavior of commercial bank non-Treasury trading accounts is another key to market liquidity. The intermediate trend of this indicator is still bullish, but it could be related to marking to market as bond yields were falling sharply. There may be a limit to how far the banks will allow these accounts to go before they take profits, as indicated by the repeated peaks in 2011 around $29 billion.



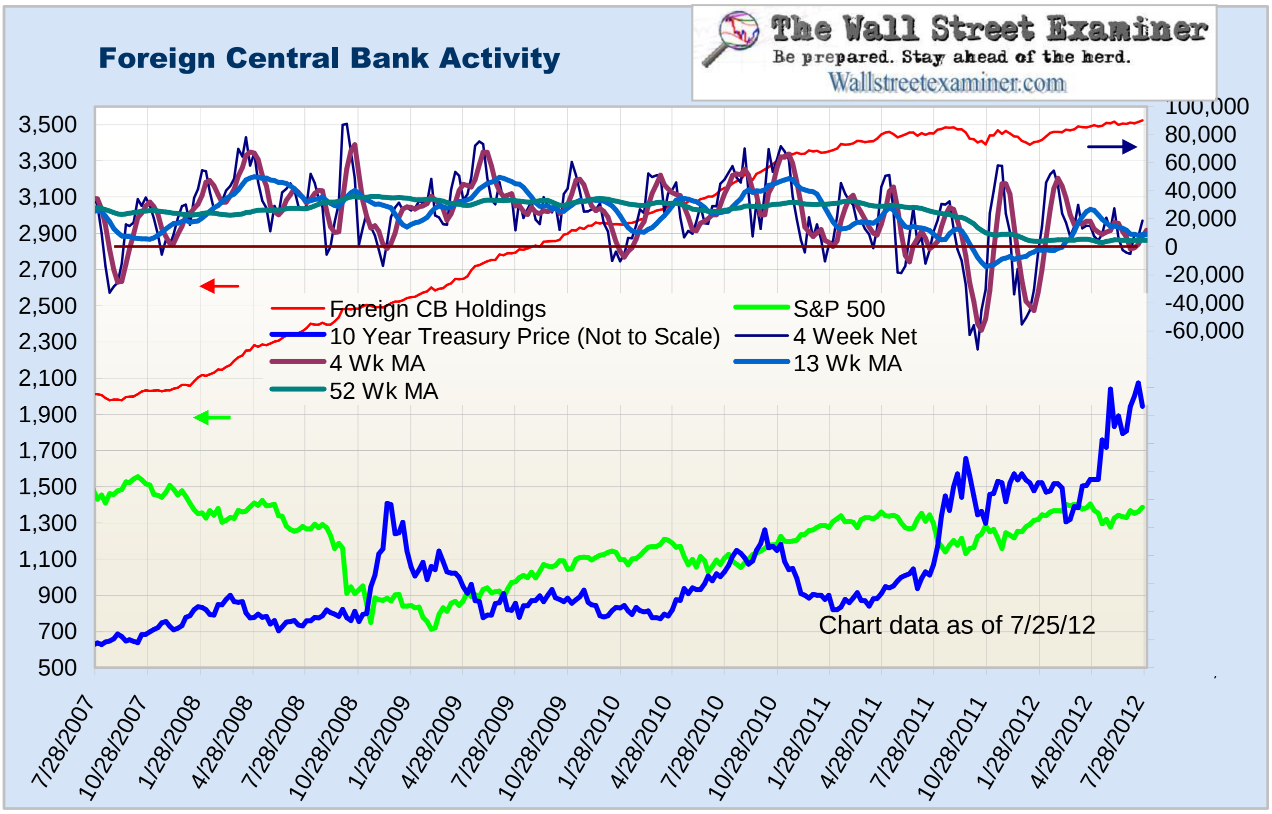
Continued on next page

Bank reserve deposits at the Fed should be a counter trend measure, but the relationship to market behavior is complex and shifting over time. In the very short run an increase in reserves held at the Fed should be bearish, and vice versa, so my focus here is a little more on a week to week basis than it is with the other measures. The weighting of this indicator in the composite is significant, and big changes in reserves will have a big inverse influence on the direction of the composite. I currently rate the short term impact as bearish.



Continued on next page

Finally, foreign central bank holdings of Treasuries and Agencies are a very significant factor in market liquidity. It is the second most heavily weighted indicator in the composite. This indicator is currently neutral after an uptick last week.



See page 15 for a compendium of updated data and analysis.

Key indicators of overall US financial market liquidity as I see them are:

1. The growth rate of the Fed's pumping of cash into Primary Dealer trading accounts
2. Changes in cash flows into and out of the US banking system
3. Changes in Primary Dealer and bank trading activities
4. Purchases and sales of US Treasury securities by banks
5. Changes in bank reserve deposits at the Fed
6. Foreign central bank purchases (or sales) of Treasuries and Agencies reflected in the weekly Fed custodial account reports

All of these can be measured to some extent either directly or indirectly. There are other peripheral items which can be important from time to time, but these indicators have tended to be the most consistently important in judging the overall picture of the direction of the US financial markets. Another key factor is Treasury supply, which, when steadily increasing, absorbs liquidity, and puts pressure on the market if liquidity is not increasing sufficiently. I cover this in the Treasury update which is generally posted on Fridays.

The two major arenas in which these variable inputs are expressed are stocks and bonds. Commodities will usually move more or less in sympathy with stocks, although that can change at extremes. That is a subject more suited for technical analysis.

Each input should be viewed in terms of its direction. Growth is bullish. Decline is bearish. Some inputs are constrained so that their overall levels are also important.

When all the inputs are strong, both stocks and fixed income securities can be in bull phases simultaneously. When the inputs are stagnant, one market should only be able to rally at the expense of another. That is the environment in which we've been for most of 2011. Finally if these measures are weak overall, both markets should be generally declining. We're not there yet.

(10/2/11) The Fed's new program of Operation Twist will be no help whatsoever. Likewise, the Fed's switch from Treasury purchases to MBS purchases to keep its balance sheet level as MBS are paid off, will not help either. The amounts will still only be $10-15 billion per month, just as it has been since the Fed ended QE2 at the end of June. We have seen the results. Nothing will change until the Fed announces QE3. Bernanke is already making noises. But it is too early. The Fed cannot act until commodity prices have completely collapsed, lest it risk another parabolic upmove in commodity prices that would wreck what is left of the functioning world economy.

2011 History (5/14/18) Primary Dealers are handing over their long term Treasury paper to the Fed as fast as the Fed will take it, and interestingly the dealers are not replacing it. PD inventory of Treasuries is crashing. This looks like distribution. They are piling up cash at a breakneck pace. But to what end? Are they preparing for the apocalypse come the end of June, or are they preparing to buy massive amounts of Treasury paper once the Fed leaves the market. The answer to that is a no brainer, but The Street wants us to believe otherwise.

Wall Street keeps telling us that there will be plenty of buyers for Treasuries once the Fed stops POMO. All the evidence that I now see points in exactly the opposite direction. Not only are the PDs treating Treasury paper like last week's garbage, banks in general are also dumping the stuff. Only foreign central banks have been good public servants picking up tons of the stuff in recent weeks, but even that appears to have stopped. If they go on strike, it will be a catastrophe for the market.

We might muddle through the next 6 weeks while the POMO still flows, or we might not. The front running seems to have already begun and even with plenty of POMO and a big Treasury paydown on Thursday adding even more cash to the market, last week's teeter totter markets suggest creeping instability. The market may look ok at times when Treasury supply is light like from Tuesday on this week, but when supply is heavy, in particular at the end of May and in mid June, the problems should be more evident.
The trends should coalesce into a crash at some point this summer, but rather than anticipate that, I'll let the indicators show the way and signal the timing. Things could change, and a crisis that develops early, perhaps due to the debt ceiling issue, could prompt the Fed to engage in emergency action.

(4/18/11) After QE ends in late June, the markets should be much weaker. If the FCBs don't step up and the banks don't invest some of the massive hoard of reserves they've built up, and I can't think of a good reason why they would, both stocks and bonds could be in big trouble. I'd want to be holding cash, or be short as we enter that period, with the technical indicators being my guide.

At some point in the summer, I suspect that we'll need to begin speculating on when the Fed will start QE 3. The first Fed meeting after QE2 ends will be on August 9. If the markets crash before that, then intermeeting emergency action would become likely.

(2/20/11) So the Fed keeps printing, and vows to print until the bitter end of this QE2 program, regardless of the howls of pain of the realists on the FOMC. The problem is that the Fed has absolutely no control over where the printed money goes. If enough of it continues to feed into commodities speculation, this will screw up the Fed's grand master plan royally. It already has, but the Fed refuses to admit it. At the same time, we are seeing massive flows into bank reserves as banks still refuse to lend and even refuse to buy Treasuries.

When I look at the data, I get the feeling the banks are in some kind of stiff, rigor mortis state. The problems of getting these mortgages into foreclosure have killed them. The fact that there's almost no collateral there isn't helping. But fear not, the Treasury's guarantee of Freddy and Fannie paper will save the day, if only they can keep the zombie banks on life support for another 20 years. The government thanks you and me for standing at the ready to provide this support.

The following introductory sections in this font are reposted from older reports as background for the benefit of new subscribers and those who want historical review.

(2/5/11) Ominous warning signs are cropping up in several financial indicators that suggest that the system may be hemorrhaging cash almost as fast as the Fed is pumping it. That's why the Treasuries have been so weak, while at the same time the stock market has gotten so little mileage out of the Fed's largesse. The stock market gains may seem like a lot, but without these forces working against them they would have been much greater. The ominous signs include:

- An apparent big loss or liquidation in the trading account of at least one major bank, most likely a primary dealer.
- Bank buying of Treasuries has been very weak, another sign that they are under pressure.
- Institutional money funds have dropped to a new low.
- An indicator of cash creation that has a strong correlation to the stock market dropped sharply last week.
- Foreign central banks continue to be no-shows, letting the Fed do all the heavy lifting.
- Primary Dealer apparent Treasury net long positions cause systemic risk in view of sliding Treasury bond and note prices.
- Speculative crack up boom commodity price increases are creating economic and political dislocations all over the world.
- Bernanke wants to take credit for stock market gains but refuses responsibility for commodity price increases, more evidence of the Fed's dangerously narcissistic, delusional thought processes and behavior.
- Banks are sitting on reserves not only because they don't have the willingness or ability to lend, but apparently, because nobody wants to borrow. New lows in loan demand and miniscule commercial paper rates even with diminishing supply suggest that virtually everyone still wants to pay down debt.
- Fed printing for the next month could be reduced by $25-30 billion due to the ending of MBS prepayments.

There's plenty of reason there to be concerned about a market downturn. But the Fed will continue to pump, and the Treasury will be paying down another $175 billion in Supplementary Financing Program (SFP) Cash Management Bills (CMBs) over the next 7 weeks. That could be enough to keep a happy face on things for a while longer.

However, the Fed can't pump indefinitely because the negative feedback loop will only grow worse. Unless the FCBs come to the rescue and start buying more Treasuries, which is beginning to look unlikely, or the banks suddenly get hale and hearty and start buying Treasuries and lending money, I believe that the markets are headed for a crisis. It could be when the SFP paydowns end in April. Or it could be when the Fed halts or at least pauses QE2 in June, if not sooner. I still suspect that Bernanke may declare victory and begin to recall the helicopters early.

With this much uncertainty it behooves us to pay close attention to the financial indicator signals, in particular the technical indicators in the weeks ahead. The trend is intact for now, but the danger signals should not be taken lightly.

(1/30/11) I speculated last week that the Fed would insert words in the FOMC statement recognizing that commodities inflation is a problem. Silly me, I thought that, in doing so, they would lay the groundwork for winding down QE2. Instead, they stuck their heads up… uh… in the sand, pretending that this inflation doesn't exist and therefore inflation is too low. They are digging in their heels for the full POMO blast through June. The question is whether reality might intercede by the time the March meeting rolls around, when we will face the issue again. Because there's little reason to think that some of the POMO cash won't continue to flow toward commodities speculation.

In the meantime, they will keep pumping, which means at least 6 more weeks of winter for bears, and anyone who cares about the debasement of the currency. Over this period the odds are that we'll see more of the initial pressure on corporate profits, and on hiring, that has begun to show up in the Federal tax collection data. This could cause the deficit to widen, and Treasury supply to increase. We'll want to keep a close watch on these numbers in the weeks ahead. They will tell us if there's a problem well before the mainstream pundits have any inkling.

In the short run, the Treasury has decided to try and give the market an additional boost by paying off $25 billion per week in expiring CMBs over the next 8 weeks. The cash will come from the $200 billion rainy day fund that the government has on deposit at the Fed. This ploy was also used last year when the government faced the problem with the statutory debt ceiling that they again face. By reducing the $200 billion outstanding in the Supplementary Financing Program (SFP) CMBs and just sitting in cash at the Fed, they give themselves a little headroom vis-à-vis the debt ceiling, and at the same time potentially give the markets a little goose. For certain, it should push short term rates back to absolute zero, and maybe even sub zero on the 4 week bill, and it might push longer term yields down a hair, but of what it does for stocks, we can't be certain.

One well known bearish website published some hysterical speculation that the cash would go pounding into the stock market pushing prices wildly higher. But there's a problem with that reasoning. Money in the 56 day SFP CMBs is short term, low risk cash, generally just being parked in those bills because it has nowhere else to go. When the holders get their money back they will stuff much of it right back into whatever short term paper is out there to absorb it. The rest they'll probably just leave to sit in cash, pushing up reserves at the Fed but like the other trillion or so in bank reserves at the Fed, doing nothing else. It will just sit there.

Meanwhile, we've seen more evidence this week that at a time in the cycle when banks and FCBs are typically increasing their Treasury purchases, they are barely doing so. Without the FCB subsidy, and without a reasonable amount of bank buying of Treasuries, the Fed will be stymied in its desire to get bond yields and mortgage rates down, and stock prices up as much as they hoped. At the same time, the Primary Dealers are likely to continue to funnel enough of the POMO dollars at the margin into commodities to continue to push prices up in those areas. The damage to the economy would thus continue.

That being said, next week will be a very easy one for the markets after the absorption of Monday's issuance of $59 billion in net new Treasury paper. Another $25 billion or so of POMO is coming this week, and the $25 billion in CMB paydowns will add to that. The POMO alone should be enough to boost stocks, but the Treasury paper needs to settle first. I'd expect to see some signs of stabilization by Tuesday, and then some gains over the rest of the week.

(1/7/18) The issue is whether the Fed's current policy will be sustainable. I have my doubts. Bernanke's printing press seems to be adding about 10 cents a gallon per month to the price of gasoline. Food prices are also rising. The negative feedback mechanism of Fed pumping is running full blast. It is boosting economic activity thanks to government deficit spending but it is primarily stimulating non core food and energy inflation—the kind of inflation that the Fed pays no attention to. Bernanke's policies are decimating the middle class thanks to soaring prices for necessities, and sending senior citizens to the poorhouse by the millions thanks to zero interest rates.

Prior History Late in 2009 all the pundits were crying about how the Fed needed to reduce the size of its balance sheet. Now all the chatter is diametrically opposed. This confirmed my long held views that we were in a deflationary debt collapse spiral, and that the Fed's balance sheet would shrink if the Fed merely does nothing. Ironically, the longer the Treasury buying panic persists and the longer that bond yields stay low, the faster the balance sheet would shrink, and vice versa. The wild card was how the Fed would react to changing circumstances. I had no doubt the Fed would panic and find a creative way to surprise us and screw things up even worse than they were, as they always do.

The Fed stopped feeding the Primary Dealers in April 9010. Not coincidentally, that's when stocks topped out. As long as the Fed continued to starve the PDs I expected the stock market to make lower highs and lower lows. The PDs would be unable to sustain extended rallies in the stock market without the Fed providing the fuel. In the meantime the rallies appeared to be tied to foreign central bank (FCB) actions augmenting the public buying panic in the Treasury market.

The Fed had made clear by its words and actions that it had no clue what to do next. As always it would wait for "something to happen" and then overreact, ultimately worsening the situation either in the short run or the long run or both.

For a while, the Fed was content to allow its balance sheet to gradually shrink. They had the good fortune of the foreign central banks going on a massive buying binge that first supported the Treasury market and saw some of the cash from that binge slosh over into the stock market.

What happens when people no longer believe the con, when they decide that they are no longer willing to play the game? We're in the first stage of finding out. Suddenly the mainstream has awoken to the issue that we have been so worried about for the past two years, government's assumption of massive amounts of private risk backed by insufficient or non existent collateral. Suddenly people are realizing that the problem is not, and was never, liquidity. The problem is solvency. The recognition is growing that the system is insolvent, and you cannot borrow your way out of insolvency. Government guarantees cannot fix the problem, they can only burden the public with obligations it did not ask for and cannot shoulder.

In a series of insane actions over the past 3 years, governments the world over, led by the Fed and the US Treasury, have burdened the public with levels of debt that cannot be repaid by liquidating the assets supposedly backing them. The collateral is largely fictitious. It does not exist in reality; therefore the repayment of that debt will burden the world's economies for generations. That realization has been leading the quicker thinkers to decide to cash out of the con now rather than later.

The ranks of those wanting out are growing. There's just one problem. There's not enough cash to make everyone whole, and a more and more people are realizing that. The sense of fear and panic is growing. Rather than being the irrational fear that often comes at the end of a move, it is the type of rational fear and panic that occurs at the beginning of a move.

At the same time, we are seeing a couple of asset classes move up in a panic that is "irrational"— US Treasuries and the US dollar. These moves can only be sustained until the panic burns out. There aren't enough dollars around the world to service all the dollar denominated debt, therefore borrowers who can are scrambling to get their hands on dollars. To do that, they liquidate what they can. Some investors are liquidating other instruments in order to hold US Treasuries as a liquid proxy for dollars, or as a "safe haven." Since the US Government's finances are no better than any of the well recognized basket cases in Europe, this panic is irrational. We know that it will end badly, but the technical indicators tell us that it is not ready to end.

The same is true of the parabolic move in the US dollar. It will end badly, but when? It will end when the bad debts are all recognized and written off. That could take a long time, or not so long. We just don't know how long the process will take. But when that point is reached, no one will need dollars any more. We may intuitively sense when the time has come for that, or we can watch the charts and the technical indicators for signs that the panic is exhausting itself and is about to reverse. In both cases, Treasuries and US dollars, we need to be vigilant in following the charts and the technical indicators, because when the end of these moves comes, the turn is likely to be sudden and violent. Whenever panics end there are always technical forewarnings. We must be alert for them. Forewarned is forearmed.

The paragraphs below written in early May 2010 laid the groundwork for some of the market behavior we have witnessed since then.

The markets and the economic data got some support from record levels of tax refunds, which totaled over so far $300 billion from January through April. That kind of stimulus boosted the data, and made things look good on the surface. The homesuckers' credit was another prop making the housing market look especially good in April, leading some pundits to conclude that the economy will have self sustaining momentum in the months ahead.

My conclusion was just the opposite. Once the props are removed, I expected demand to collapse, tax receipts to plunge, Treasury supply to grow, and without the support of the Fed for the time being, stock prices to fall. The alternative would be for Treasury prices to fall and yields to rise, and we know that that's the last thing the gummit wants. They will find a way to tap the pool of liquidity available via the stock market. So stocks should bear the brunt.

The period of most favorable liquidity has come to an end. Over the next month, cash will come into the market in fits and starts as the Fed completes its forward MBS purchases. This will mix with periods of intense supply pressure from the Treasury. As a result, we should begin to see signs of change in the market environment. The past week was a bellwether of what to expect. The markets' reactions gave us a hint about how they will behave in the months ahead without the support from the Fed that it has had over the past 17 months.

As Treasury supply begins to rebuild following the late April paydowns that accompany tax collections, the Fed's MBS settlements will be reduced in May, and will end completely in June. That could make for a brutal summer for the markets, unless the Fed restarts its support operations, or the FCBs decide to become heavy buyers again, or the banks decide to take some of that mountain of reserve cash on deposit at the Fed and buy more Treasuries. If none of those things happen, then we may be on the doorstep of a renewed bear market in both stocks and bonds. If one or more of those things happen, then we'll judge the likely outlook according to how the market handles it.

As FCB short term cyclical cutbacks and the long term trend of less purchases coincide from time to time with increased Treasury supply in the coming months, it should put the markets under pressure. I continue to believe that the government would be happier to see stocks pull back and provide liquidity to support the Treasury market, but, as always, I'll let the technical indicators be the guide in the days ahead (covered in the Professional Edition Daily Market Update).

The Treasury has expressed confidence that the domestic banking system and other investors will pick up any slack in Treasury market demand. The banks buying nowhere near the amount of supply which they would need to absorb in order to keep rates from rising once the Fed subsidies and the brief period of paydowns ends. This is another reason why liquidation pressure is likely to show up in the stock market.

These factors taken in context with a steady flow of heavy Treasury supply create the perfect mix of conditions necessary for a liquidity crisis beginning to rear its head in the stock and bond markets in the coming months. We have been seeing hints of a building crisis in the collapsing loan balances and commercial paper outstanding and collapsing money market fund balances.

Meanwhile, the economic news looked "better" in the first quarter. Federal tax receipts continued their rise in March after showing the first year to year rise since 2007 in February. At the same time, a mammoth wave of tax refunds in February and March helped to fuel economic activity. Those tax refunds will now taper off dramatically, coincident with the Fed ending its direct propping of the markets and the government ending the homebuyers' tax credit. That credit seemed to finally be boosting home sales as the April 30 deadline approached, but overall housing demand remains near record low levels. It will be very interesting to see if the recent momentum we've seen in the financial markets and the economic data can be sustained into May and June without the benefit of the housing stimulus, Fed propping of the market, and the tidal wave of tax refunds.

So what comes next? Does the economy have enough residual momentum to continue building on the phony impetus of waves of government debt spending, or will that debt act as an anchor dragging down, and even reversing further growth. I think the latter, but the next 2 months' data should give us some solid clues as to what the likely path of the economy, tax collections, and additional Treasury supply will be. Even slow improvement will leave Treasury supply at excrementally high levels, and those levels will hit the fan sooner or later without those Fed and FCB subsidies.

The crunch that I envision will take time to develop, but I think that we should start to see some of the ill effects in May. In the meantime, interest rates have risen. The Fed's announcement in late February that it was raising the discount rate, but not tightening, was a signal to the market that it should start sniffing out economic recovery. Treasury bill rates and Fed Funds have been rising gradually ever since.

An increase in its borrowing costs coupled with the upward push that this will give yields on housing debt is not what the government wants. The last thing the government wants to see, in addition to a renewed rise in its own borrowing costs ultimately leading to a debt trap, is a rise in mortgage costs in a sick housing market.

The Treasury needs some bad news. While good news might contribute to a further upside overextension of the stock market rally, a month of better than expected economic data would be horrible news for the Treasury market and the housing picture.

The Treasury got its bad news (the Greece debt crisis). That news ignited a buying panic into Treasuries. The panic is based on the belief that Treasuries are safer than other instruments. That belief is mistaken, and at some point must lead to a dramatic repricing of the risk inherent in Treasuries and in all markets.

The extraordinary directive that the Fed sent the banks early in January 2010, to manage their interest rate risk, seemed to be a clear warning that the Fed intends to follow through on its plan to end the MBS purchase program and allow yields to rise to some extent. The gradual reduction of support could result not only in rising Treasury yields, but in a worsening environment for stocks as well. Continuing weak tax receipts mean that Treasury supply should build, and longer term yields should rise, at least until the Fed panics and tries to reflate the bubble again.

Now that the mad scientist has been reconfirmed for another 4 year term as the emperor of the financial system, we can expect more instability as he continues his wild experiments in monetary policy. Unexpected, unintended consequences are likely to rear their ugly heads at any time. It's our job to be on the alert for those consequences, hopefully before they occur, or at least early in the game. The risks are now so great that the best strategy is probably not to play at all.

I continue to believe that those manning the controls at the Fed and Treasury are delusional. Over the past couple of years as the crisis has unfolded, they have continually made the wrong tactical move at the wrong time, making an already horrific situation worse. I have chronicled these errors for you every step of the way. If the Fed has any thought that it can begin to remove its subsidy from the system now without a catastrophic market response, then it is truly not only blind to the facts, but it is operating in some kind of alternate reality that bears no resemblance to the real world, where the economy is again dropping off a cliff.

Groupthink remains the order of the day at the Fed, in Washington, on Wall Street, and in the financial propaganda ministries of Rupert Murdoch and CNBC. As reality continues to weigh on the population at large, the disconsonance and discontent only grows. The weak consumer confidence data only goes to prove that the public gets it. It's the pundits and people in power who don't get it, and even if they do, it's too late to do anything about it. This is all leading to a very bad place.

Meanwhile, Federal tax collections have collapsed [*followed by a rebound February-June*]. Money market funds are collapsing. Bank loans are collapsing. The commercial paper market is collapsing. Polonius rules. Nobody wants to either borrow or lend. Bank CDs are ballooning, and the banks either can't or won't lend the money out, so it sits in a growing pile in a vault at the Fed [*beginning to reverse since April*]. Everyone from the biggest financial institutions to the smallest individual consumer is desperately trying to pay off debt and build up a cash reserve. Everyone, that is, except the US government, which is doing the borrowing in our stead, and burdening us for generations to come, against our will and better judgment. These debts will be a drag on the economy and the markets from now till kingdom come, and that might not be too far off at the rate things are going.

This is how bubble mechanics work when they go in reverse, a vicious cycle continually feeding on itself.

The problem is that those in charge believe the data that the economy has turned a corner, but it's all temporary activity based on borrowed money that can't be repaid. Consumers do not have the ability to take the handoff and carry the ball.

Money supply data is reflecting the stagnation of total Fed credit, but not the decline in the quality of the assets backing the numbers. Other measures, such as money fund assets combined with checking deposits are showing much steeper declines. Even these probably grossly understate the real shrinkage of money supply because they don't show the reduced value of the assets backing the money liability. In spite of that, they have been declining sharply since March.

Compendium of today's updated sections: All are repeated in context in the balance of the report. See additional **charts and tables in body of report**.

Treasury Auctions, Federal Revenues and Supply Impact, and Treasury Yields See http://wallstreetexaminer.com/money/treasury072812.pdf for latest update

Continued on next page

Open Market Operations (OMO) and Monetary Policy Actions

The Fed will tilt toward cashing out the Primary Dealers for $6 billion in August, buying that amount more than it is selling to them under Operation Twist. It will also shrink its balance sheet by redeeming $12 billion in Treasuries, cash which the Treasury will need to raise in the market. Since the Fed has already redeemed all of its bills and now holds only notes and bonds, the remaining redemptions would need to come from longer term paper. The Fed made no explanatory comment.

The Fed's securities holdings dropped by $6.9 billion in the week ended 7/25/12 as it redeemed bills, and saw net paydowns of MBS holdings. That was the third decline in a row. The Fed has had no public discussion of the balance sheet shrinkage.

The Fed continues to settle the bulk of the forward MBS purchases around mid month each month while starving the market at the end of the month when the Treasury has a big settlement of notes. Last week it appeared to settle $5.2 billion of forward MBS purchases, but paydowns were apparently around $16 billion, for a net paydown of $9.7 billion. It currently has $31.4 billion in MBS forward purchase commitments outstanding.

The Fed's total securities holdings are down by $44.8 billion since December 21, 2011. The Fed had pledged to keep its holdings steady under Operation Twist. The failure to do so appears mostly due to the delayed settlements of the MBS purchases, resulting in a mismatch between the paydowns and the replacement purchases. Since the Fed has stopped growing the SOMA in June 2011, stock prices have been virtually unchanged.

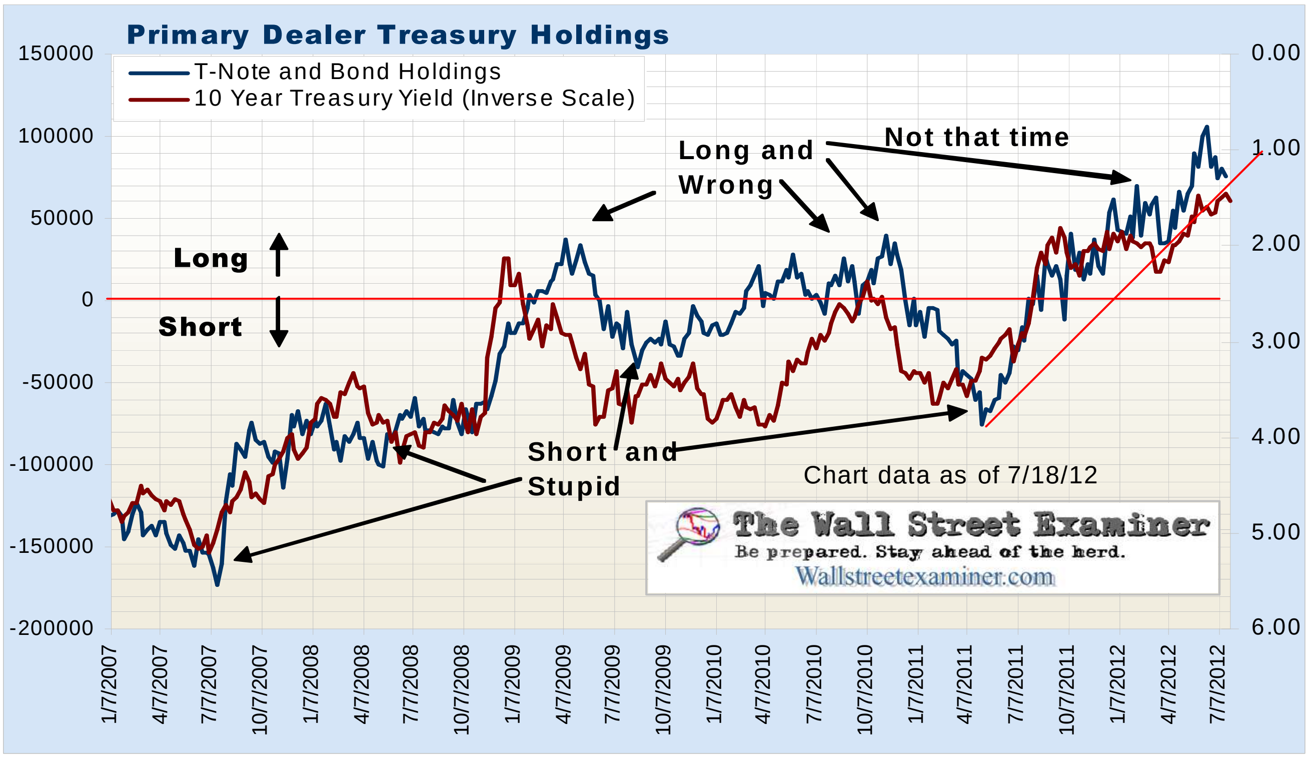
Currently at $2.595 trillion, the SOMA is now $59 billion below the Fed's target of $2.654 trillion. This gap had ranged from $13 billion on December 21 to $56 billion in the weeks ended February 8 and April 18. This is a new record, which should widen further in August as the Fed redeems more of its SOMA holdings, barring a new purchase program announcement on Wednesday.

Primary Dealers

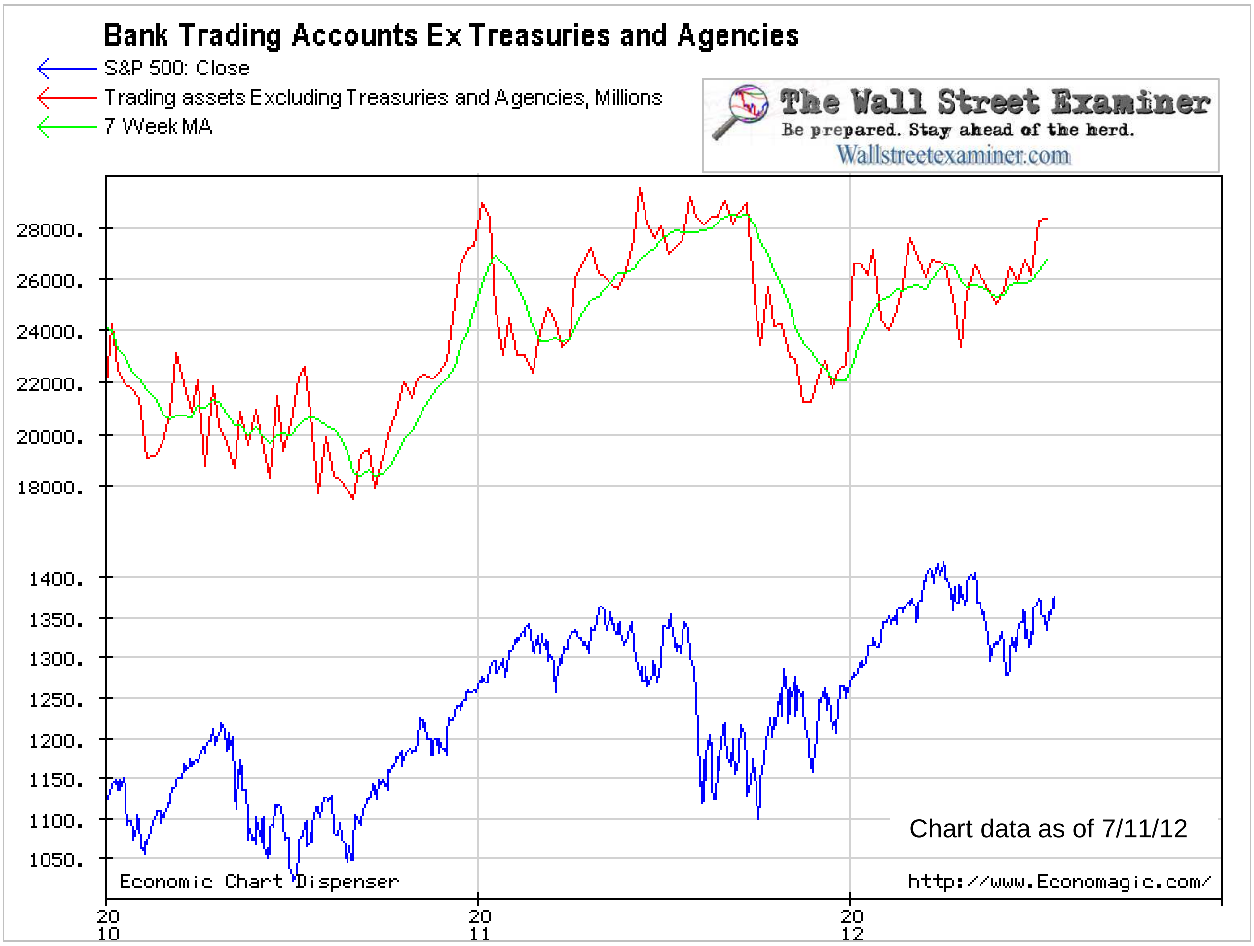
Net Weekly Changes (Millions)		
	T Bills	-22,405
T Notes and Bonds		-4,693
Total Treasuries		-27,098
	Agencies	-5690
	MBS	-2,483
Corporates		+1,918
	Total	-33,353

Primary dealers' fixed income holdings fell sharply in the week ended 7/18 (reported with a one week lag). The bulk of the decline was in T-bills. When they start reducing their longer term positions consistently, that should signal a more persistent rise in yields.

Primary Dealers sold Treasuries in the week ended July 18. Their holdings have been downtrending since reaching an all time record long position in the week of June 13. Is this the beginning of the end of the Treasury bubble? If the Primary Dealer selling continues and breaks the uptrend line, that would be a signal I would take seriously.

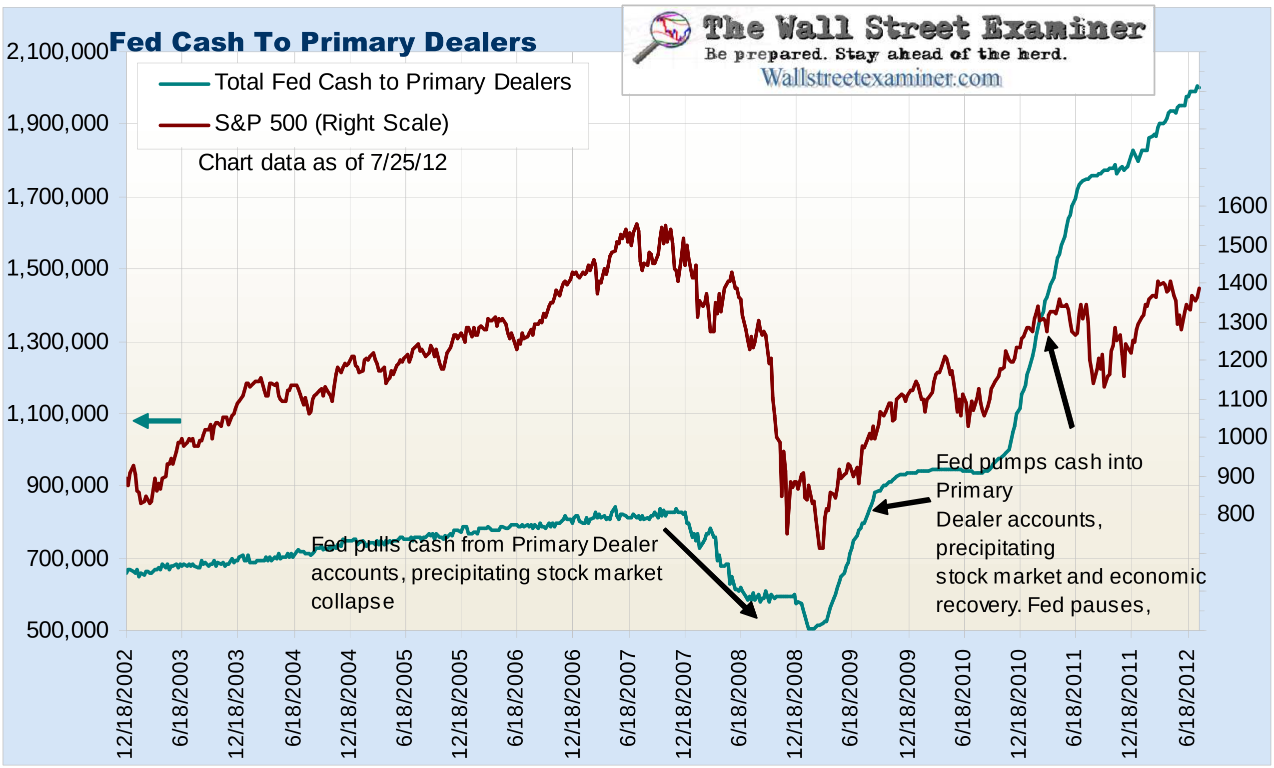


Continued on next page



Commercial bank (including foreign based US branches) trading accounts increased by less than $0.1 billion in the week ended July 18 (after revisions). The intermediate trend of this indicator is still bullish, but it could be related to marking to market as bond yields were falling sharply. There may be a limit to how far the banks will allow these accounts to go before they take profits, as indicated by the repeated peaks in 2011 around $29 billion. This indicator is included in the liquidity composite.

The Fed settled an apparent total of $5.2 billion MBS purchases in the week ended July 18, before deducting paydowns. That was the amount of cash going into PD accounts. It's not significant, but as long as these flows continue from time to time, the dealers will have cash to deploy.



Fed Funds Rate

Fed funds plunged last week after being in an uptrend for several months. It suggests another large influx of deposits.

Continued on next page

Other Policy Tools and Total Fed Credit

	7/25/2012	Change
Total Fed Credit	2,849,108	7,100
Securities	2,595,823	(6,915)
Repos	0	0
TAF	-	-
DWB	123	(7)
AIG	-	-
CPR	-	-
MLI	2,081	53
MLII	61	43
MLIII	7,155	991
Swaps	27,232	(3,320)
TALF	3,570	(868)
TALF LLC	845	-
Alico/Aurora	-	-
Total Soup	41,067	(3,108)

Total Fed credit fell last week as securities holdings and swaps fell. The total size of the Fed's balance sheet is little changed from where it was a year ago.

Other Fed Balance Sheet Items - Liabilities

The Treasury withdrew a net of $20.4 billion from its checking account at the Fed last week. This brought its deposit balance to $38.2 billion in the week ended Wednesday. That's cash that got spent into the banking system and created, or represented, economic activity.

Banks deposited a net of $30.6 billion to their accounts at the Fed last week. The mysterious "Other" deposit accounts (GSEs, and unnamed foreign official organizations and government entities- People's Bank of China?) saw withdrawals of $21.6 billion, leaving combined bank and "Other" deposits up by $9 billion. Other liability items had only minor changes resulting in a drop of $9 billion in total liabilities, matching the decline in assets. The transfers appear partly related to the MBS paydowns flowing out of the accounts of Fannie and Freddie (Other deposits) reducing the Fed's asset base.

Bank loans outstanding fell by $25.6 billion to a total of $7.045 trillion in the week ended July 18 (after revisions). The renewal of the uptrend from the April 2011 low is now threatened.

Foreign Central Banks See http://wallstreetexaminer.com/money/treasury072812.pdf for latest update

The Dollar See http://wallstreetexaminer.com/money/treasury072812.pdf for latest update

Commercial Paper CP outstanding extended a tiny rebound from a low set the July 4 week. There's no sign of recovery of the CP market. Non-financial paper has been strong for 3 years, but hasn't made much of a dent in the overall totals.

	Total	Asset-backed	Financial	Nonfinancial
7/18/2012	1,000,577	313,264	480,552	206,376
7/25/2012	**1,005,496**	**310,117**	**489,300**	**205,568**
Change	4,919	(3,147)	8,749	(808)
	In billions			

Money Supply and Fund Flows MZM and M2 both increased in the week ended 7/16/12 (charts on page 95). The quarterly growth rate has come down from 15% on MZM and 12.6% on M2 to around 0-1% over the past month, while the annual growth rate has declined from over 10% earlier this year to 7-8% now. If the M's go negative on a quarterly basis, that might give the Fed a green light to act more aggressively. But with Euro capital flight cash still flowing into US banks, near term shrinkage of the US money supply seems unlikely, even though the Fed is doing its part to keep money growth slow by holding the SOMA flat.

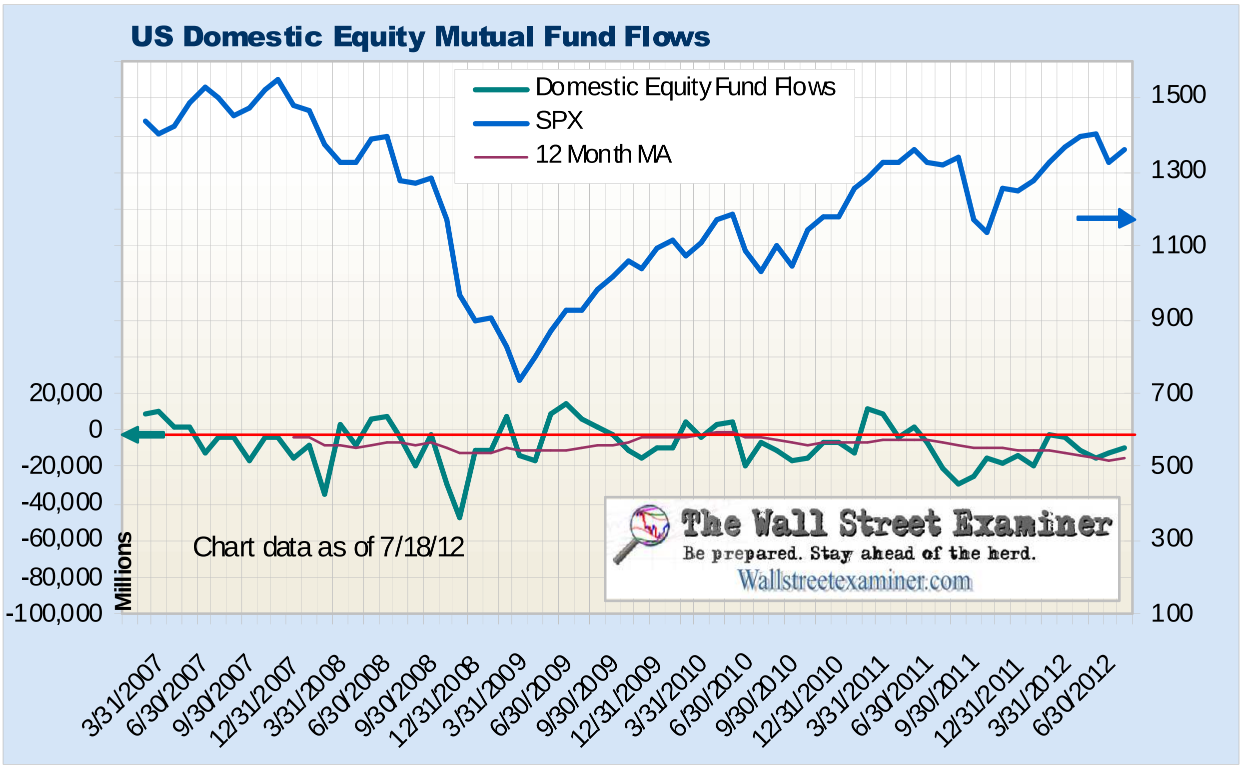
		Total	Change	Qtr.%Ch.	Y/Y %Ch.
MZM	2012-07-16	11,022.4	14.9	1.10%	7.90%
M2	2012-07-16	10002.5	-6.9	0.53%	8.59%

Retail money fund assets have been trending down since the beginning of 2012. Normally, falling money fund assets follow rising stock prices but that has often not been the case in much of 2012. That is probably a sign of forced liquidation to meet current needs, a symptom of ZIRP Bernankecide. Institutional funds have been downtrending since December, but have edged slightly higher over the past 5 weeks and are now $38 billion above the low point reached in August 2011. Institutional investors and corporations have so much cash, that they're forced to park some of it in these funds.

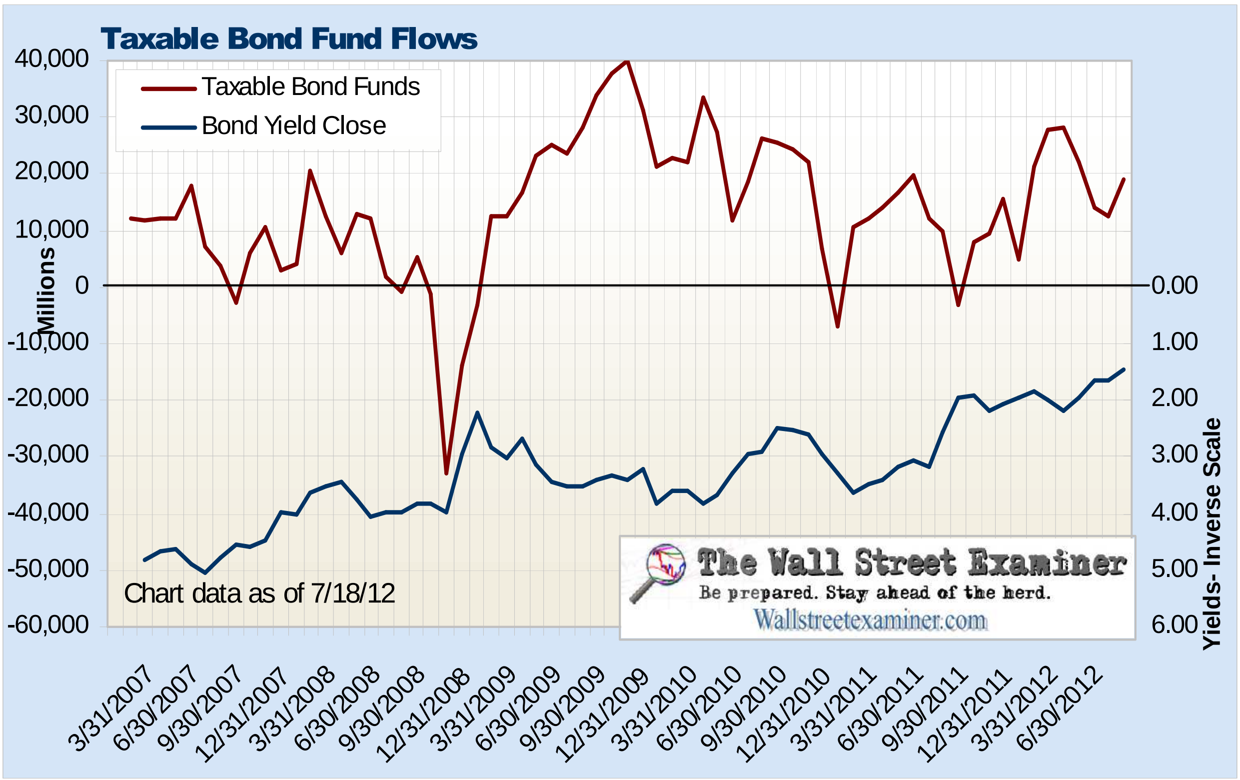
Date		Institutional				Retail		
		Total	Change	% Ch.		Total	Change	% Ch.
7/18/2012		1,653,120	-11,860	-0.71%		885,680	-470	-0.05%
7/25/2012		**1,671,500**	**18,380**	**1.11%**		**883,470**	**-2,210**	**-0.25%**
Since 9/9/09		-711,333	-29.85%			-277,818	-23.92%	
Since Peak		-34.43%	1/14/2009 peak			-35.46%	3/11/2009 peak	

Continued on next page

The ICI reports mutual fund flows weekly with a one week lag. Domestic equity mutual funds had $0.1 billion of net inflows in the week ended 7/18/12, after net outflows of $1.5 billion the week before. This was the best performance since May 30. Small investors have been fleeing the market for years, but that hasn't stopped the bull market since 2009.



Continued on next page

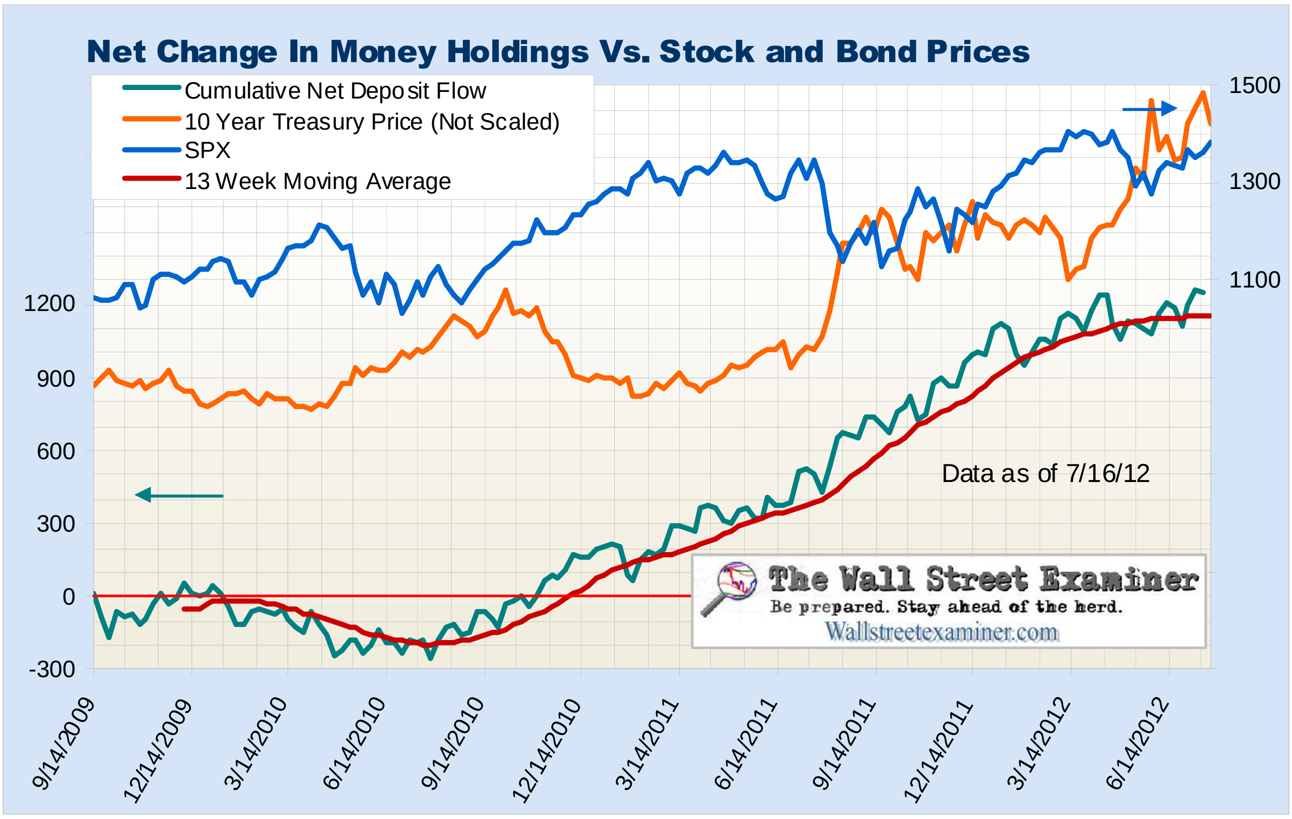


Investors put a net of $5.1 billion into taxable bond funds in the week ended 7/18 versus $5.2 billion the prior week. These were the biggest weekly inflows since May 16, but still well below the record $9.1 billion of inflows the week of April 4. Buying remains well below those levels in a sign that investors may be losing the will, if not the ability, to continue buying at that pace. Domestic equity funds saw a tiny inflow in the July 18 week, in a change from the usual patterns of outflows.

Continued on next page

Banking system net money flows showed an outflow of $13 billion in the week ended July 16, pulling back from a nominal new high, while the 4 week moving average upticked slightly from being flat. None of these changes seem material yet. The indicator has barely emerged from the range it has been in since March. Stocks have gone nowhere during this time.

A downturn from this point would be a bearish indication. If the indicator breaks out to a new high, the trend would be bullish.



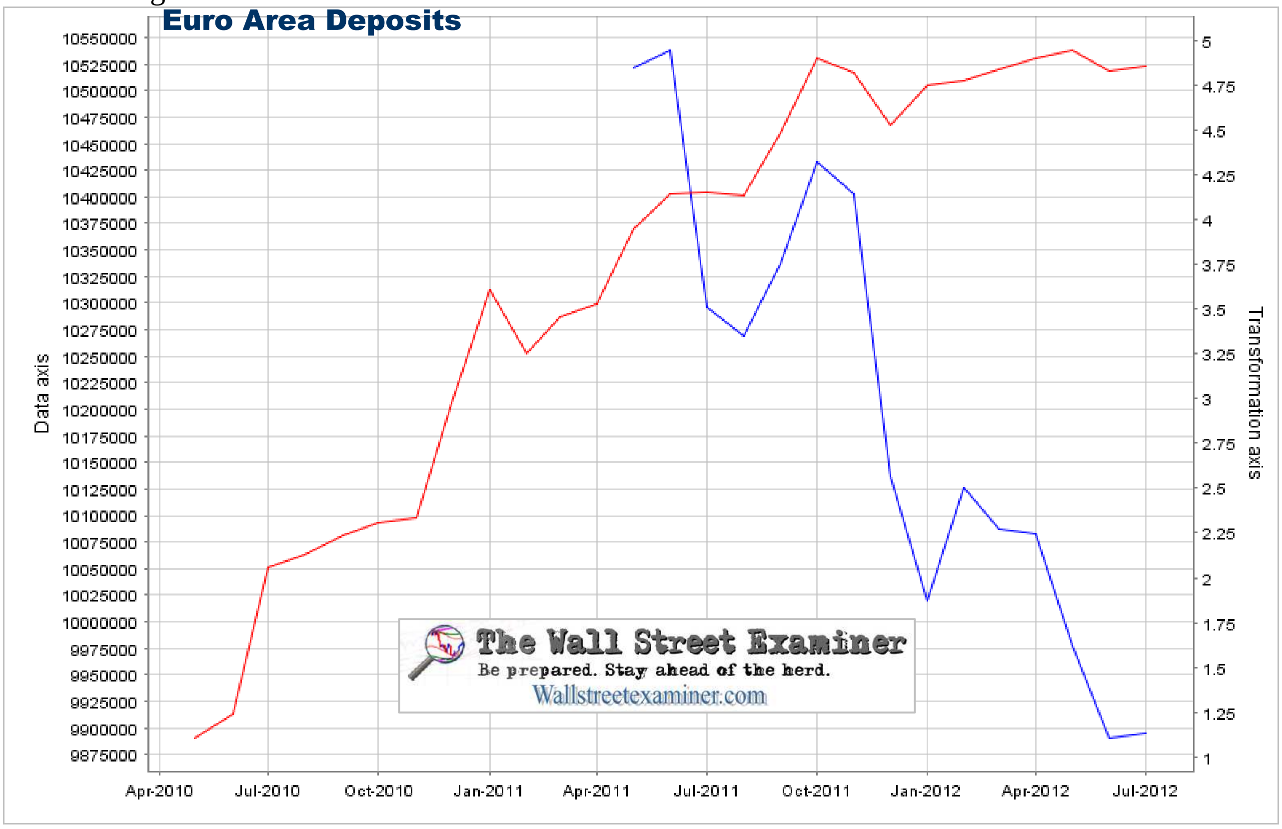
Money Supply Components in Billions

Week Ended	WSE Alt. M Total	Total Checking	Currency	Total Savings	Checking + Savings
07/09/12	3,504.9	1,205.0	1053.9	6,419.2	7,624.2
07/16/12	**3,477.2**	**1,190.6**	**1050.6**	**6,433.5**	**7,624.1**
Change	(27.7)	(14.4)	(3.3)	14.3	(0.1)
				Change since 9/7/09	2235.4

Week Ended	Total MMF	Retail	Institutional
07/09/12	2299.9	634.9	1665.0
07/16/12	**2286.6**	**633.5**	**1653.1**
Change	(13.3)	(1.4)	(11.9)
Change since 9/7/09	-985.0		

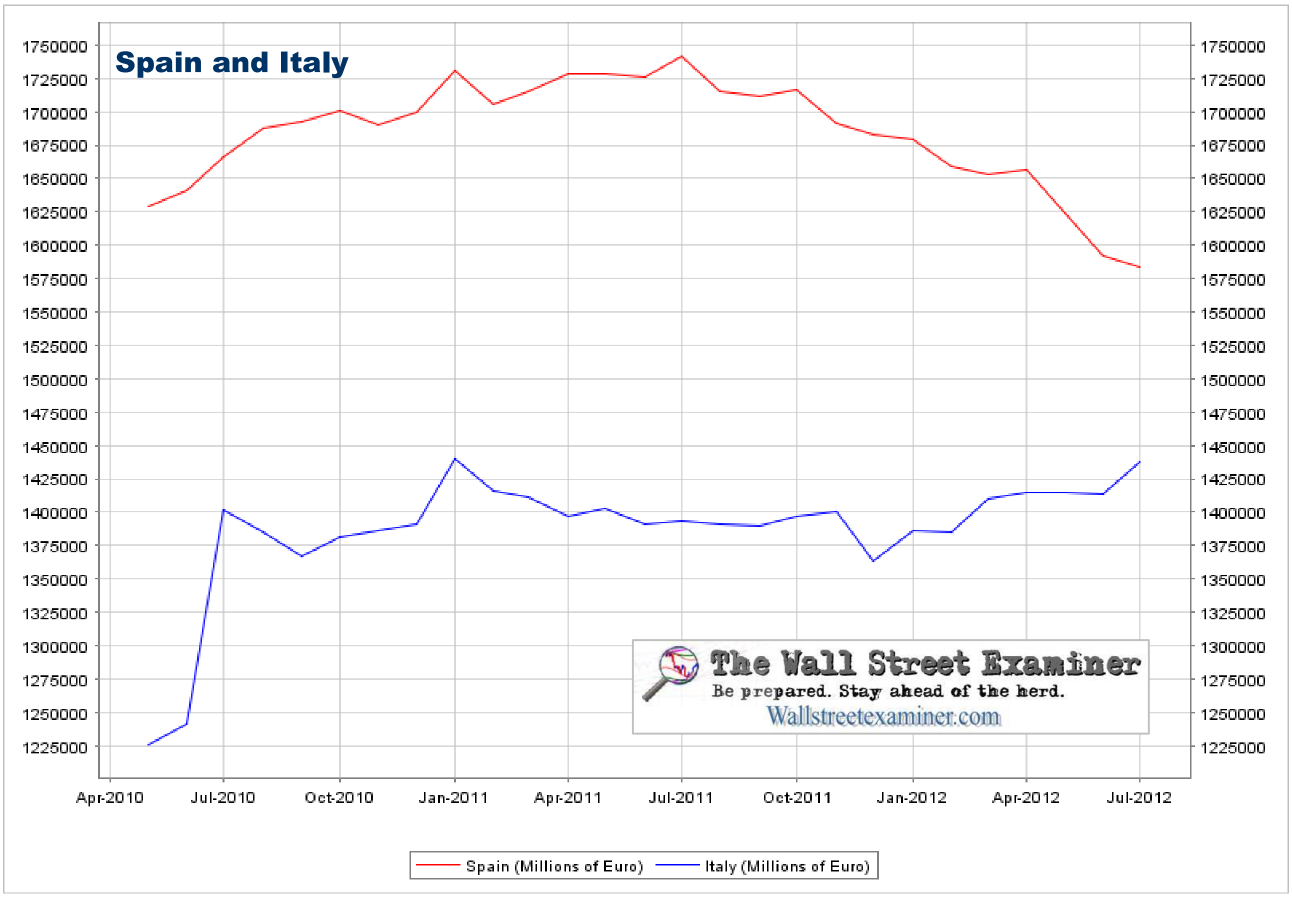
Weekly Change in Difference between MMF's and Bank Deposits	**(13.4)**

The following chart shows the ECB data on bank deposits for the Eurozone as a whole for the period through June 2012. Deposit growth has stalled since October 2011. The right axis shows the 12 month rate of change.

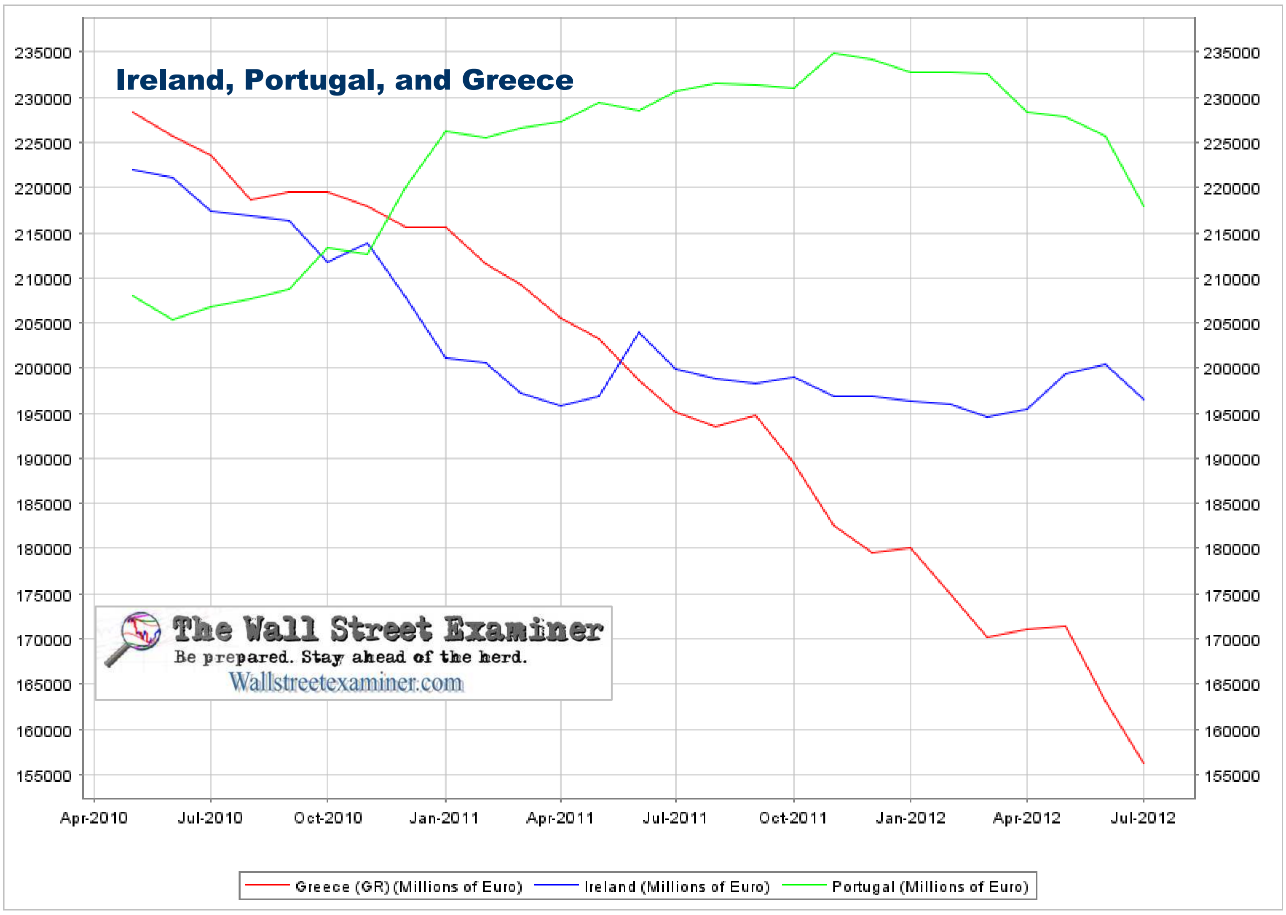


The charts of the problem countries are shown below. Outflows continued from Spain in June. Italy's deposits are growing again. Portugal has now joined Greece in complete collapse and Ireland returned to outflows.

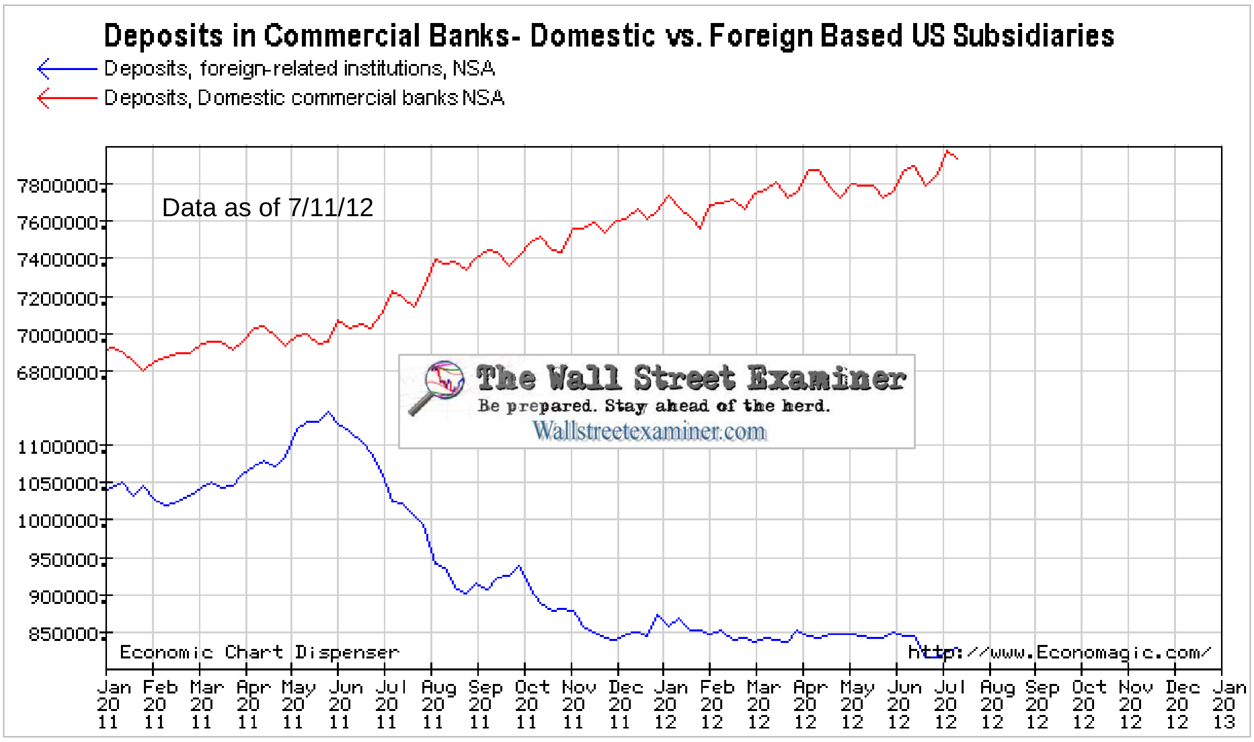
The correlation of European bank outflows with US bank inflows, strong Treasuries, and modest increases in US economic data suggest that, contrary to the conventional wisdom, what's bad for Europe has been good for the US. It has funded money into the US Treasury Ponzi scheme economy that has kept US economic activity afloat. The ending of these outflows, whenever they occur and for whatever reason, should be bearish for the US markets and economy.



Continued on next page


Ireland, Portugal, and Greece
235000
230000
225000
220000
215000
210000
205000
200000
195000
190000
185000
180000
175000
170000
165000
160000
155000
Apr-2010
Jul-2010
Oct-2010
Jan-2011
Apr-2011
Jul-2011
Oct-2011
Jan-2012
Apr-2012
Jul-2012
The Wall Street Examiner
Be prepared. Stay ahead of the herd.
Wallstreetexaminer.com
Greece (GR) (Millions of Euro)
Ireland (Millions of Euro)
Portugal (Millions of Euro)

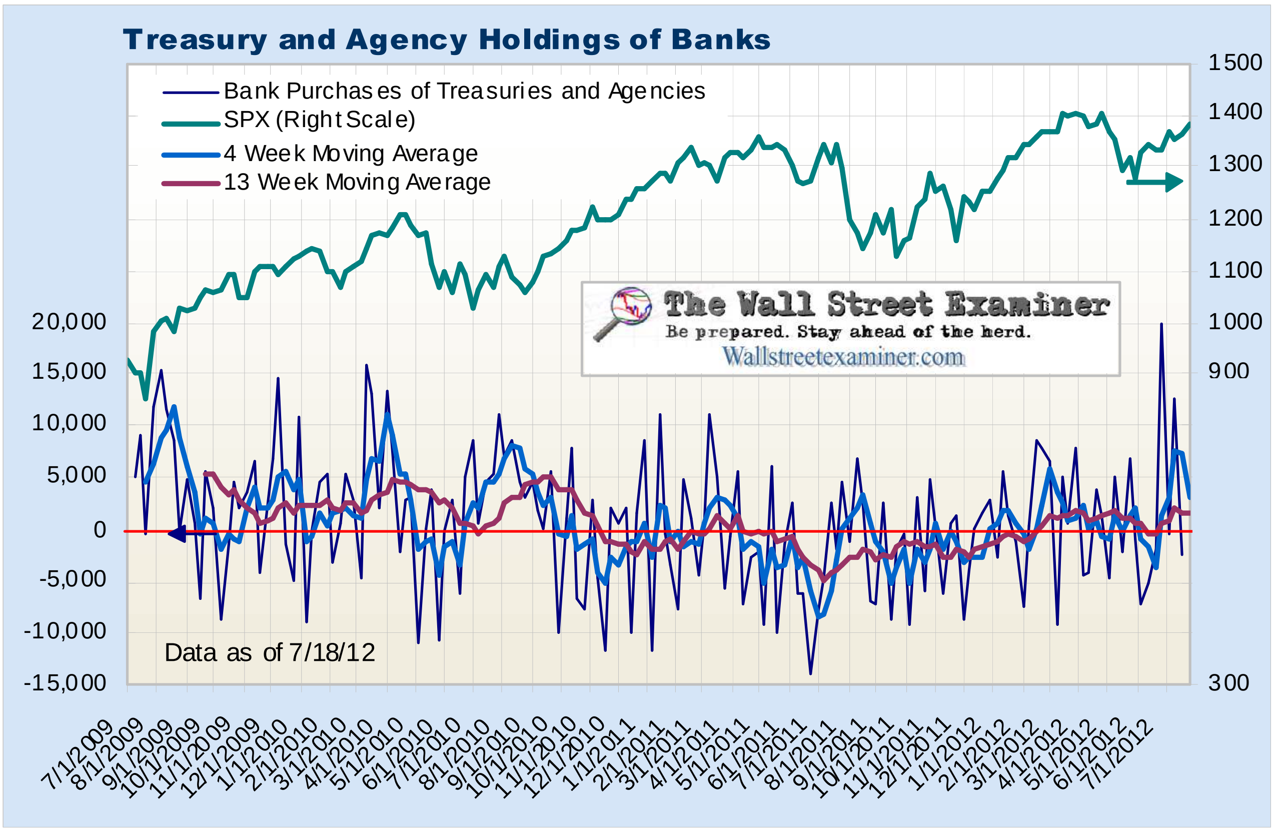
Deposits in US subsidiaries of foreign banks are available weekly with a lag of about a week. They had been in a flat trend since December but they dipped to a new low in mid June before upticking slightly in July. Declining deposits in US branches of foreign banks are not a good sign for Europe, but it means that more capital is probably pouring from the Eurozone into US banks. Domestic deposits surged to a new high in early July but have pulled back over the past two weeks as foreign branch banks in the US gained back some deposits. As long as US domestic deposits are uptrending at the apparent expense of European banks and their US branches, the US Treasury Ponzi will continue as the Last Ponzi Game Standing, enabling the US economy to continue to look relatively good compared to the rest of the world.

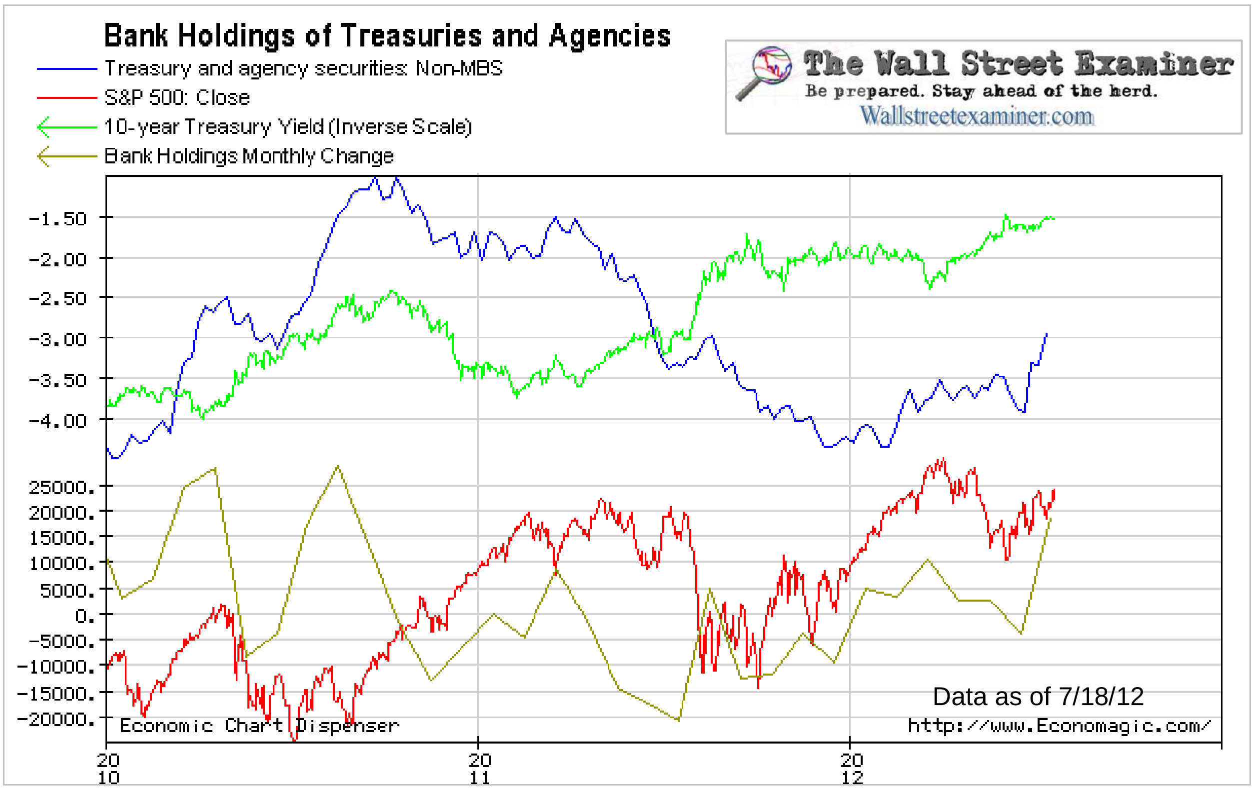


Bank Holdings of Treasuries and Bank Condition

Commercial banks' Treasury and Agency (GSE) holdings dropped by $2.5 billion in the week ended July 18. That followed a jump of $12.5 billion the previous week, and a record surge of $19.8 billion in the week ended June 27. That was a stunning and mysterious reversal in the typical pattern of small sales or purchases each week. I did not think that this buying surge was sustainable, but perhaps I'm wrong about that. It's too soon to know for sure. Given what happened in the market on Friday, with bonds taking a huge hit, I have to wonder if that surge somehow marked the final blowoff of the bond market buying panic. We should have an answer from the technical indicators soon. Charts below

Continued on next page





Composite Liquidity Indicator - See page 1

End Updates – Repeated in the balance of the report in context.

(Recent History 2008-2010) We have seen for years that when the Fed conducts Primary Dealer pumping operations—let's stop kidding ourselves by calling them "Open Market Operations"—that the stock market rallies. When the Fed pumps, eventually the market responds, although apparently not to the same degree that it did in the past.

The stock market rarely has a deep correction when Fed Primary Dealer Pumping Operations (PDPO) are under way. The PDPO campaign in 2009 was the biggest in history, and while the Fed did not get the mileage it once got from these things, thanks to the Treasury supply sponge sucking up so much of the liquidity and the dealers' need to reduce leverage and pay down debt, we saw again that when stimulus is persistently applied, eventually the dogs salivate. The dealers apply the cash and resulting leverage in their high frequency, delta hedged, black box, double secret program robot front running trading operations. Since they find it far easier to sucker their customer base when stock prices are rising, that becomes the path of least resistance when their trading accounts are bursting with cash and T-bills.

It has nothing to do with whether there are green shoots or not. That's just the background noise that people need to hear as they undergo market hypnosis.

The Fed's first long term Treasury buying campaign, which came to be known as Quantitative Easing or QE1 began in March 2009 and was scheduled to end in September 2009, but the Fed extended the $300 billion commitment until the end of October 2009. I wrote at the time that under the circumstances it was difficult to imagine the stock market selling off much before that. The GSE purchase campaign had begun in Nov ember 2008 and would go on for even longer based on the Fed only having acquired just over half the promised $200 billion. The Fed set no time limit for the GSE campaign, but the remaining amount to be acquired, unless deployed over a concentrated time period, would not have as much impact as the campaign to buy Treasuries.

Apparently the Primary Dealers were not leveraging up on all that cash being pumped in by the Fed. I was thinking about the gap that developed on our Primary Dealer liquidity chart in 2009. If that even came close to returning to the old tight correlation, stock prices would have climbed to a new all time high. I did not think that would happen, because the Treasury supply along with all the new corporate supply was absorbing much of the buying power.

As long as the Fed was pumping at those astronomical levels we were in uncharted waters, but it needed the help of FCBs to keep the pot boiling. Without that help, the Fed's buying alone would not have been enough to keep things levitated. Beginning in August 2009, there were signs that that help was diminishing. That meant that the Treasury would be paying more to float its debt, unless the stock market sold off and scared investors back into the Treasury market.

Over the 4 years prior to 2009, money supply grew at about a 10% annual rate, or about 45% total. So where's the inflation that's supposed to cause? You would think that we've had enough "lag" to see some inflation by now. Yet most things costs little more than they did in 2005, and some things, particularly real estate and equities now cost a lot less. Some commodities are a little higher than 2005 levels, but only because they rallied in 2009 on the "fear of inflation." Will those fears be proven wrong yet again?

I think the answer lies in the fact that all that "money" that's supposedly out there doesn't really exist. It's based on a bunch of empty promises now made by the government in backing worthless assets. Those promises will be meaningless if people decide that they no longer want to believe the con that the money really is there, and suddenly ask for their money back.

Meanwhile, throughout 2009 in virtually every data series that we follow in this report we saw signs of contraction, including not only the Fed's balance sheet which had been flat since October 2008, or Commercial Paper outstanding, which continued its collapse, retail money funds, also collapsing, or Primary Dealer holdings, which remained in a downtrend in 2009, or most assuredly, mortgage applications, which appeared to be on the verge of another breakdown to new lows at any time [*since fulfilled*]. The desire, and the need, and the drive to pay off debt seemed universal. Is that trend going to suddenly turn on a dime? I saw no sign of it at that that time, and as of mid 2010, still saw no sign of it.

The only thing that was growing was Treasury debt, which has been sucking capital from every other asset class. Watching yields skyrocket from time to time gave me the impression that we seemed to be getting to the point where the market's capacity to absorb more and more and more paper was being severely tested. Then along came the European debt crisis, and the big selloff in stocks that began in May 2010, boosting the Treasury market yet again.

As long as the Fed is pumping cash into dealer accounts, history tells us that stocks will get a bid. But history has no lesson on what happens when the market faces extreme levels of Treasury supply week in and week out. Sooner or later I would expect the correlation between Fed sending cash to the PDs and the direction of stock prices to begin to unravel as the Treasury soaks up all available cash. The growing gap between Fed liquidity and stock market performance in 2009 suggested that there was increasing drag. The combination of Fed pumping and FCB buying was enough to keep the stockpot boiling.

Commercial Paper outstanding showed big declines in 2009. The Fed's CPR (Commercial Paper Resuscitation) program did likewise, it was apparent that companies had little interest in borrowing. The Fed was pushing on the proverbial string, but as long as the Fed was pumping cash directly into the veins of the Primary Dealers, I wrote at the time that there was a good chance that the stock market would continue to get a bid. I expected that to change as the supply pressure on the Treasury market built, and as Big Finance and Big Business continued to raise equity capital and sell junk debt. Under the circumstances I expected that if the Fed was unable to prevent the shrinkage of its balance sheet, crisis conditions would return.

Ironically, the media pundits were worried about exactly the opposite problem—inflation as a result of the Fed not having a plan to reduce its balance sheet when the economy began to improve. The Fed's balance sheet actually shrank in parts of 2008 and 2009. I wrote that if the Fed's bout of shrinkage continued, inflation would be the least of our worries, and we could forget about an economic recovery any time soon.

But as Joe Granville said a long time ago, "What does that have to do with the stock market? Absolutely nothing." While I don't completely agree with Granny about that any more, it's still more about the cash, who has it, and what they are doing with it. The Fed was still pouring cash into the coffers of the PDs through March 2010, and they were in turn using some of it to buy stocks, hooking a new round of suckers in the process.

The Fed said when it announced its MBS buying program back in November 2008 that it their intent was to buy and hold. They lied. The Fed was buying AND selling MBS, and they were doing it on as much as a 3 month forward basis, which meant in essence that they could trade forward contracts without settling the actual paper. It took the Fed until July 16010 to settle all the forwards.

This smelled suspiciously like a giveaway to Fannie and Freddie, actually Uncle Sam in drag, and other favored players in the market. The Fed didn't reveal anything about pricing on these deals or pricing on the GSE or Treasury buys for that matter. So the public could not know whether it was getting screwed or not. It's a safe assumption that it was. In the end, it appears that the Fed bought little of the paper directly from Fannie and Freddie, but it's probably safe to assume that whomever the Fed bought it from got a sweet deal and was bailed out as a result. Ultimately the Fed ended up owning over a trillion in MBS paper backed by Fannie, Freddie, and other federal agencies. Ultimately, you and I as taxpayers are responsible for making good on the Fed's holdings. Those who were the original buyers of the paper already got theirs.

At the time the Fed announced its intent to buy longer term Treasuries back in March 2009, I wrote that it was possible that Fed buying of $10-12 billion of Treasuries weekly, along with another $5 billion or so of GSE buying would be enough to keep propping things up.

Faced with the mammoth increase in Treasury borrowing the Fed took a drastic step, announcing in March 2009 that it would pump $1.15 trillion in cash into the financial system over the next 6 months, effectively monetizing, directly or indirectly, the new Treasury supply that will be coming over that time. So the inflationists were right. The Fed printed. It was a conclusion that I too had reached, writing that in facing the coming tsunami of Treasury supply, the Fed faced the choice of "print or die". It chose "print".

The Fed knew that when this mountain of debt came to market it would force a wave of liquidation of other assets that would either crush the market, cause a Treasury auction to fail, or both, and ultimately shake the world's confidence in the ability of central banks to handle the problem. The Fed thus took the only step that remained to be taken. It decided to announce in no uncertain terms that it would provide enough cash to monetize all this debt. There would be no failed Treasury auction. And if the Fed could help it, there would be no more forced liquidation such as the one in September-October 2008, when the stock market effectively crashed.

When the Fed began its campaign, I was reluctant to conclude that Fed printing would be highly inflationary simply because I suspected that FCBs would have an equal or greater opposite reaction. They did not, but banks opted to keep enormous excess reserves on deposit at the Fed rather than deploy them in the economy. That effectively locked up the inflationary potential of that liquidity.

The liquidation trend in the markets caused money supply data to surge as cash poured in to institutional money market funds and non-transaction deposits in bank, much of it backed by new or expanded government guarantees. The illusion that these numbers represent money can continue as long as the holders do not demand cash. The assets to fund any large scale runs on the banks or money market funds do not exist. The Federal Government better hope that its ability to sell debt to fund the bailouts and backstops isn't curtailed, because if that happens, there will be no backstop.

The Fed faced an especially huge problem created by the FCBs dumping of up to $60 billion in GSE paper each month in the second half of 2008. The PDs had joined the fray, also dumping GSE paper hand over fist during that period. Add to that the fact that the GSEs had a reported $300 billion in notes and bonds coming due, and the Fed found itself faced with the threat of systemic collapse.

The Fed announced on November 25, 2008 that it would begin buying up $600 billion in GSE and MBS paper. It began buying the GSE paper in early December. In spite of that, GSE spreads to Treasuries began creeping up again. Late on the evening of December 30, the Fed announced that it would begin buying direct GSE issued MBS paper. The Fed intended to acquire ALL of this paper by the end of the first half of 2009. The purchases were made through Primary Dealers, who could participate as principals or brokers. The Fed said that because the paper was backed by Fannie, Freddie, and Ginny, and because it intended to engage in a buy and hold strategy, its risks were minimal. We know better. Much of that paper was, and is, trash.

In 2008, the Fed engaged the market in a circle jerk, sucking funds in from the banking system by paying interest on reserves only to lend those funds out to the system via the alphabet soup programs. But rather than reinvigorating the credit markets, they were sucking the lifeblood out of them with these programs. The money went into the system, then right back to the Fed via the buying of Treasuries, or depositing of funds at the Fed. Meanwhile the real economy was frozen out of this cycle, causing a worsening vicious cycle of deflation and liquidation.

The Treasury had dumped $1.2 trillion of new supply on the market from the end of April 9008 through November 2008, and yet rates and yields kept declining. The worse the US Government's finances became, the more Treasury debt that panicked investors bought. We knew that this wouldn't end well. We just didn't know when.

The Fed ended the game of pulling in reserve deposits to fund the bailouts by lowering the interest rate it paid on reserves effectively to zero when it cut the Fed Funds target range to 0 to 25 basis points. When we dig into the Fed's balance sheet it looked like they were trying to monetize through the back door of the CP market rather than buying Treasuries outright. However, they continued to attract massive deposits from the banks as a result of paying 1% interest on reserves, which was increasingly out of whack with a market where the real short term money rate was effectively zero. So the reserves poured in to the Fed, putting increased pressure on the market and on the Fed to recycle those funds back out via its alphabet soup programs.

Meanwhile FCBs and everybody else continued to flee the GSE market as they dumped more of that paper back on the market, causing spreads to Treasuries to balloon to record levels. That helped send mortgage applications crashing to their lowest levels in 8 years. That spurred the Fed into announcing late in 2008 that it would buy Agencies and MBS paper outright.

In the mid September to mid October 2008 period when new Treasury supply was running between $100 and $200 billion per week, stocks crashed. As I had warned would happen, stocks had to be liquidated as Treasury supply grew.

A big question from there was how the indirect bid for Treasuries would hold up. As we have seen in GSE paper, the FCBs pulling out of that market caused a disaster, with spreads to Treasuries widening, forcing the Fed into the breach. When the panic buying of Treasuries subsides, including the buying coming from FCBs, then we should see the whole rate spectrum begin to rise, tightening the financial system's noose around the world economy's neck.

As the market begins to realize this, we could face the ultimate collapse, the collapse of US Government finance. The world as we know it would be changed in ways that we cannot imagine. Even if the US Government were to reverse course now and say, flat out, no more bailouts, no more Treasury borrowing to finance bailouts, it's probably already too late. The government has already transferred billions of risk on to its own books, and ultimately ours.

It's one thing to allow private capital markets to fail. It's another thing entirely to foster, foment, and cause the failure of government. A loss of confidence in financial markets is one thing. A breakdown of confidence in government would mean societal changes that we never dreamed of.

Treasury Auctions, Federal Revenues and Supply Impact, and Treasury Yields See http://wallstreetexaminer.com/money/treasury072812.pdf for latest update

Open Market Operations (OMO) and Monetary Policy Actions

I have moved some of the background discussion for 2009-2011. If you were not a subscriber during this period, you may want to review it. http://wallstreetexaminer.com/money/fed2009-2011.pdf http://wallstreetexaminer.com/money/fFOMC-history2009-11.pdf. Other historical discussions which are still directly relevant are reprinted below.

(December 2009) The Fed announced that it would begin **reverse repo operations** at the end of November 2009. http://www.ny.frb.org/markets/opolicy/operating_policy_091130.html

It was odd for several reasons.

First it was a follow up to the previous month's announcement of practice reverse repos with play money. Evidently, the new one would be with real money, but in such small amounts as to have no effect on monetary policy. In other words, we're going to practice tightening, but we're going to stay loose. According to the Fed, they needed to "practice" in order to be prepared when the time comes to do this for real. Can you believe it? They needed to practice temporary open market operations, their only policy tool for eons until 2007.

They needed to practice.

Right.

This was a shot across the bow to warn those bad bad speculator people to stop selling the dollar short and buying "stuff" with the proceeds. How dare they circumvent the Fed's easy money policies by running up commodity prices and raising inflationary fears! They will be forced to get with the program or else. The Fed would show THEM! Yes it would. It would drain reserves from the system, which would curtail the speculators' ability to sell dollars and buy stuff. The dollar would reverse and head higher. Commodity prices would head down and interest rates would rise.

This was the threat that the Fed would hold over the market with that announcement. It was a "transparent" attempt to jawbone the players into thinking that, so that they would stop speculating on things like gold, oil, and industrial and agricultural commodities, forcing their prices higher in an atmosphere of weak end user demand.

I saw this as just more proof that these clowns are completely delusional. If it weren't so pathetic and frightening, it really would be comical. Past history tells us that if the Fed does not take real, concrete, even draconian action to reduce the size of its asset base, the speculators will not believe it, and they will keep on doing what they're doing. Eventually, that WILL force the Fed to tighten the screws. Past history again tells us that the Fed will tighten gradually, always one step behind what really needs to be done until the market simply forces its hand.

By telling the market that it was practicing for that it hoped to cow the speculators into submission. That won't work. As long as the gunslingers can borrow dollars at zero cost, they're going to do it. The Fed will not be able to jawbone anyone into doing anything differently. It's a big game of chicken, and the Fed is a chicken without a head. Buck buck buck buck. Buck buck buck buck.

If the Fed was going to borrow this cash from money market funds via these reverse repos, I don't see how that could work. The MMFs need all the cash they have to meet the steady drumbeat of withdrawals that they have been facing. If the Fed really tried to follow through with this, then these operations would put even more pressure on money market funds. The Fed would have to offer a very high interest rate in order to enable the MMFs to draw reserves back from the banking system. That would be a non-starter.

The Fed's little experiment with reverse repos lasted only two weeks in December 2009. I fail to understand how the Fed expects to borrow cash from money market funds, since those funds hold very little in the way of cash deposits. Virtually all of their assets are in short term paper. It would seem impossible to use this as a tool to drain reserves.

That's why the Fed proposed a **term deposit facility** at the end of 2009. It wanted to keep that trillion or so in bank reserves locked up on its balance sheet should the day come where the banks see loan demand from creditworthy borrowers. The Fed will simply offer the banks more interest on a risk free basis than the banks can get by lending. That should be a fun experiment. Of course it's probably a long way off, since under current conditions no one of sound mind wants to borrow. The pundits keep talking about how small businesses have trouble getting credit. Why would any small business want to invest borrowed money in any project when their sales stink and they have too much capacity as it is?

The Fed conducted its first reverse repo on December 3, 2009 and if they hadn't announced it in advance no one would have noticed it. The operation totaled just $180 million, on Treasury collateral, for a term of 3 days expiring Monday 12/7. The Fed paid 16 basis points. It was reported to be a tri party repo, meaning that a third party, presumably a money market fund, provided the cash. In such operations the primary dealers would act as middle men, and there would be no impact on their cash. They conducted a couple more of these "practice" operations in late August. God knows why.

(4/18/11) The Fed put its "operational readiness" reverse repo operations back in cold storage last week. The previous week the Fed suddenly got serious about these practice operations, conducting one every day. My opinion has not changed since the program was first announced in November 2009. It's a con and a sham.

(4/18/11) Apparently, by engaging in all this "practice," the Fed is trying to send the market a signal that it is really really serious about fighting inflation. Meanwhile, the fact is that reverse repos with money market funds for all practical purposes can never be used to drain large amounts of cash out of the financial system. This is all about the "show," not about the "dough."

August 2010 FOMC- Various Fed governors and Bernanke himself had sent up trial balloons regarding QE II. Market pundits had been excitedly making pronouncements that the Fed would announce something any day now along those lines. Bernanke was a little more cautious with his words, suggesting that while the Fed still had tools at its disposal, there wasn't a need to use them at this time. My sense was that there was more of a debate under way at the Fed than they were letting on, and that they were frozen in confusion about how to proceed. I am biased of course. I tend to have a negative view of the Fed's competence.

While all this speculation about the Fed's next move was raging, the Fed's balance sheet was quietly shrinking, week in and week out.

By early August the data had deteriorated so much that Bernanke panicked, just as he always does when it becomes clear that all of his best laid plans have turned to dust. He decided that the Fed would have to start buying Treasuries again. But instead of soothing the market, it freaked. The paragraphs below summarize my take on the FOMC's decision as originally posted in the update of August 11.

(8/11/2010) Seven or eight months ago the Fed was worrying publicly about how it was going to shrink its balance sheet because that's what the pundits were worried about. So they started a pilot program to do tri party reverse repos with money market funds. Then the worry focused on the massive reserve balances on the Fed's balance sheet so the Fed developed a program of interest bearing term deposits to keep the money locked up on the Fed's balance sheet. I said at the time that these ideas were laughable and absurd because the payoffs from their MBS holdings would shrink the balance sheet, including the reserve balances involuntarily. The Fed didn't have to do anything, and they would shrink by themselves.

The tri party repo idea was even more ridiculous, since the idea was to drain cash from money market funds. The market was already doing that. The money market funds hold very little cash. It's almost all short term paper. How were they going to lend large amounts of cash to the Fed when they need what little cash they have to fund redemptions?

Fast forward to half a year later and the Fed announces a program designed to prevent the balance sheet from shrinking. They will buy exactly enough Treasuries to offset the maturing GSE paper and the MBS that are being paid off. The particulars are here-
http://www.ny.frb.org/markets/opolicy/operating_policy_100810.html

The important thing is that these will be standard Permanent Open Market Operations conducted with the Primary Dealers. This is high powered juice for the markets, unlike the MBS purchases and the old alphabet soup programs. The original MBS purchases mostly bypassed the PDs to deal directly with other holders of MBS, whose primary business wasn't primarily trading.

Am I allowed to say that this shows yet again the Fed is clueless, delusional, incompetent, and only acts when the shit hits the fan? Here we were, 6 or 7 months from the time that the Fed was floating all kinds of trial balloons about shrinking the balance sheet, and they are forced to enact a program to stop it from doing just that.

These buffoons, these clowns, these jerks, had no clue that the picture of growth in the economy was nothing more than a flimsy Hollywood movie set, produced, directed, and sets designed by Tim Geithner and Ben Bernanke, with the Fed fronting the money and the American middle class ultimately left holding the bag. Elderly savers have been viciously destroyed in this process. The benefits that younger workers have paid for are being stolen.

What a disgrace these people are. In a just world, they would be facing criminal charges, but in this Wonderland NO ONE is ever held responsible for their criminal malfeasance. Instead, all we do is bail out all the bond holders and the big Wall Street banks, at taxpayer expense, so that the criminal executive class can go right on skimming, and then lining the pockets of the politicians. Meanwhile, the fools who keep lending the Treasury the money to play these scams lend even more money. It's so outrageous, I just want to cry.

After taking a day to mull over the net effect of this program, I decided that it won't amount to all that much. The GSEs were originally purchased from the Primary Dealers. About $47 billion of that paper will mature between August 2010 and August 2011. That would be about $4 billion a month in replacement cash to the Primary Dealers. Had the Fed not taken this step, the PDs would have been under greater liquidation pressure as more Treasury supply hits the market. This move will alleviate some of that pressure.

(8/21/10)- The big deal is in the replacement of the prepaid MBS. Gross prepayments started out with about $13 billion paid off in 3 weeks in late July-mid August. Let's call that a rate of $17-$18 billion a month that the Fed would need to make up with its Treasury purchases. Primary Dealers were not the primary sellers of the MBS paper to the Fed. Conversely, the Fed's Treasury purchases are through Permanent Open Market Operations, in other words direct purchases from the PDs. So when the Fed buys $17-$18 billion this month in Treasuries to replace the paid off paper, this is new juice for the PDs. OK, so it's not the $50 billion a month in Treasury purchases that we saw from March to September of last year, but it is something.

(9/17/10) The Fed announced on Monday 9/13 that it would purchase $27 billion in Treasuries over the next month to replace maturing GSEs and prepaid MBS holdings. That's 50% higher than the amount of purchases in the first month of the program. The Fed is playing catch-up as MBS prepayments have outrun their initial estimates. What else is new? The Fed has shown itself to be utterly incapable of forecasting or estimating virtually anything accurately.

(3/12/11) The Fed's POMO schedule for March-April calls for another $102 billion in purchases, which is an increase of $5 billion from the previous month's allotment. The Fed scheduled $80 billion for the proration needed to reach the $600 billion QE2 target. The other $22 billion is the amount that the Fed's black box says will be needed to replace the MBS paydowns and GSE maturities that will occur this month. That may be more than they'll actually need given the collapse in refi activity, but if there's a panic into Treasuries, then rates would come down and refi activity would pick up. At any rate, it's more than enough to cover virtually all of the expected Treasury supply for the next month. So the Fed continues to monetize the debt and provide fuel for the speculative inflationary fires, even though lately the banks have chosen to put that fuel in storage.
http://www.ny.frb.org/markets/tot_operation_schedule.html.

(1/28/11) The cash payments for the Treasury purchases will continue to flow into Primary Dealer trading accounts, which will continue to push energy and commodity prices up. That will worsen the negative feedback loop that will continue to work in opposition to the Bernank's ultimate goals, which were lower mortgage rates and a growing economy that will lead to more hiring. Instead, it will lead to increased cost pressures that will squeeze consumers and producers and force the economy to slow. Meanwhile the program should keep a bid under stock prices adding to the sense of complacency.

Bernanke and the Sycophones, aka the FOMC, have decided to pretend that this inflation does not exist and therefore has no impact on the economy. They are hell bent on continuing this money printing until the bitter end. I see no reason why the dealer community and others with cash available would not continue to speculate in commodities, preferring to hold "stuff" rather than constantly depreciating dollars. This would seem to be a classic Austrian Economics crack up boom, just like in 2007.

We are already possibly seeing signs of the pressure on the economy in a slowing rate of corporate tax growth over the last 3 months as business profits begin to reflect the cost squeeze (chart below). Russ Winter also has been chronicling the anecdotal evidence. His most recent piece is here.
http://www.wallstreetexaminer.com/blogs/winter/?p=3593 He's been covering this in greater depth in his Actionable service, which you can add to your Professional Edition subscription for half price ($35 quarterly) if you send me an email requesting that the service be added.

If it hasn't already, the Fed will eventually realize that it has created a Catch 22. It will panic and continue its long term pattern of irrational, reactionary policy responses. My guess was that it would be forced to wind down QE2 ahead of schedule. Based on the January 26 FOMC statement however, it seems that they've decided to keep their heads buried in the sand, irrationally pretending that the commodities inflation does not exist. If it continues to rage, the March meeting will give the FOMC another opportunity to face reality.

(1/14/18) One of the goals Bernanke said he wanted was a higher rate of inflation. Be careful what you wish for Ben. He is getting that rise but it is in the area of inflation that he ignores- food and energy.
The "core" rate, which measures only those things that aren't inflating, has given the Fed the impression that inflation is too low. As a result, Bernanke, supported in his self delusion by his sycophant cohorts, seems unable to make the connection between his actions and skyrocketing commodities inflation. Here are a couple of examples with the charts beginning around the time the Fed began buying Treasuries back in August.

(3/12/11) I've added the COTs to these sample commodity charts, including net positions and open interest. There's been a correction in the past week, but over the longer run since QE2 began, open interest has soared, and the big specs have mostly gotten longer and longer, but lo and behold the producers of the stuff (commercials) have been massively short. That shoots down the Fed's argument that these price increases are based on economic demand. It's clear that the producers don't see it that way, and that the price increases have been driven purely by massive speculation by the large traders. I think it's safe to assume that the primary dealers are playing a role in this, either through their own direct speculation, or through their financing of the funds doing the buying.

(5/13/11) The commodity exchanges have begun moving to curb the speculation that led to the parabolic moves in many commodities, beginning with silver. This campaign started within days of Bernanke protesting too much (methinks he didst) at his press conference that the Fed had no control over commodity prices, and that the price increases were "transitory." On count one, he lied. Clearly, the phone lines between the Fed and the exchanges were buzzing in the days that followed. On count two he told the truth, because he was lying on count 1. The first broadside was against silver. Crude oil and corn followed. They have yet to move against others. They may or may not need to; the contagion of margin calls, and the shift in sentiment they've triggered, may do the trick.

7/24/12 We continue to watch the commodities to see if they come down enough to give the central banks maneuvering room to do more printing. Energy and metals have bounced a little after they had weakened to major support levels. That bounce has now met resistance and the intermediate downtrends remain intact. I believe that the last support levels would need to be broken for the central banks to feel they have room and reason to act. A rally in those commodities would probably keep the Fed on hold.

Due primarily to the drought and heat wave in the central US, grains and soy have gone ballistic. If the ags are making new highs, that's a real problem for the rest of the world, but not so much for Europe, the US, UK, and Japan. I suspect that the central bankers are probably more focused on the industrial commodities, energy and metals.

A weather driven rise in agricultural commodities would probably not stop the Fed from taking more aggressive action if the industrial commodities were breaking down. But until energy and industrial commodities do break down, the Fed would run a bigger risk in doing more QE than not doing it, so I think that Bernanke will continue to be cautious. He said as much in his recent Senate testimony.

Charts below show price trend, and COT net positions reported by the CFTC.

Continued on next page


SI - Silver - Weekly Continuation Candlestick Chart
Op:27.685, Hi:28.110, Lo:27.515, Cl:27.985
TMA (13): 28.122
TMA (52): 32.061
The Wall Street Examiner
Be prepared. Stay ahead of the herd.
Wallstreetexaminer.com
(c) Barchart.com
Vol: 42,771
Open Interest: 97,885
Momentum (13): -2.504
Large Spec: 8159
Small Spec: 7296
Comm Spec: -15455
Producers: -33585
Swap Dealers: 18130
Managed Money: 3015
Other Report: 5144
Oct 10
Jan 11
Apr
Jul
Oct
Jan 12
Apr
Jul


HG - High Grade Copper - Weekly Continuation Candlestick Chart
Op:3.4290, Hi:3.4555, Lo:3.4025, Cl:3.4150
TMA (13): 3.4281
TMA (52): 3.6589
The Wall Street Examiner
Be prepared. Stay ahead of the herd.
Wallstreetexaminer.com
(c) Barchart.com
Vol: 63,948
Open Interest: 113,233
Momentum (13): -0.3100
Large Spec: -13069
Small Spec: -10277
Comm Spec: 23346
Producers: -24098
Swap Dealers: 47444
Managed Money: -7636
Other Report: -5433
Oct 10
Jan 11
Apr
Jul
Oct
Jan 12
Apr
Jul


CL - Crude Oil WTI - Weekly Continuation Candlestick Chart
Op:90.14, Hi:90.95, Lo:89.40, Cl:89.81
TMA (13): 87.32
TMA (52): 98.62
The Wall Street Examiner
Be prepared. Stay ahead of the herd.
Wallstreetexaminer.com
(c) Barchart.com
Vol: 439,462
Open Interest: 1,105,586
Momentum (13): -9.57
Large Spec: 190693
Small Spec: -828
Comm Spec: -189865
Producers: -59452
Swap Dealers: -130413
Managed Money: 124133
Other Report: 66560
Oct 10
Jan 11
Apr
Jul
Oct
Jan 12
Apr
Jul

ZS - Soybeans - Weekly Continuation Candlestick Chart
Op:1645-2, Hi:1672-0, Lo:1642-0, Cl:1656-2
TMA (13): 1414-4
TMA (52): 1277-1
(c) Barchart.com
1800-0
1700-0
1656-2
1600-0
1500-0
1400-0
1300-0
1200-0
1100-0
1000-0
900-0
Vol: 262,371
Open Interest: 648,481
400K
300K
200K
100K
0K
900K
800K
700K
600K
500K
400K
Momentum (13): 258-0
200
0
-200
Large Spec: 255959
Small Spec: -3594
Comm Spec: -252365
200000
100000
0
Producers: -313702
Swap Dealers: 61337
Managed Money: 230933
Other Report: 25026
200000
0
Oct 10
Jan 11
Apr
Jul
Oct
Jan 12
Apr
Jul

(6/6/11) Interestingly, over the past 10 days, the CME reduced margin requirements on first, stock index futures, then Treasury futures. Again, I don't think that this was simply the exchanges acting on their own, and I do think there's a message in these actions. The Fed wants commodity prices lower and stock and bond prices higher, and it will pull the strings to try anything to make that happen. In the end, without QE, the manipulation cannot succeed. Therefore, I think we will see a return of a modified QE in the not too distant future. Look for it to include MBS again. The Primary Dealers have been accumulating that crap hand over fist over the past 2 months.

Meanwhile, we have already seen much of what I was discussing with you back in January and February come to pass.

(2/13/11) I believe that skyrocketing commodity prices are the true measure of the Fed's policy. QE2 is encouraging massive speculation in these commodities. That in turn is squeezing consumers and businesses. The Fed's focus on the core rate, which understates inflation, will soon be diverted as the headline CPI number begins to soar. The MIT Billion Prices Project, which measures prices of thousands of retail prices in real time, shows that prices have risen at an annualized rate of 5% since August when the Fed began the first phase of QE2. The recent acceleration should show up in the headline CPI measure this month.

(1/14/18) Over time this will cause the increases in economic data to slow and then reverse. The Fed has a very brief window where it can declare "mission accomplished," stop the printing and walk away. If they don't do that, they will be in a box with no way out. One Fed official already went on record this week, announcing that it was time to review the policy in light of the evidence of strong economic growth. If this celebratory chorus grows, watch for the Fed to begin scaling back the printing.

If they don't move in that direction, the inflationary fears and market responses will begin to wreak havoc on the bond market, commodities might go into a parabolic blowoff, and skyrocketing gas prices would stop the consumer in his tracks. I would also have to wonder how FCBs would respond. If they cut back enough, the Fed would be running in quicksand in its efforts to keep the stock market bubble inflated. So my hunch is that the Fed will begin to scale back on QE sooner rather than later.

(6/6/11) At the end of the buying program, they'll go cold turkey, buying only enough to replace the MBS paydowns and GSE expirations. That should only be around $10-15 billion per month. While the market's reaction may not be immediate, I expect it to be profound, with losses primarily hitting stocks as the government's manipulators and dealer henchmen attempt to use liquidation of equities to support the Treasury market. I'm not sure that will work for long. Treasuries should begin to weaken before too long. We'll have to watch the technicals closely.

(8/8/11) The dilemma for the dealers was that they were short Treasuries from the end of last year until the end of July and they had been getting pummeled on those positions. Their short covering exacerbated the uptrend in Treasuries, and in my opinion, the losses they incurred, along with the continuing requirement to absorb mass quantities of Treasury paper twice a month, made them unable to maintain orderly markets in equities once the Fed stopped buying.

(8/29/11) Bernanke did create the expectation of Fed action with his speech at Jackson Hole, reporting that the September FOMC meeting would be expanded from one day to two. This is what's called making monetary policy "expansionary." Just imagine how the market would have reacted if Bernanke announced a 3 day meeting.

Clearly, this would have been inflationary, so he stuck to two days. Jimbo over at Capitalstool.com called it Synthetic QE3, where the market gets to enjoy the effects of QE without the actual QE. http://wallstreetexaminer.com/2011/08/29/synthetic-qe-3/ However, my position would be that without actual cash to back it up, the effects would quickly disappear. In this case, the cash appears to be flowing in a tidal wave into US bank accounts as capital flees Europe. It creates the illusion that the market is "pricing in" Fed action, but instead, it is a perverse measure of crisis. Ironically, in the short run, it could prevent the Fed from acting, because it will present the illusion that all is well in the US. That will plant the seeds for the next crash.

(9/22/11) The Fed's new policy announced at the September 21 meeting, dubbed Operation Twist, calls for the exchange of $400 billion of the Fed's shorter term holdings for $400 billion of longer term holdings. The net impact on Primary Dealer trading accounts will be zero. The overall impact on the market should be zero. The mechanics and tentative operation schedule are posted on the NY Fed website.

The Fed also announced a change in how it will replace maturing GSE paper and MBS paydowns. Instead of purchasing Treasuries from the Primary Dealers in amounts equivalent to expected GSE and MBS portfolio shrinkage, the Fed will now replace that paper with purchases of GSE backed MBS paper from the Primary Dealers. The net effect on dealer trading accounts will be essentially unchanged from the prior program of purchasing Treasuries. The monthly amounts will depend on the MBS paydown rate, which had been about $10 billion a month. Over the past 4 weeks that increased to $13 billion as low mortgage rates stimulated refi activity. These amounts are too small to have a significant positive impact on overall market liquidity.

(7/16/11) We know that the panic flows of capital into the US are absurd, but to many investors the US looks like the best choice out of a bunch of horrible options. As long as that continues, the real problem of a massive underlying supply demand imbalance will be obscured.

The Fed and Treasury have, with the help of the Europanic, succeeded at Job One, keeping yields down during big long term auction weeks, mostly at the expense of the stock market. (6/26/11) There's a steamroller running amok in Europe without a driver and it looks like it's headed this way. So the camp that thinks the end of POMO means the immediate end of the Treasury rally could get run over.

(8/15/11) The current monthly POMO schedule was posted on Wednesday, August 10. It calls for purchases of $14 billion over the course of the following 4 weeks to offset expected paydowns of MBS and scheduled GSE maturities, thereby holding the Fed's balance sheet nearly level. Level is not good enough when the Treasury is pounding the market with $120-150 billion a month in new supply. If the central banks don't absorb it, something has to be liquidated to pay for it.

(10/2/11) The Fed posted the schedule for the first month of Operation Twist. This replaces the previous schedule that ran through October 12. It does not include the schedule for purchasing MBS to replace the paper being off. http://www.ny.frb.org/markets/tot_operation_schedule.html

7/10/12 At the June FOMC meeting, the Fed extended both Operation Twist and the MBS purchases with no announced changes to the programs, but the NY Fed subsequently announced operational changes that will have a minor impact. First, the Twist schedule for July is no longer a dollar for dollar swap. The schedule calls for $45 billion in purchases and just $39 billion in sales, leaving the Primary Dealers with an extra $6 billion to play with. That's minuscule in the big picture. The Fed will make up the difference with redemptions of maturing short term securities on its balance sheet. That's the second change in the execution of the policy. The kicker is that it will redeem not just the $6 billion that it will not be buying from the dealers to offset its purchases. It will also redeem another $14 billion in maturing holdings, for $20 billion in total redemptions.

This is no longer a wash on either the dealers balance sheets, or the Fed's. The dealers will have more cash on their balance sheets because the Fed will be buying $6 billion more Treasuries from them than it will sell to them. Second, since the Fed will redeem $20 billion in securities from the Treasury, its balance sheet will *shrink*! This acts to sterilize whatever growth might result from, for example, the currency swaps with foreign central banks. The Fed's balance sheet has been flat since last June. That will remain the case now at least through July. If there's no growth in swaps or other programs, the Fed's balance sheet will shrink slightly in July.

At the same time it means that the Treasury will need to sell additional debt to pay off the Fed because the Fed will not be rolling over those holdings. It's not clear if this extra $20 billion a month in Treasury borrowing is baked in to the TBAC supply forecast. Even if it is not, it is not enough to have a material impact on the market.

The Fed's changes to Operation Twist mean that its balance sheet should shrink by $20 billion by the end of July.

The Fed just released its August schedule. The comments above again apply. The Fed will tilt toward cashing out the Primary Dealers for $6 billion in August, buying that amount more than it is selling to them under Operation Twist. It will also shrink its balance sheet by redeeming $12 billion in Treasuries, cash which the Treasury will need to raise in the market. Since the Fed has already redeemed all of its bills and now holds only notes and bonds, the remaining redemptions would need to come from longer term paper. The Fed made no explanatory comment.

Across all operations in the schedule listed below, the Desk plans to purchase approximately **$44 billion** and sell approximately **$38 billion** in Treasury securities over the month of August. The Desk will redeem approximately $12 billion in Treasury securities.

PURCHASE OPERATIONS				
OPERATION DATE[1]	SETTLEMENT DATE	OPERATION TYPE	MATURITY RANGE	EXPECTED PURCHASE SIZE
August 2, 2012	August 3, 2012	Outright Treasury Coupon Purchases	02/15/2036 – 05/15/2042	$1.50 - $2.00 billion
August 6, 2012	August 7, 2012	Outright Treasury Coupon Purchases	08/15/2020 – 05/15/2022	$4.50 - $5.50 billion
August 7, 2012	August 8, 2012	Outright Treasury Coupon Purchases	08/15/2018 – 05/15/2020	$4.25 - $5.00 billion
August 8, 2012	August 9, 2012	Outright Treasury Coupon Purchases	02/15/2036 – 05/15/2042	$1.50 - $2.00 billion
August 9, 2012	August 10, 2012	Outright TIPS Purchases	01/15/2019 – 02/15/2042	$1.00 - $1.50 billion
August 13, 2012	August 14, 2012	Outright Treasury Coupon Purchases	02/15/2036 – 05/15/2042	$1.50 - $2.00 billion
August 14, 2012	August 15, 2012	Outright Treasury Coupon Purchases	08/15/2020 – 05/15/2022	$4.50 - $5.50 billion
August 16, 2012	August 17, 2012	Outright Treasury Coupon Purchases	02/15/2036 – 08/15/2042	$1.50 - $2.00 billion
August 20, 2012	August 21, 2012	Outright Treasury Coupon Purchases	08/31/2018 – 08/15/2020	$4.25 - $5.00 billion
August 22, 2012	August 23, 2012	Outright Treasury Coupon Purchases	02/15/2036 – 08/15/2042	$1.50 - $2.00 billion
August 23, 2012	August 24, 2012	Outright Treasury Coupon Purchases	11/15/2022 – 02/15/2031	$1.50 - $2.00 billion
August 27, 2012	August 28, 2012	Outright Treasury Coupon Purchases	02/15/2036 – 08/15/2042	$1.50 - $2.00 billion
August 28, 2012	August 29, 2012	Outright Treasury Coupon Purchases	11/15/2020 – 08/15/2022	$4.50 - $5.50 billion
August 29 , 2012	August 30, 2012	Outright Treasury Coupon Purchases	08/31/2018 – 08/15/2020	$4.25 - $5.00 billion
August 30, 2012	August 31, 2012	Outright Treasury Coupon Purchases	02/15/2036 – 08/15/2042	$1.50 - $2.00 billion

Continued on next page

SALE OPERATIONS				
OPERATION DATE1	SETTLEMENT DATE	OPERATION TYPE	MATURITY RANGE	EXPECTED SALE SIZE
August 3, 2012	August 6, 2012	Outright Treasury Coupon Sales	01/15/2013 – 06/30/2013	$7.00 - $8.00 billion
August 10, 2012	August 13, 2012	Outright Treasury Coupon Sales	07/15/2013 – 01/31/2014	$7.00 - $8.00 billion
August 15, 2012	August 16, 2012	Outright Treasury Coupon Sales	02/15/2014 – 08/31/2014	$7.00 - $8.00 billion
August 21, 2012	August 22, 2012	Outright Treasury Coupon Sales	09/15/2014 – 04/30/2015	$7.00 - $8.00 billion
August 24, 2012	August 27, 2012	Outright Treasury Coupon Sales	05/15/2015 – 11/15/2015	$7.00 - $8.00 billion

The next release of the tentative outright Treasury operation schedule will be at 2 p.m. on August 31, 2012. At that time, the Desk will also publish information on transaction prices for securities included in the operations listed above.

The Fed's securities holdings dropped by $6.9 billion in the week ended 7/25/12 as it redeemed bills, and saw net paydowns of MBS holdings. That was the third decline in a row. The Fed has had no public discussion of the balance sheet shrinkage.

The Fed continues to settle the bulk of the forward MBS purchases around mid month each month while starving the market at the end of the month when the Treasury has a big settlement of notes. Last week it appeared to settle $5.2 billion of forward MBS purchases, but paydowns were apparently around $16 billion, for a net paydown of $9.7 billion. It currently has $31.4 billion in MBS forward purchase commitments outstanding.

7/13/12 The Fed had been buying just $25 billion a month in MBS in May and June. That was the heart of the semi dry spell that we expected as a result of the brief spike in yields back in April. Since then yields have dropped to new lows and there have been a surge of mortgage refis that I expected to result in increased MBS paydowns soon. The Fed slightly increased the purchase rate to $27 billion in the monthly schedule posted on Friday, July 13. The purchase rate should increase in August and September. It is doubtful whether the increases will be large enough have a material impact on the markets.

4/23/12 The Primary dealers are loaded with cash at mid month, but looking for cash at the end of the month when they have to settle another big round of longer term Treasuries. That means they need to do some selling each month toward the end of the month. When they don't have Fed help, and they need to support Treasury prices, they sell stocks.

3/23/12 As long as these MBS settlements continue, currently indicated to be through August, I can't see the markets selling off too much. The $25 billion a month the Fed is now buying isn't much relative to the heydays of QE1 and QE2, but it's probably enough to stop a meltdown, especially with a couple of trillion in excess reserves just lying around at the Fed and ECB. I just can't see a major meltdown under the circumstances. Something would have to change. We'll just need to keep an eye out for what that might be. My guess at the moment would be raging commodity inflation, but that's just a guess. Something will come along. My job is to spot it early enough to take the appropriate action.

4/1/12 The MBS purchase program ends in June but the settlements will continue until August. Meanwhile, the Fed's GSE holdings will continue to mature at the rate of about $2 billion per month for the next 12 months and MBS paydowns will continue, probably at the rate of $10-12 billion per month as long as mortgage rates remain at current levels or higher. The Fed will need programs to replace those disappearing assets. It will not want more balance sheet shrinkage. So we should expect at least small programs to keep the balance sheet stable. Those programs will pump $10-15 billion per month into Primary Dealer accounts, which is about half the current rate, and not enough to keep bull markets alive in both stocks and bonds, assuming the ECB is in a similar mode. One or both markets will feel some pressure from time to time at that low a level of Fed support.

The question is whether the Fed (or ECB) will come with a bigger program to continue to prop the market. That will depend on how weak the economy gets and whether commodity prices weaken enough to allow the Fed to do more printing. At this point commodities have not backed off enough to allow a major QE.

The MBS paydowns have less impact than the purchases, because they do not involve transactions with Primary Dealers. The purchases are direct injections of cash into Primary Dealer accounts, which directly impacts the markets, while the paydowns simply reduce reserves in the banking system generally, with only a weak and indirect link to the markets.

2/20/12 Looking ahead, if bond yields rise, the pace of refis will slow and the Fed will schedule fewer MBS purchases at the same time as Treasury borrowing will soar in May and June. The month end periods of those two months are likely to see some weakness. How much will depend again on how much Treasury supply the market faces, and other factors.

The Fed's total securities holdings are down by $44.8 billion since December 21, 2011. The Fed had pledged to keep its holdings steady under Operation Twist. The failure to do so appears mostly due to the delayed settlements of the MBS purchases, resulting in a mismatch between the paydowns and the replacement purchases. Since the Fed has stopped growing the SOMA in June 2011, stock prices have been virtually unchanged.

4/24/12 10 year yields have been plunging. If that continues, there could be another mini-refi boom that would increase paydowns and require the Fed to increase its purchases. We're not there yet, but it's something to think about as we watch the decline in yields. If the number of refis expand, the Fed will be settling larger block purchases of MBS about 3 months after the surge in refinancing. At this point that would be after the end of the current program. Bet on some kind of extension.

12/22/11 The first large MBS settlement took place in the week ended December 14 when the Fed finally began to settle the MBS purchases that it had made in October and November. Net MBS settlements totaled $31 billion during the week ended December 14. These were purchases that had taken place under forward contracts that the Fed made with Primary Dealer sellers. Those purchases are scheduled in advance and confirmed in postings on the NY Fed website every Thursday. Those postings include the issues and amounts purchased as well as the settlement month, but not the exact date.

Regardless of whether the settlements are scheduled weekly or once or twice a month, to the extent that the capital flight from Europe into the US continues, the MBS purchase settlements will be a little extra gravy each month possibly helping to put a bid under stocks. However, should the buying panic out of Europe and elsewhere subside at all, for any reason, the $25 to $30 billion a month in MBS purchases would be insufficient to absorb $100-150 billion per month in new Treasury supply. The question now is whether the ECB's immense long term refinancing operations of hundreds of billions of Euros injected into the European banking system will be enough to sufficiently calm fears to begin to stem the capital outflows from Europe.

ECB data on bank deposits is currently available only available through October. On a Eurozone wide basis, deposits fell by over $400 billion in October. There were large outflows from the southern periphery nations. More current data is not available for the EZ as a whole.

1/9/12 I use deposits in US based subsidiaries of foreign banks as a proxy for European bank deposits. That data, covered in another section of this report, is available on a weekly basis with a one week lag from the Fed. It showed a run on deposits through November, but there were signs of stabilization at the end of November and early December, and by the end of December those deposits were rising. That followed the massive ECB Long Term Refinancing Operation (LTRO) of December 21. The rise in deposits is probably a reflection of the flows from that operation, rather than an indication of a lessening of stresses.

If the outflows from Europe to the US should slow, then a Treasury market decline would seem inevitable. Even $40 billion a month in peak MBS settlements will absorb only about a third of the new Treasury supply each month. The Fed's MBS purchases will actually subside as the current refinancing wave runs its course. If Treasury yields and thus mortgage rates rise at all, the MBS paydown rate would drop back to around $10 billion a month. Under the current program the Fed would lower its rate of purchases accordingly, barring an announced policy change. In fact, if yields begin to rise, that would force the Fed's hand toward further easing.

Currently at $2.595 trillion, the SOMA is now $59 billion below the Fed's target of $2.654 trillion. This gap had ranged from $13 billion on December 21 to $56 billion in the weeks ended February 8 and April 18. This is a new record, which should widen further in August as the Fed redeems more of its SOMA holdings, barring a new purchase program announcement on Wednesday.

3/5/12 As the MBS settlements continue through the balance of the MBS replacement program, the gap between the target and actual size of the balance sheet should vary until the operations come to a conclusion. The settlements will then continue for another 6-8 weeks, during which time the gap should be closed. Later this summer, we and the Fed will be faced with the issue of what comes next—to QE or not to QE. That is the question.

This weekend Bernanke leaked a story through his fair haired boy Jon Hilsenrath of the WSJ that the Fed would do nothing for 6-9 months. He's hemmed in by the commodities rally. Bruce Krasting posted a good piece covering this. http://wallstreetexaminer.com/2012/03/04/bernanke-leaks-spoils-the-punch/

1/30/12 Because the MBS settlements are a month or two behind the purchases, the cash would continue to flow into the market for about two more months. Treasury yields have fallen again which should keep the pace of refis, and thus the pace at which the Fed buys MBS relatively strong. Bernanke's pledge to keep ZIRP in place through 2014 was a nice ploy to keep the lid on Treasury yields which threatened to break out to the upside. The question is what the half life of those pledges is. At some point, the players will look past them.

1/21/12 The Fed continues Operation Twist, with purchases of longer dated Treasury securities offset by sales of short dated securities. The decline in the Fed's Treasury holdings is the result of something more than just the offset timing of purchases and sales under Operation Twist.

(10/18/11) These operations are a wash for the PDs and for the system as a whole, so there's no need to go into detail on the amounts, which in round numbers have totaled roughly $9 billion in purchases and $9 billion in sales per week. You can find the particulars of the daily operations at this link. http://www.ny.frb.org/markets/pomo/display/index.cfm?showmore=1&opertype=orig.

6/19/12 As a result of the European panic and capital flight into Treasuries, in May yields finally fell below the 1.70 level on the 10 year, where they were when Operation Twist was announced. Through most of the ensuing months yields remained above the levels they were when the program began.

The mainstream media and Wall Street pundits have now universally concluded that Operation Twist forced rates lower. This is a dangerous idea because it's wrong, and it embeds a false expectation in the market. Twist did not force yields lower. Whether it suppressed them at all is debatable. Fear still seems to have been the great motivator in that regard. Whenever the situation in Europe worsened, capital flooded out of Europe into the Treasury market sending yields crashing. Operation Twist had nothing to do with that.

12/24/18 The Fed and its apologists give the Fed credit for pushing yields down. But in examining the timing of the Fed program and the cash flowing out of Europe, it's fair to say that the European panic has had a much greater impact than Operation Twist in pushing long term interest rates down.

Bernanke got lucky for a while, but now 3 months into the operation the 10 year yield is 23 basis points higher than the day after the operation was announced.

(10/2/11) The Fed has posted FAQs on the MBS replacement purchase program here: http://www.ny.frb.org/markets/ambs/ambs_faq.html

(10/18/11) The Fed has scheduled MBS purchases of $22 billion in the period of October 14-November 10. This is in recognition of the increased rate of MBS paydowns from its balance sheet due to increased refi activity in the wake of the sharp drop in bond yields in August and September. Prior to that, the MBS paydowns were occurring at the rate of about $10 billion per month. As rates rise, they should recede to that level again, and the Fed's purchases from the PDs will follow.

(10/30/11) In a speech at the annual Fed meeting with Primary Dealers on October 24, Fed head trader Brian Sack said that the Fed will be buying $25 billion of MBS per month for the next several months. That may be an over estimate because the currently elevated level of refinancing activity should fall sharply with the recent rise in mortgage rates. Applications have already begun to drop back. That means that within 2 months the level of MBS paydowns upon which the Fed bases its schedule of MBS purchases should fall sharply.

Sack also made an important point regarding the Fed's Maturity Extension Program (MEP), in that it will require the Treasury to increase its issuance in the year ahead. "…the MEP has implications for the amount of debt that the Treasury has to issue over the next several years. As you know, when the Federal Reserve has maturing holdings of Treasury securities, the proceeds are automatically rolled over into newly issued securities at Treasury auctions. However, under the MEP, we will have sold $400 billion of securities maturing through June 2015. With these securities no longer being rolled over to the Federal Reserve, the Treasury will have to issue a larger amount of debt to private investors…"

While, on a monthly basis, the additional debt is not that much in the overall scheme of things, this is just another negative the market has to look forward to.

All of the Fed's policy adjustments have inherent negative aspects that the market does not understand. The biggest one of all is that zero interest rates rob a large swath of the economy of the usual interest income it has available for consumption and payment of financial obligations, forcing destruction of principal. This loss of consumption and wealth destruction is never discussed by the mainstream economics community. But there is no free lunch. Somebody always pays.

(7/26/11) That is grossly insufficient for helping the Primary Dealers absorb all of the new supply. They and the markets have been saved by the "miracle European panic." As long as this continues the Fed won't need to consider QE3. At some point, that panic flood will subside; either because it is exhausted or the news in the US will have become so bad that capital will begin to flow out rather than in. We'll keep an eye on our financial indicators for any sign of that.

(9/9/11) I have expected MBS paydowns to increase sharply in response to a wave of refinances triggered by record low mortgage rates causing another refi wave. My take was that the Fed's Treasury purchases would fall short of covering for that and its balance sheet would shrink a little. So far, paydowns have increased only slightly. Refi applications surged in early August. Funding of the new loans should result in paydowns increasing later this month or early in October. However, the refi boomlet has been sputtering. It's not clear that it will have a major impact on the Fed's balance sheet.

MBS paydowns should continue to expand as the recent surge in refinances driven by the crash in mortgage rates gets processed through to settlement over the next couple of months. When rates rise, the surge will recede. The Fed should increase its purchases to offset the MBS leaving its balance sheet, but again, the impact should not be material relative to the level of net new Treasury supply which should be between $100 billion and $150 billion per month.

The Fed estimates the MBS paydowns in advance and schedules POMO to replace them on the balance sheet. The POMO are Treasury purchases from Primary Dealers, even though they were not the holders of the MBS. But the amounts are immaterial in relation to the new Treasury paper the dealers must absorb each month

Recent history of POMO and QE (8/25/10) Prior to August 10 we were looking at the prospect of the PDs getting NOTHING from the Fed, which would be an unmitigated disaster for the stock market, and ultimately for the Treasury market as well, once the current buying panic burns out.

(9/17/10) Generally, in weeks such as the last week of September, when the Treasury offers $40-60 billion in new paper, the Fed's buying will have much less impact. In those weeks, the markets performance will be more dependant on the participation of FCBs and banks in the Treasury auctions. If they don't buy more in those weeks, then stocks are likely to feel some pressure as the Primary Dealers are forced to liquidate some equity positions to accommodate the Treasury supply.

(11/6/10) The FOMC announced QE2 on November 3. The program was initially scheduled to purchase $75 billion a month of intermediate term Treasuries through June for a total of $600 billion. This was on top of QL1.5, which the Fed estimated would total another $250-300 billion through June or from $31 billion to $37.5 billion per month. Thus the Fed expected to buy a total of $850-900 billion through June. That would average out to between $106 billion and $112.5 billion a month, or $24-25.5 billion a week. I had estimated that they would need to do just $65 billion a month to keep things moving along at the recent pace. The announced amounts should be enough to blow the doors off.

The Fed said that it would monitor the situation and make adjustments on the fly. I wonder what adjustment they will make when commodity prices go through the roof, putting the world economy in a vice, and creating even greater hardships for struggling Americans.

(11/6/10) The amount of QE2 to come each month will vary with mortgage rates. If the Fed is successful at forcing yields lower, then the MBS prepayments hitting the Fed's balance sheet will turn into a tsunami, and the Fed will need to buy that much more in Treasuries. That would potentially accelerate a feedback loop forcing yields toward zero even faster. If yields don't start down, the rate of prepayments will diminish and the Fed's Treasury purchases will also diminish. The Fed might then be forced to increase its purchases. Commodity prices are likely to be the key to whether it could get away with that.

(11/13/10) The Fed had bought $32 billion in Treasuries in the October-November monthly period under the old "Quantitative Leveling" program (QL1.5) where it bought enough Treasuries to replace the amount of MBS that had been prepaid. November's projected purchases of $105 billion include $30 billion of replacement paper for the MBS that will be paid off.

(11/13/10) The Fed's game plan under QL1.5 was to estimate the monthly prepayments of MBS for the month ahead and make up for any excess purchases or shortfall in the following month. They had a big miss in the first month, resulting in the purchase schedule increasing from $18 billion in the first month to $27 billion in the second month, and then to $32 billion in the third month.

The Fed estimated only $30 billion in MBS prepayments for November-December. If they hold to the $2.654 trillion figure as the new target, somewhere along the line it may need to increase its purchase rate, depending on the rate of MBS prepayments, which in turn will depend on how low mortgage rates fall. If rates rise instead, which would take an unlikely combination of heavy selling by banks and FCBs, then the rate of MBS prepayments would fall off to near zero and the Fed's purchases would drop commensurately. The Fed would then face the decision to what to do about the unwanted rise in long term yields.

Results: http://www.ny.frb.org/markets/pomo/display/index.cfm?showmore=1&opertype=orig

Prior to "Quantitative Leveling version 1.5", (QL 1.5) announced on August 10, the Fed had been allowing small amounts of its GSE holdings to mature and roll off its balance sheet without replacement. That acted as a small drain on the system. The Fed included the GSE maturities in the amounts of Treasuries that the Fed will buy under QL1.5.

(12/23/10) Meanwhile, we know that in those weeks where there's little or no new Treasury supply, there's nothing to absorb all the Fed cash, so it finds its way into market mischief, mostly in stocks. The most surprising thing is just how muted that impact has been. I suspect that's because of increasing friction, including the hobbling of the banks, recent reduction of the FCB subsidy, and the pullback in individual investor buying.

(2/5/11) The Treasury took the action of paying down the $200 billion of SFP funds because of the looming problem of hitting the statutory debt ceiling in March. Winding down the SFP fund will provide a little more headroom. But it will also add cash to the markets as holders are met with a temporary shortage of available paper. That could still push short term paper rates down toward absolute zero. It still might push longer term yields down a bit. Even if only a fraction of the cash heads for the stock market, it should create enough marginal demand to raise prices there especially on top of the Fed's cash every week.

(3/25/11) With the SFP paydowns now ended, the market's challenges will become that much more difficult. (4/18/11) Since mortgage rates have risen from their super low levels of last winter, MBS paydowns have slowed dramatically, just as we expected. This reduces the amount of POMO required to reach the Fed's stated goal of increasing the size of its balance sheet to $2.654 billion by the end of June.

The Fed has also been selling a billion or so of the Maiden Lane portfolio assets a week. These maturities and asset sales are drains on the system as a whole but they do not have the direct effect of direct withdrawals from PD trading accounts, which would be the case if the Fed actually sold GSE or Treasury paper. Instead, they marginally reduce bank reserves, but at only a tiny fraction of the rate at which the Fed is buying Treasuries and adding to its balance sheet. The Fed might add $4-5 billion to next month's POMO to counter these drains. I don't see that as material.

(5/7/18) From 2012 to 2015 an average of $20 billion in GSE paper will mature per year. With higher interest rates and slowing MBS paydowns, based on the maturity schedule of its Treasury holdings, the Fed's balance sheet would probably shrink by $100-150 billion per year in the absence of a program to replace maturing paper. At his press conference Bernanke confirmed that the Fed would indeed replace maturing paper for the foreseeable future. I've never had any question about this. The Fed simply cannot allow its balance sheet to shrink because the system could not tolerate it.

Even when the Fed just stops pumping new money into the system, it would have the effect of putting the PDs and the markets on a starvation diet. The markets absolutely require this $25 billion in weekly feeding to function smoothly. Taking it away will have consequences. I expect the effects to be immediate, dramatic, and not pretty. Therefore I would expect a resumption of QE within a couple of months, if not weeks, of its suspension at the end of June.

This stop-start policy should introduce wild volatility into the market. This summer and fall should be a very different environment from the low volatility environment we've experienced for the past 6 months. I think that it will be important to be in cash, or short if suitable, prior to the end of QE2. The specific timing should be guided by the technical indications in our daily market updates.

(2/20/11) The Fed can refrain from rolling over its maturing Treasuries if it should want to shrink its balance sheet more than that at some point. Existing Treasury holdings are set to mature at a rate of $100 billion per year. It is for these reasons that I think the issue of how the Fed will shrink its balance sheet when the need arises is a red herring. Maturities and MBS payoffs alone would shrink the balance sheet by 8-10% per year. All this talk about reverse repos, possible asset sales, and paying interest on reserves is nonsense designed to misdirect the market to thinking that the Fed really is concerned about inflation. It's not working. The speculators are still buying commodities and refusing to buy Treasuries so bond yields are stubbornly resistant to the Fed's desire that they decline.

Recent history of QE2 (8/14/10) If the Fed did not take action to prevent the balance sheet from shrinking, that would have resulted in a subtle but very real tightening. MBS holdings are all long term and would not mature for 10 years. The Fed had been discussing whether to actually begin selling this paper in order to shrink its balance sheet. They decided against that for the foreseeable future, given the fragility of the market, but left the option open for the future should conditions warrant. The thought of prepayments, which I raised last November when they first floated ideas to shrink the balance sheet, never entered their little heads. Bernanke and the Fedheads were so out of touch that they appear to have had no clue until early August that they would have to take steps to keep the balance sheet from shrinking.

The Fed had sent a message to the market early in the year that it intended to reduce the size of the balance sheet through the use of reverse repos with money market funds. I thought at the time that the idea was laughable, but it was the signal to the market and what it said about the Fed's mindset that was important. They completely misunderstood what was happening in the economy, expecting a self reinforcing recovery. They had no clue that the recovery would soon falter. Reality has sent them a wake up call. Click the link below for background historical discussion of the Fed's Quantitative Easing Programs. This may be especially useful if you were not a subscriber at the time. http://wallstreetexaminer.com/money/qe.pdf

(8/14/10) The MBS prepayments represent an involuntary, passive shrinkage of the Fed balance sheet, and a reduction of liquidity in the financial system. Mainstream pundits began to notice this in the week before the August FOMC meeting, and they suggested that the Fed would at least buy Treasuries to replace the MBS that were getting paid off.

As it turns out, those people were plugged in. I suspect that the Fed had sent them trial balloons to gauge the market's reaction. In the preliminaries before the FOMC announced on the 10th, things were looking good. Boy, did they get a surprise when the market cratered on August 11. I had wondered some months back whether, if the Fed were to take this step, it might scare people. Sure enough, that's what happened. Investors were asking what the Fed knows that they don't. The answer was "nothing", but the doubts that were set in motion are not constructive. They should continue to drive more investors out of stocks and into Treasuries.

I had previously discussed that I expected most of the MBS paper on the Fed's balance sheet to gradually roll off as it was prepaid. But we also have surmised that about 30% of Fannie and Freddie backed paper is not backed by adequate collateral. Whether the Fed elects to sell the paper into a market where interest rates are rising or sit and wait for the payoffs, there will be losses. Even though the Fed bought existing paper, this was effectively be the same as printing cash, since the money that the Fed paid for these worthless securities has been converted into cash by the banks and other institutions that sold the paper. The Fed will never be reimbursed. However, as long as this cash stays locked up as deposits on the Fed's balance sheet, it has no inflationary impact.

The New York Times had an excellent discussion of some of the thorny issues involved with the MBS holdings. http://www.nytimes.com/2010/07/23/business/23banks.html?ref=business It quoted Brian Sack, a NY Fed executive, as estimating that $200 billion in MBS would be prepaid by borrowers by the end of 2001. That's about $11-12 billion per month. That estimate now looks very light unless the Fed allows competing yields to rise.

(8/14/10) Bernanke woke up early August with economic data showing renewed signs of implosion, so instead of allowing market interest rates to seek a rational level, he elected to continue to subsidize the banks and penalize savers by replacing the magically disappearing MBS holdings with Treasuries. KABOOM went the Treasury market in a Roman Candle buying orgy. For the stock market however, not so good. To put it bluntly, Bernanke scared the crap out of the hoi-polloi with the announcement that the Fed would buy Treasuries to keep the balance sheet from shrinking.

(8/14/10) The Fed allowing the GSE paper to mature without buying other paper to replace it would have been a form of tightening and de-monetization. Combine this with the MBS payoffs and there would have been potential for a fairly dramatic shrinkage of the balance sheet with concomitant reduction of reserve balances over the next several months.

QL 1.5 will vary in amount depending on bond yields. If yields rise, the mortgage prepayments will drastically slow if not virtually stop. That would stop the Fed's purchases of Treasuries. There would not be enough liquidity out there to support the markets under the circumstances, and both stocks and bonds could go into tailspins. At that point the Fed would be forced to unveil a massive QE2 program.

(8/27/10) We are again in uncharted waters. The MBS paydowns will shrink the financial system, and especially the shadow banking system, so much of which was based on mortgage finance. Will the Fed find itself swimming upstream against such a torrent of collapsing debt that its efforts will be swept along with that? The markets should give us clues over the next few weeks.

(9/4/10) The biggest MBS payoffs so far have come in the middle of the month. If that's a regular pattern, then the monthly rate will be volatile from week to week, and the real rate would be that rate calculated after the third week. We'll have to see how this plays. If interest rates stay low, then the prepayments may continue to accelerate. They will slow dramatically if rates rise because refis would dry up and borrowers with cash would find returns more competitive with paying off the mortgage. But if Treasury note yields stay low, that would have the perverse effect of involuntarily shrinking the Fed's balance sheet, thereby generating even more Fed purchases of Treasuries, leading to a vicious spiral.

(9/4/10) The Fed's decision to buy Treasuries as a replacement for the magical disappearing MBS will prevent the balance sheet shrinkage from that source but not from the paydown of Fed alphabet soup loans and equity investments, not to mention, eventually, loss recognition. It should keep the reserve side of the balance sheet more stable than they would have been, since the Fed's purchases will flow into bank accounts, and the banks aren't likely to change their behavior and suddenly start withdrawing the cash in the absence of a decline in their own deposits. That would in theory only be enough to induce a kind of homeostatic situation in the economy. Where it gets sticky is if borrowers continue to pay off other kinds of debt. The system would then continue to shrink, regardless of whether the Fed keeps its balance sheet stable.

I had initially overlooked the fact that interest rate refis alone would shrink the Fed's balance sheet because the Fed's MBS would get paid off while the new loans would be held elsewhere. The Fed discussed this at the August meeting, as revealed in the minutes and it's one of the reasons they panicked.

Now that I've taken a half second to think about it, my thought is "so what?" The reserve will still be out there, only instead on the Fed's books, it would be on the books of Fannie and Freddie, the shadow central bank. It makes not one iota of difference on a systemic basis whether the Fed holds the asset or the Treasury holds it. It's still out there. The only paydowns that matter are the ones that actually pay the mortgage off and extinguish the deposit. And those are happening, albeit at a much slower pace than the MBS shrinkage on the Fed's balance sheet. We see the evidence in the gradual shrinkage of Fannie and Freddies balance sheets.

(9/17/10) If MBS prepayments continue at their recent rate, that combined with GSE maturities would add up to around $325 billion in Fed balance sheet reduction over the next year. That would mean that the Fed would need to continue buying $27 billion a month in Treasuries.

(11/6/10) With $32 billion in Treasury purchases in the October-November month, the Fed was able to drive the stock market higher and kept bond yields suppressed at artificially low levels. If that program was "working" why is the Fed doing even more, risking exacerbating already raging commodities inflation? I am increasingly of the belief that the real reason is that the banking system is in much worse shape than the mainstream realizes and that the Fed is taking this action as a massive pre-emptive campaign of shock and awe designed to rescue the banking system from collapse by inflating asset values. Either things are so bad that the Fed is willing to risk the pain that raging commodities inflation will cause, or the FOMC members are insane and they simply know nothing else other than to listen to the voices in their heads.

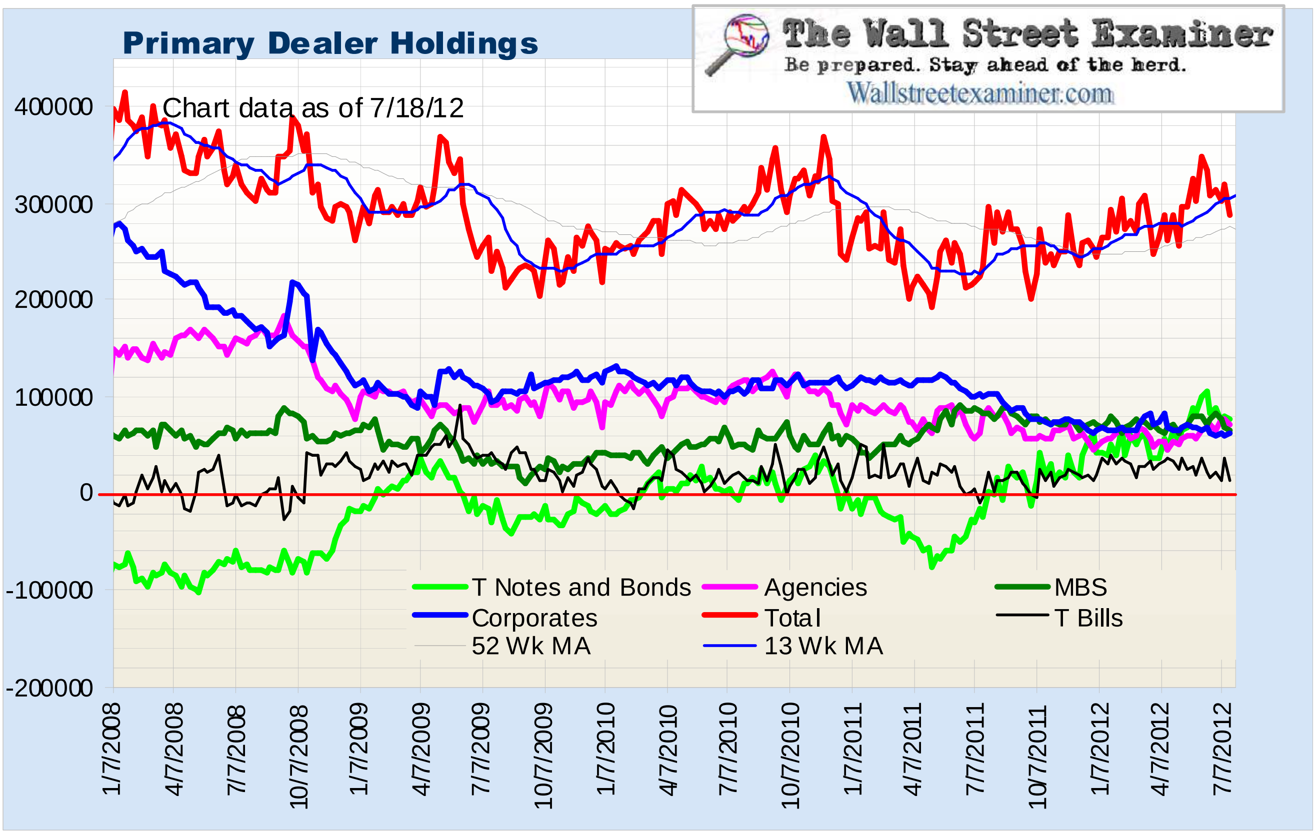
Continued on next page

Primary Dealers

Net Weekly Changes (Millions)	
T Bills	-22,405
T Notes and Bonds	-4,693
Total Treasuries	-27,098
Agencies	-5690
MBS	-2,483
Corporates	+1,918
Total	-33,353

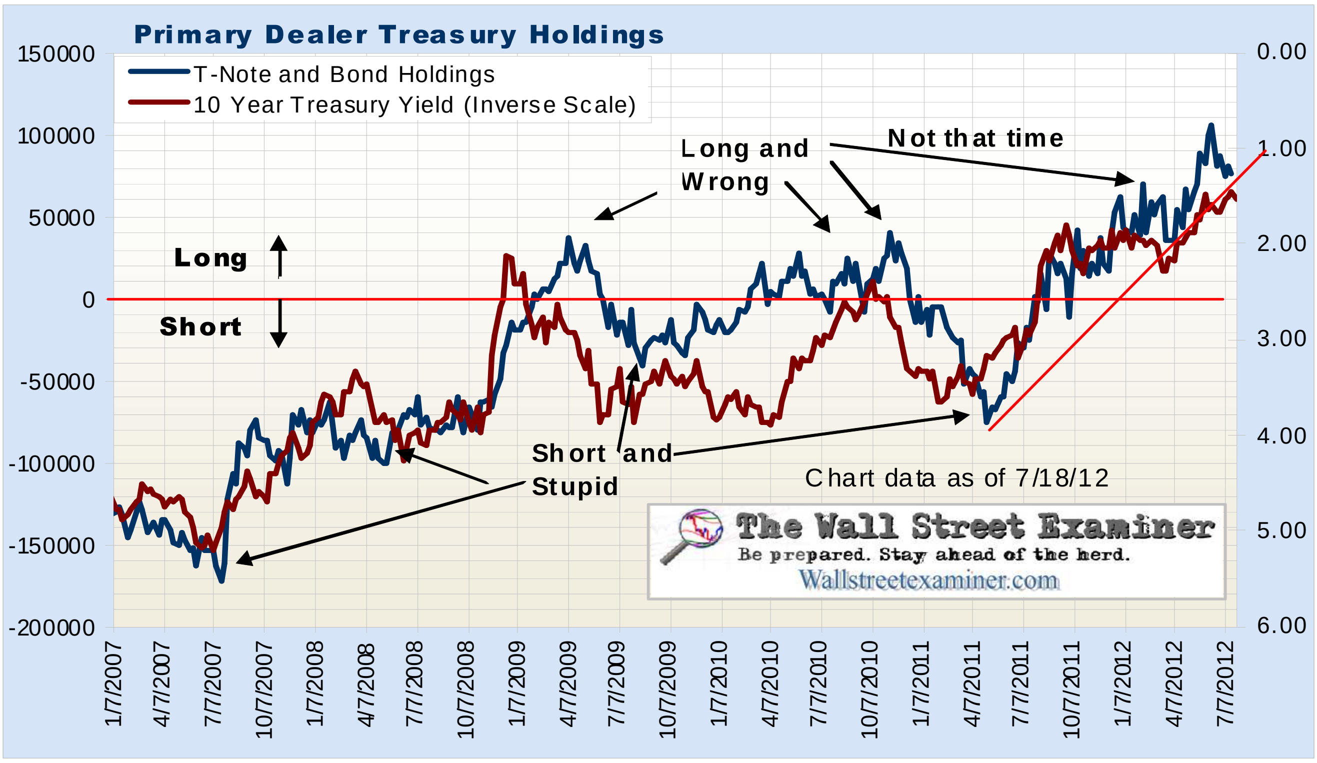
Primary dealers' fixed income holdings fell sharply in the week ended 7/18 (reported with a one week lag). The bulk of the decline was in T-bills. When they start reducing their longer term positions consistently, that should signal a more persistent rise in yields.

(10/10/11) On September 21 the Fed announced that it would start swapping short term Treasuries for long term with the PDs but, more importantly, it also announced that it would now buy MBS from the PDs, instead of Treasuries, to replace the MBS being paid down from its balance sheet. So the dealers, being the sly, on the ball fellows that they are, promptly went out and bought a pantload of MBS and dumped Treasuries across the spectrum. It didn't matter what maturity they were. They sold them all. And the Treasury market showed the effects. It seems Bernanke may have just made another one of his patented miscalculations.



Continued on next page

Primary Dealers sold Treasuries in the week ended July 18. Their holdings have been downtrending since reaching an all time record long position in the week of June 13. Is this the beginning of the end of the Treasury bubble? If the Primary Dealer selling continues and breaks the uptrend line, that would be a signal I would take seriously.



6/19/26 If Treasury yields were driven down by panic in May, Primary Dealers led the way. They furiously bought longer term Treasuries again in the week ended July 18 (reported with a one week lag) setting another new record level set the week before. Based on the long term chart of the 10 year yield (next page), Treasuries remain at an extreme level of extension from the trend. In fact, every move of 15 to 17 points in 10 Year Treasury prices over the course of a year or so has led to a severe correction. This move just reached 17 points. That suggests that this is the end of the blowoff (10 Year Yield chart, below).

5/24/12 The dealers are still getting a lot of help from European capital flight and heavy public (read “institutional”) buying. As long as they maintain their positions at this level, to say nothing of growing them even more, yields should stay low or go lower. When this pattern breaks is when yields are likely to start trending higher.

4/1/12 The Primary Dealers sold a ton of Treasuries in the week ended March 21 (reported with a one week lag), finally realizing that they, along with everyone else, were on the wrong side of the trade. They had barely sold any of the record long position in long term Treasuries they had accumulated in the week ended February 8, after having been net long for 6 consecutive months, a record.

Their sudden dumping came after, not before or during the Treasury market shock treatment of March 7-14 when prices plunged and yields surged. The dealers were caught with their pants down. This is not new. I have documented their past embarrassments. Lest we forget, it was their stupidity, greed, and venality that caused the system to crash in the first place. Having gotten away with it with nary a slap on the wrist, it will happen again, only in not quite the same way.

3/17/12 Since they reached this peak in early February, I have pointed out that, given their track record of being most wrong around the time of major turns (see chart below), at least an intermediate term drop in bond prices (rise in yields) may lie just ahead. I have also illustrated that that was consistent with the long term chart of Treasury futures showing momentum at levels consistent with market (price) tops. Last week was probably the beginning of the turn that I have been expecting based on this data.

(9/2/11) Their massive short covering since May eliminated their long term Treasury net short position in late July while being a driving force for the giant rally in Treasuries.

(8/22/11) I have a feeling that this will not end well. Their net long Treasury position is approaching the level it reached in November of last year and March of 2009. Both times, the Treasury market followed with big selloffs. This time, I suspect it will mark not only an intermediate turning point, but the end of the 30 year bond bull market.

(8/15/11) Normally, the dealers get short to absorb the bi monthly load of longer term paper they are called on to absorb. They cover that at the settlements on the 15th and 30th or 31st.
(1/21/11) Earlier in January, several of the big dealers had reported poor trading results that crimped profits in the fourth quarter. A tipoff to this was that they were positioned wrong in their long term Treasury holdings in early November, being heavily long just as the market topped out, leading to the November-December meltdown (note the 12/3/10 comment below).

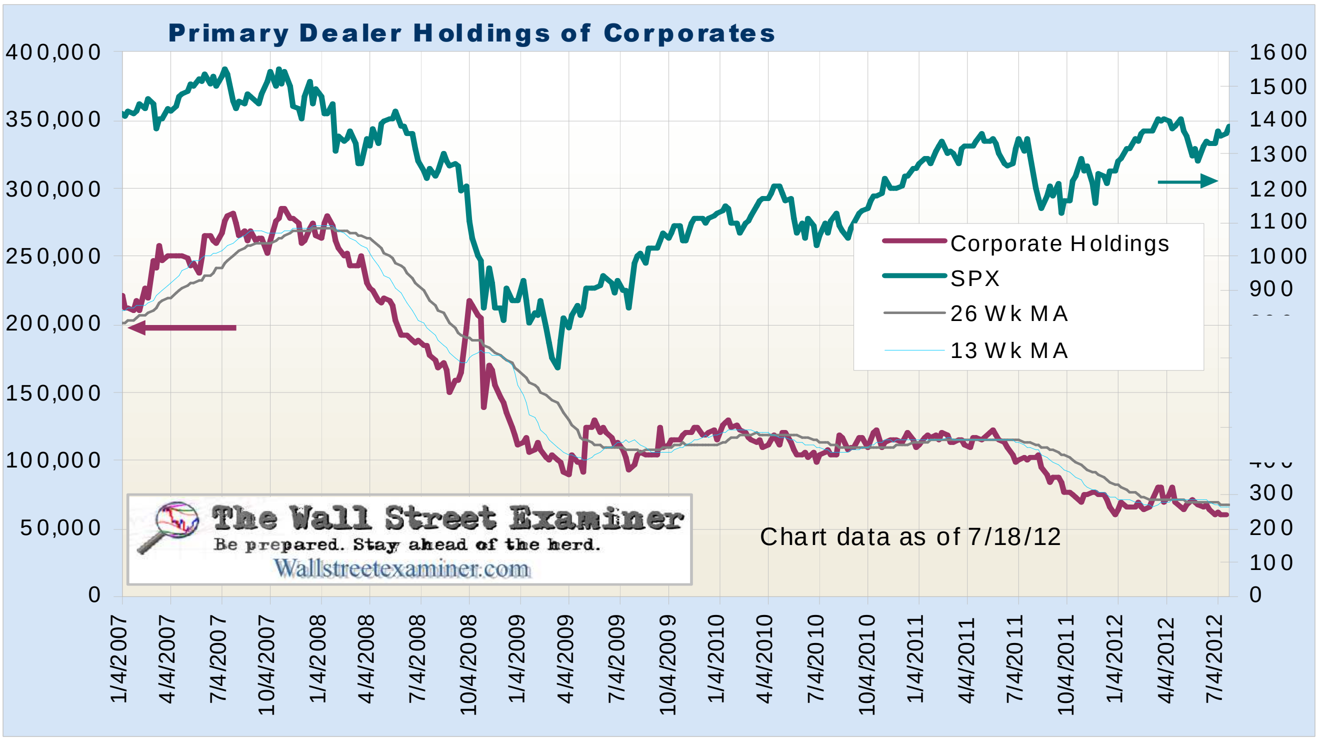
This impacted their ability to support both stock and bond prices even with the Fed pouring cash into their accounts. If they are forced to sell their inventories to the Fed at a loss, it impedes their ability to stand and make bids when sellers appear. The dealers are in no position to sustain losses. They had better get their acts together or they will be responsible for triggering the next crisis, just as they were for the last one.

(4/18/11) The dealers are stuffed with cash and they continue to build more cash. They are still buying commodities, apparently in rotation, taking profits in one and pushing prices higher in another. Bank data suggests that their appetite for stocks is picking up again. Meanwhile, cash deposits at the Fed have mushroomed (see Fed Liabilities below) as the dealers consign most of QE2 to the Fed's vault.

(6/26/11) At the end of June the Fed reported a massive restatement of the H8 weekly statements going all the way back to 2004 showing that the banks were much less profitable than originally reported. The charts showing that are at the end of this report. There's more going on behind the scenes in terms of losses than meets the eye. The banks are insolvent and are hoarding cash. The Primary Dealers' activities reflect that and vice versa—the bank data in part reflects the condition of the PDs, most of whom are subsidiaries of the biggest banks. This is weighing on the markets and will continue to do so in the months ahead.

We need to be clear that the dealers are not as omniscient and all-powerful as many people seem to think. They are no smarter than the average criminal syndicate. They get their way by lying, stealing, strong arming and threatening with dynamite strapped to their waists. They now have their bombs strapped on, and they are threatening to blow us up. This time they may succeed.

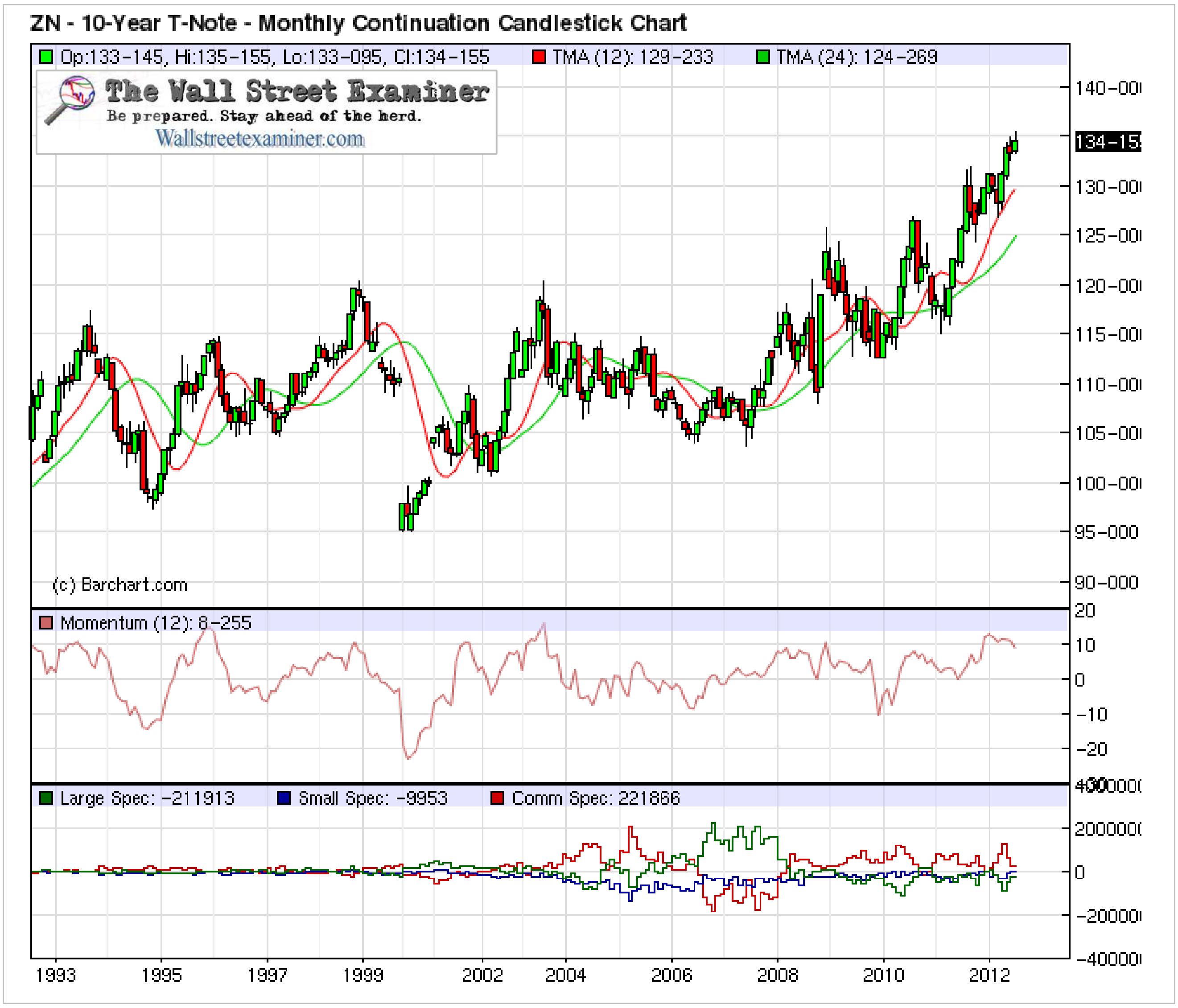
(7/12/11) It's time to call attention again to the Primary Dealers' corporate bond holdings, which have been plunging in recent weeks. I continue to believe that the huge divergence versus stock prices over the past two years means something. There's a logical disconnect here. Now this graph is on the verge of a breakdown. I think that this is both a symptom of the disease that is decimating the dealers, as well as a contributing factor. With the massive losses the PDs are probably taking on their Treasury shorts, this has the earmarks of a distress sale. I would have said that it's just a matter of time until stock prices follow, but they are already doing just that.



(9/22/11) Why are the PDs dumping corporates again? Why didn't they buy them during the recently departed cyclical stock bull and what does this imply about the future performance of the stock market? Notably, this wave of dumping of corporates came in advance of the stock market meltdown. Normally stocks lead. What did the PDs know and when did they know it? Obviously the dealers are privy to inside information from their corporate clients, so when they start selling their bonds, that's something that we need to pay attention to.

(12/03/10) The series most closely correlated to stock prices is corporate bond holdings. They have tended to move in the same direction as stocks since 2002. Since July of 2009, growth in dealer holdings of corporate bonds has lagged the rally in stocks. I'm reluctant to draw any inferences from this, but this growing divergence between the direction of stock prices and the dealers' willingness to hold corporates is troubling. We know that they certainly have the wherewithal to buy more corporates. Instead, they are buying only Treasuries.

The question is, why, if stocks are so strong, aren't the dealers willing to increase their holdings of the debt of those companies? Do they know something that we do not know? Why… yes. Yes, they do. That's what's troubling.



4/24/12 Even after beginning to roll over, the Treasury market remained extended on a long term basis and is now rebounding toward new price highs. This is starting to look different than the last two times in the past decade when the market was this extended. When Treasury futures prices hit their peak in January they had only been that extended twice before in the past 10 years. Both times were followed by steep price declines.

Commercials have actually been increasing their long positions in the past 2 months. Ironically, Barrons reported over the weekend that bond portfolio managers were the most bearish they had been in history, with just 2% bullish, 81% bearish, and 17% chicken. Meanwhile Primary Dealers are the most bullish they've ever been and commercials, of whom the PDs make up a significant portion, are getting longer. Now, who do you think is more likely to be right?

The COT reports on the commercial hedgers show that the dealers have been wrong in a big way at major turning points in the past. I don't look at them as particularly "smart money." They were, after all, the ones who brought the system down.

(8/27/10) The COTs show that the commercials seem to have gotten smarter since 2009. Before that, they were most wrong at extremes in the market. Since then they have been more right than wrong, reducing long positions at highs and being most long at the lows. The PDs were also most long in May, so, while they didn't capture the whole rally, they got most of it. The commercials have been selling into the rally more and more aggressively as it has progressed. They got down to neutral last week. The last time they did that, the market sold off for 4 weeks. The time before that, it sold off for 6 months.

The PDs biggest mistake was when they were most heavily short in July 16007 and prices were at their lows (yield highs). It was partly their furious short covering that drove the collapse in yields over the next 5½ months. This could be a similar situation, only the implications of a Treasury selloff by the PDs has even more disastrous implications than a short covering binge. Watch that bright green line, at the bottom of the Primary Dealers' Holdings chart. If it starts trending down, the rout will be on.

Note that they were massively long corporates just before the spreads blew out and went to the moon, another example where the PDs were positioned exactly wrong, and one of the main causes of the financial collapse. We like to complain about how these guys control everything and rig the markets. From this perspective they look more like Sergeant Schultz, appearing to know nothing.

This calls to mind that they were positioned completely wrong in the futures in July of 2007. And this is supposed to be the "smart money." I guess we could say that if they were so smart, we wouldn't be in this mess and they wouldn't be on the public dole.

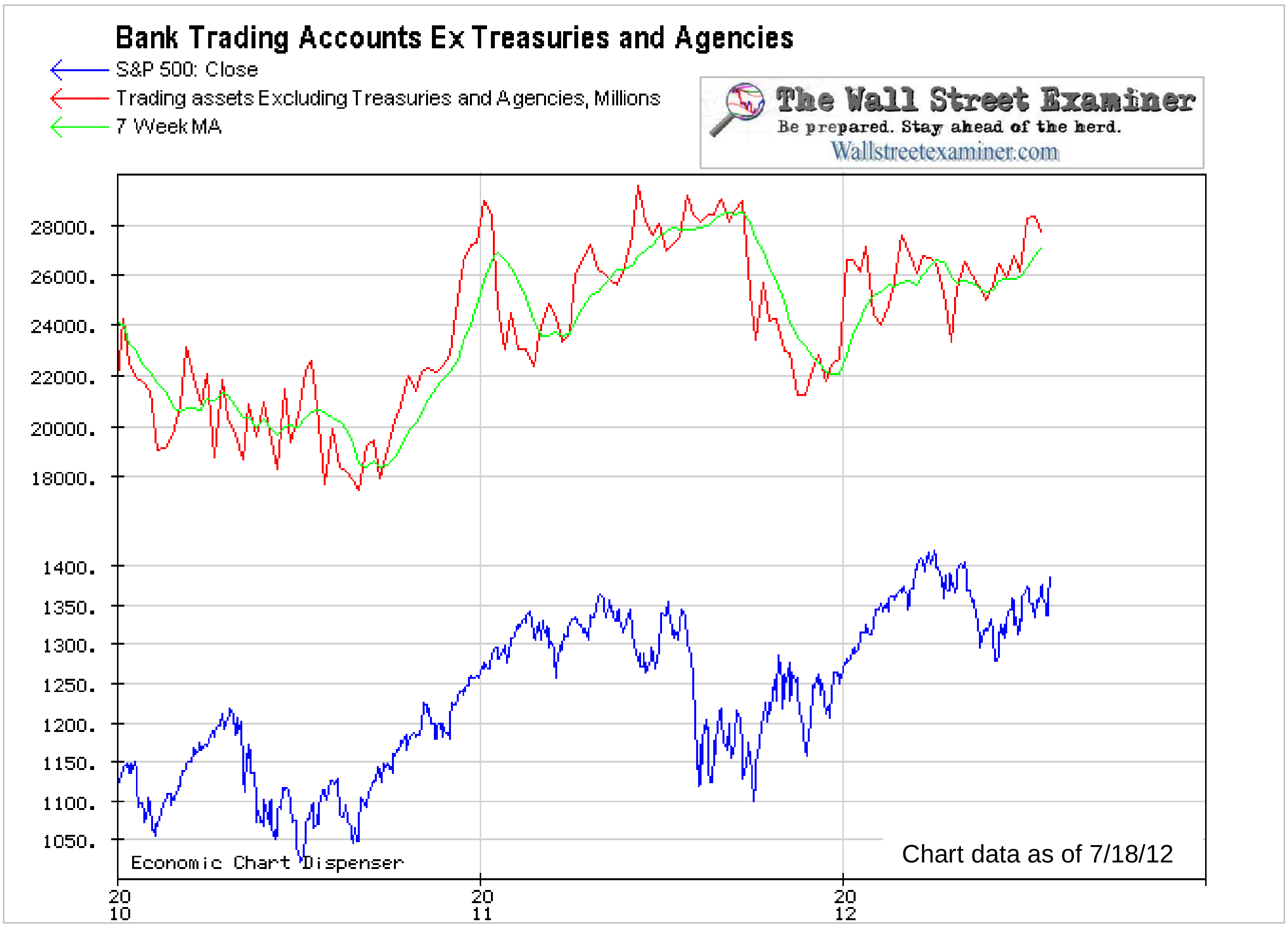
The dealers had been continually dumping corporates and Agencies while not buying enough Treasuries to offset the sales of other paper throughout 2008. They apparently used the proceeds of the sales to pay down debt as they attempted to reduce the size of their balance sheets in this new risk-averse environment. Treasury yields fell sharply when the dealers were on their a buying binge from October through December. They stopped buying during the week ended 12/24/08. That coincided with the top in the Treasury market. As Treasury supply increases the PDs must buy more, otherwise Treasury prices will fall. Add a buyers strike by FCBs and you would have the makings of potential disaster in the bond market.

The PDs had joined the FCBs in parading out of GSEs late in 2008. This caused the destruction of the mortgage market, worsening the housing decline. With the government now in control of Fannie and Freddie it faced a crisis of such magnitude that the potential repercussions simply could not be tolerated. As a result the Fed stepped up and began its program of direct purchases of Agency and MBS paper on 12/5/08. The Fed's actions and words apparently tricked other investors into thinking that Housing Agencies were now safe securities. While PDs and FCBs distribute, and the Fed buys, the rest of the paper was being distributed to the market at suddenly sky high prices. Once again, a transfer of wealth was under way.

(12/28/10) Meanwhile, since the NYSE stopped reporting member and specialist positions just before the crash of 2008, and the Primary Dealer data does not include stock holdings, I've been thinking about how we could get some idea of what the equity holdings in the trading accounts of the biggest market makers might look like. I found an item in the Fed's H8 weekly condition statement on commercial banks that might be interesting to follow in this regard. Using the footnotes on other balance sheet items, by process of elimination, I deduced that this item largely represents equity trading accounts, and includes the likes of BAC, GS, MS, and C (Merrill Lynch). I am hesitant to draw any conclusions due to the small available time sample, but I will post the pictures and let them speak for themselves over time. Perhaps some useful correlations will emerge.

(1/3/11) The recent surge in large bank equity trading accounts corresponded with the inception of QL1.5 in August, and that appears to correspond with the rise in stock prices. Given the theories under which I operate, there's nothing surprising here. It just another data point that tends to confirm that POMO drives stock trading.

Continued on next page



Commercial bank (including foreign based US branches) trading accounts increased by less than $0.1 billion in the week ended July 18 (after revisions). The intermediate trend of this indicator is still bullish, but it could be related to marking to market as bond yields were falling sharply. There may be a limit to how far the banks will allow these accounts to go before they take profits, as indicated by the repeated peaks in 2011 around $29 billion. This indicator is included in the liquidity composite.

(10/18/11) It's been my position that once these accounts begin to shrink, it would have bearish implications for both Treasuries and stocks. So far, we have only seen the Treasuries weaken, but if this trend weakens, stocks should follow. The obvious question is, "When?" I expect the signals to be when overall liquidity as estimated by the macro liquidity chart declines, and when the market's intermediate technical indicators, as tracked in the daily market update, roll over.

(10/2/11) Why haven't the big banks' "Other Trading Accounts" plunged with stock prices? They include numerous types of securities, including MBS, state and local government securities, asset backed securities, equities and mutual funds. As the weightings of these holdings change, their influence on the indicator will as well. The fixed income side of these books has been rallying more than equities have fallen in value. As trading accounts these accounts are marked to market regularly. Their value has held up as fixed income securities rose in value. That offset the losses in the stock portions of the accounts.

Also, securities may be moved into these accounts from investment accounts for distribution purposes. MBS investment accounts at the big banks have been undergoing massive declines over the past year in spite of rising values. The banks have been unloading these securities, possibly moving some of them into trading accounts before getting them off the books. In any case, these are not bullish developments. It may be just a few more weeks before these trading accounts roll over and begin to have a negative impact on overall market liquidity.

(4/18/11) The market needs the support of these players in order to continue rising. Note the big negative divergence with stock prices since January. If these lines turn back down from this configuration, stock prices should follow in dramatic fashion. In the meantime, the big banks' traders seem to be trading to mark up equities again, although not with the same enthusiasm as they did from September to January, at least not yet. Facing the end of QE in June, I wonder just how far they are willing to push this. My guess is that they will push it a long way, perhaps not to the bitter end at the end of June, but there will likely be some brinksmanship.

(2/4/18) This chart is one measure of where the Fed's cash has gone. The non fixed income trading accounts began to increase in size around the time the Fed started QL1.5 in August 2010. The surge continued when the Fed began QE2 in November. The big foreign banks operating in the US market added about $15 billion to these accounts between August and January, and the big domestic players added around $11 billion. While the Fed only aggregates the numbers into this category and does not name which banks are included, the list probably reads like a who's who of the Primary Dealers.

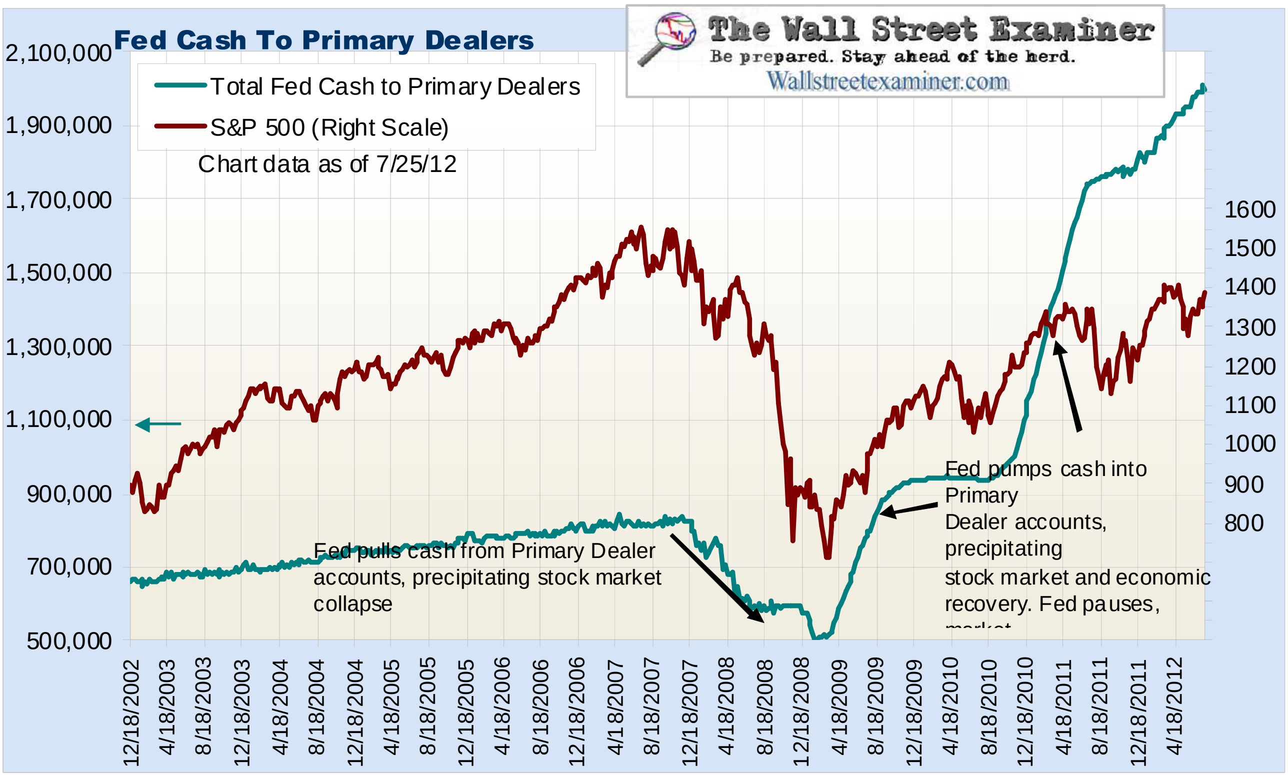
The big banks have committed the vast majority of the POMO cash to simply building reserves. Some of it has gone back into their fixed income accounts, and as this chart shows, clearly some of it has gone toward speculating in other "stuff", including equities and commodity futures. The correlation between the direction of the stock market and the direction of these accounts is strong.

While cause and effect isn't proven by the lines on this chart, clearly they feed on each other. And just as clearly, "something" happened to one or more of the big domestic players in January. At the very least, this should be a contributing factor to the headwinds the Fed is facing. If this negative divergence continues, and especially if the foreign bank trading accounts turn down, that could be a death knell for the bull market in equities. At this point I would classify it as a warning.

This doesn't stand alone. There are other data series that complement this chart which I'll cover in later sections of the report.

(1/21/11) At the same time, there have been increases in their loans to non-bank financial institutions, as well as their liabilities for trading account items over this period (charts not shown, but similar in shape to this one). Again, this is evidence that while the banks are not lending and are holding most of the excess cash as cash reserves, they are committing a small portion of it to speculation. This trading at the margin is creating ruinous havoc in commodity prices, while at the same time causing rising stock prices to give the impression to the Wall Street chattering class that things are getting better. The general public, the ordinary folk who are getting squeezed, knows better, and so do we.

Continued on next page



The Fed's SOMA holdings of Treasuries and GSE paper augmented by repos, or reduced by reverse repos, represent liquidity which the Fed supplied directly to the financial markets through the Primary Dealers. This chart shows the amount of Fed assets held in the SOMA, plus repos, less reverse repos, but excluding the MBS. We have evidence, via the separate Primary Dealer reporting, that relatively little of the MBS paper was purchased from the Primary Dealers. Since the cash from the MBS purchases for the most part did not flow through PD accounts, it did not have the direct high powered impact of repos or especially permanent purchases of Treasury or Agency paper. That is the cash that flows directly through Primary Dealer accounts.

The Fed settled an apparent total of $5.2 billion MBS purchases in the week ended July 18, before deducting paydowns. That was the amount of cash going into PD accounts. It's not significant, but as long as these flows continue from time to time, the dealers will have cash to deploy.

7/17/12 At the current levels of new Treasury supply of around $70 to $80 billion a month against the Fed's MBS purchases of $27 billion a month, the bullish effects of the Fed purchases of MBS will be limited. The Fed has added another $6 billion to that through the now unbalanced Operation Twist. This is still not enough to keep both stocks and bonds in bull trends. One market should suffer at the expense of the other. The job of determining which will be which is left for technical analysis.

The trend of this indicator remains bullish and will continue to be bullish under the extension of the MBS purchase program through the end of 2012. The world markets are too fragile for the Fed to simply sit on its hands and allow its balance sheet to shrink as MBS are paid down. But as we guessed, there was not enough weakness in commodity prices to spur the Fed to do more than extend the status quo at the June meeting. So far, it's my opinion that nothing has happened that would lead to a change at the next FOMC gathering at the end of the month.

2/20/12 This is the most important indicator in the liquidity composite and its weighting in the indicator reflects that.

3/23/12 We can now say bye bye to Maiden Lane II. The Fed sold the last sale of that portfolio of AIG assets in a deal with Goldman Sacks. That's not only a system drain, but it results in a cash withdrawal from a Primary Dealer account. Therefore it is netted out from this indicator. Still, it's not enough to turn the indicator down whether in the big picture or week to week.

11/16/11 Operation Twist results in no net change in the amount of cash pumped into dealer accounts over time, although from week to week there are minor deviations depending on the timing of purchases and sales. This is a technicality due to the offset of purchase and sale dates. Purchases and sales net out keeping the line on the graph flat, which is bad news for the market.

1/17/12 The Fed's MBS purchases began to settle in December, showing up at the end of the month as a sharp rise in this indicator. That line should move higher in stairstep fashion in the weeks where MBS settlements occur. With the help the dealers have been getting from European investors in absorbing Treasury supply, these settlements should give the market a boost.

1/21/12 I don't know yet what the deal is with the Fed's sales of Treasuries. The Fed talks about transparency but here's something that cries out for an explanation and it seems the Fed only wants transparency for the good news, or things that will move the markets in the desired direction. An involuntary balance sheet shrinkage is not one of those things. We simply do not know who the counter party is to these sales. However, given the massive expansion of the US money supply in recent months it's not too far fetched to think that the Fed might intentionally be tapping the brakes a bit. This may also be an attempt to sterilize the currency swaps, which have been growing at a rapid pace.

10/21/11 The Fed's trades with the Primary Dealers are viewed in terms of direction. Currently the Fed is not adding liquidity to the system. This is opposed to during QE1 and QE2 when it was adding massive amounts of liquidity by purchasing large amounts of various securities, mostly Treasuries, from the PDs. Historically, it is normal for the Fed to be constantly adding relatively small amounts of cash to the system. On rare occasions it removes cash. That causes securities prices, and usually commodities prices, to fall, such as in the fall of 2008, when the Fed withdrew cash from Primary Dealer accounts to directly fund other financial institutions. This was a catastrophic error that nearly caused the total collapse of the system until the Fed realized its mistake. The Lehman bankruptcy did not cause the crash. The Fed caused the crash by pulling cash from the PDs, while diverting it to other players, when it should have been increasing its funding of the PDs through direct securities purchases then, instead of playing alphabet soup.

How the Fed adds liquidity is critical. The only liquidity that really matters to the market is that which comes through the usual channel of open market operations conducted with the Primary Dealers, because the markets are then the conduits and the first point of contact for the transmission of monetary policy. Open market operations are the only direct form of market manipulation and impact, and they are the norm, rather than the exception. Manipulating the market is a normal function of the Fed.
When the Fed engaged in its more creative, direct financing of market participants in 2007-2008, it did so at the expense of the financial markets. When the Fed actively pulled cash from Primary Dealer accounts as it did in 2008, the dealers could no longer perform their function of making markets adequately. The markets crashed, sending a signal to all market participants, that, well... the system was crashing, and they acted accordingly. The Fed will not make that mistake again. But rest assured, it will find other mistakes. That's what the Fed does.

Bear in mind that none of this has anything to do with solving the underlying issues. That's above my pay grade. We all know that printing money will not solve the problem. This is about understanding the driving forces and timing the markets to the best of our ability, ultimately to preserve capital, our capital, to the extent that is possible.

2/13/11 We also note from the chart that the mileage the Fed is getting from QE2 in terms of stock market returns is minuscule and is even less than was apparent under QE1. The law of diminishing returns is at work.

10/18/11 Normally the Treasury hits the market with $5-10 billion in new supply in the weeks where only T-bills are offered, and then $45 to $70 billion in the weeks where the Treasury sell notes and bonds. The Fed's swaps of Treasuries with the PDs are useless in assisting the absorption of that supply. The MBS purchases aren't helping either, and won't over the longer haul because the amounts are too small to have a material impact. So the market and especially the PDs have to absorb it.

(10/2/11) During QE2, the Fed's purchases covered virtually 100% of new Treasury supply, freeing up cash that allowed the dealers to speculate elsewhere. With the Fed now absorbing almost none of the new paper, and FCBs now suddenly adding to supply, the dealers don't have the luxury of mounting speculative buying campaigns, or even basic market support operations in equities or commodities. The only thing saving the Treasury market has been the run on European banks, bank paper, and sovereign debt. That cash has flooded into the Treasury market. When that ebbs, even a little, and with the FCBs now net sellers, Treasury supply could crush the PDs, who are obligated to buy it, forcing them to liquidate all types of financial assets in order to absorb the Treasury supply. We are seeing evidence of that wave already in commodity and stock prices, and in falling PD holdings of corporates.

The Fed's new program of Operation Twist will be no help whatsoever. Likewise, the Fed's switch to MBS purchases from Treasuries to keep its balance sheet level as MBS are paid off, will not help either. The amounts will still only be $10-15 billion per month, just as it has been since the Fed ended QE2 at the end of June. We have seen the results. Nothing will change until the Fed announces QE3. Bernanke is already making noises. But it is too early. The Fed cannot act until commodity prices have completely collapsed, lest it risk another parabolic upmove in commodity prices that would wreck what is left of the functioning world economy.

(9/6/11) The market will then be looking forward to another Fed rescue on September 21. The scuttlebutt is that the Fed will do Operation Twist, which will have as much impact on the market as the dance invented by Chubby Checker in the 1960s, leaving market participants twisting the nights away in the wind.
My understanding of the Twist as the supposedly plugged in sources describe it is that the Fed would sell its shorter term Treasuries back to the Primary Dealers and buy an equal amount of longer term Treasuries from them. I guess the theory is that by pushing longer term rates even lower than they are now, this will magically transform the US economy into a growth dynamo. They apparently haven't noticed that long term rates have been collapsing and that this has been accompanied by a weakening economy. They also haven't noticed that Japan has tried variations of this theme for 15-16 years. Lots of good it did them.

This is in no way a QE if the Fed simply holds its balance sheet flat. It would still be a net negative for the markets without actual SOMA expansion. It's a mean, stupid, and futile gesture (with apologies to Animal House) for an economy locked in a liquidity trap , and it could be a net negative for the banking system if it were successful in reducing long term yields (which I doubt it would be.)

History 2010 (12/10/10) The dealers were highly leveraged on their Treasury holdings; therefore much of this cash initially was pure profit which could be re-leveraged when it was deployed. In recent weeks however, the dealers have apparently taken a beating on their long Treasury positions. This condition is exacerbated by the fact that other buyers are backing away, forcing the PDs to carry larger than normal inventories. If this continues, it should begin to take a toll on their ability to prop stocks. This is where the technical indicators in our daily market updates will come in.
(10/29/10) Contrary to all the noise about the market "pricing in" or "discounting" QE2, this was a simple quid pro quo. The Fed added cash to PD trading accounts, and they bought stocks, and perhaps more importantly, commodity futures.

(10/22/10) Other players got caught up in the excitement. But most are already fully invested. That's why we're beginning to see the market stalling and a dangerous concentration of money in the big cult stocks. They're selling everything else and chasing whatever is popular. It's mindless. As I mentioned on the message boards, it reminds me of 1972 when the Nifty Fifty were flying, pushing the Dow higher while most stocks were going in the tank.

(9/24/10) We had surmised ahead of time that this would help stabilize the market in weeks when Treasury supply is heavy, and should give the PDs enough firepower to goose stock prices in weeks where Treasury supply is light, like the past week. The market has not disappointed our expectation.

(8/27/10) The markets are likely to seesaw back and forth every week unless the Fed revises its schedule of purchase operations to coincide with weeks of heavy Treasury supply. As it stands, in weeks when supply is light, the Fed's cash infusions could head for stocks, since there would be no need to prop Treasuries during those weeks. But when the Treasury is auctioning notes and bonds, the stock market may again become the cash sink supporting that because the Fed's purchases will only make a small dent in supply during those weeks.

Prior to the Fed beginning these purchases, the total of this indicator had dropped by $9.3 billion between April 7 and August 11. This contributed to a minor drop in financial market liquidity.

(8/14/10) The prepayments of the Fed's MBS holdings do not have as direct an effect on the markets as declining Primary Dealer balances. On the other hand, the purchase of Treasuries is a direct cash injection to the PDs and therefore will have more impact on the market. We will not be able to guesstimate the direct impact of these purchases, given the immense amount of Treasury supply that the dealers must still absorb. My guess is that it will cause some bobbing and weaving in the trend when the cash hits, especially in weeks where Treasury supply is light. It will be a net plus compared to what would have been. We'll get an idea of just how much when see how the markets behave over the next couple of weeks. Then we can make some more informed guesses about the future.

(Earlier 2010) As it turns out, the following paragraph, first posted in May 2010 and since reposted weekly, was prescient.

"The ending of Fed pumping operations has been a factor contributing to stock market weakness. A similar but more severe exercise is what caused the crash in 2008. At that time, the Fed was actively draining cash from Primary Dealer accounts. This time they were just in standstill mode, but with the pressure on the market from Treasury supply combined with the need to service worthless fictitious capital in the "extend and pretend" game, the effect should be the same, and so far it has been. **If this continues, we are likely to see a resumption of open market operations in some form, or an alternative emergency program**." What we got was direct open market operations buying longer term Treasury paper.

2008-2010 The total increase in Fed liquidity to PDs between the February 2009 low and the ending of quantitative easing in March 2010 was $413.5 billion. Because of the massive Treasury supply the PDs had to absorb over this time, that cash failed to drive the stocks all the way back to where they were when the amount of liquidity was last at this trend level. The PDs had a lot more on their plates over the past year than they did in 2006 and 2007.

In mid March 2010 the Fed allowed $1.5 billion in maturing GSE paper to roll off its balance sheet. While maturing GSE paper held by the Fed is not a direct hit on PD trading accounts it was a signal that the Fed was beginning to pull in its horns. If the Fed actually begins to sell some of this paper back to the PDs, that would represent a direct hit on market liquidity. However, even the fact that the Fed isn't providing the usual flow of cash to the PDs should be bad news for both stocks and bonds.

Throughout this campaign we have seen how relatively weak the stock market's response to Fed pumping has been compared to the 2002-2007 period. The Fed is driving a gas guzzling clunker that can't make it up the hills any more. As the growth rate of this line on the chart slows in the months ahead, stocks should roll over.
On August 19, 2009, the Fed's total security holdings first exceeded the levels reached at the market's 2007 highs. So it was no surprise that stocks continued to rally. When they have the cash, PDs manipulate stock prices higher as a profit center, since it is easy to entice investors and traders to take the other side of the trade when stocks are rising in price.

While stocks have followed the direction of Fed credit supplied to the PDs, the lag has been increasing, as the PD's sought to continue to pay down liabilities, thereby reducing their leverage. They were also forced to use a significant portion of the cash to absorb the burgeoning supply of Treasuries, rather than using the cash to speculate heavily in stocks is they did from 2002 to 2007.

In the middle of the second quarter of 2009 they began selling their Treasuries back to the Fed. That's when the stock market really took off into the stratosphere. With the Fed buying less, the dealers were being forced to return to their primary function of supporting the Treasury market. No doubt they positioned accordingly by preparing to sell stocks.

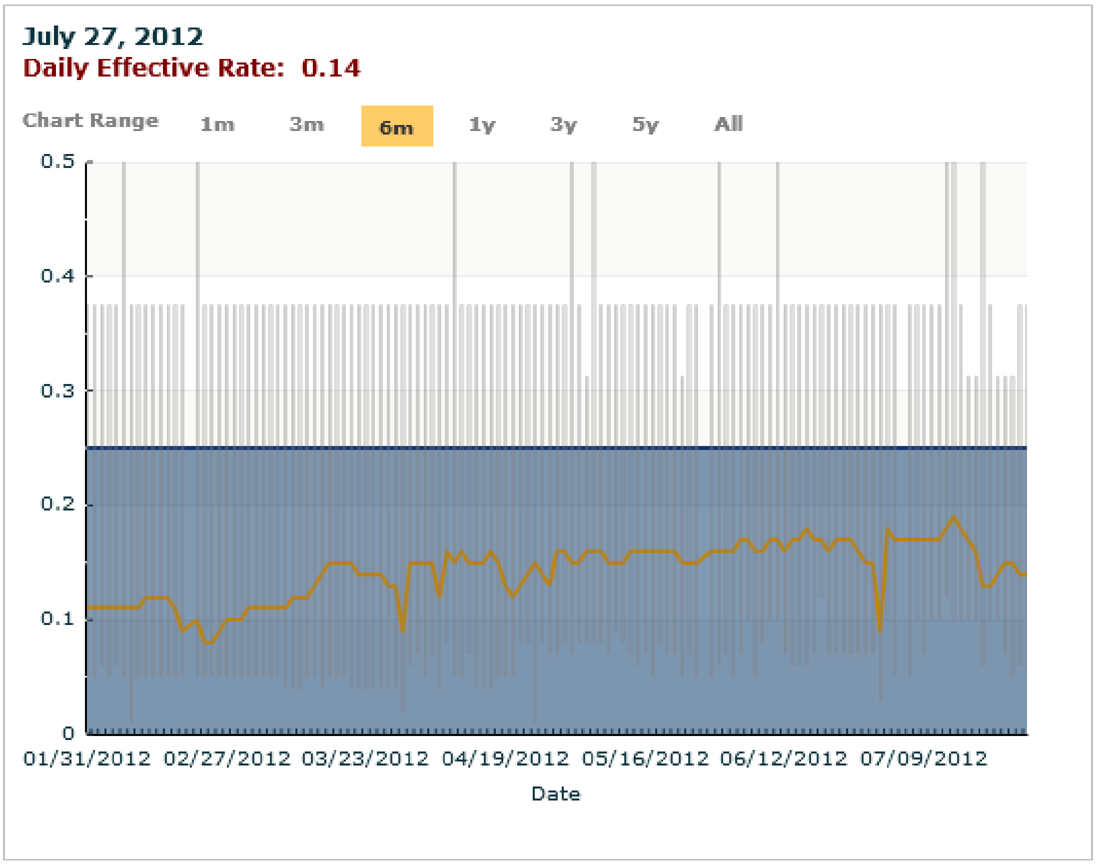
In the past, under different circumstances, we would have looked at this pumping by the Fed and concluded that it was powerfully bullish, but I surmised when these programs began that in an environment where everyone wants to reduce leverage, the Fed's old tricks may not work as well. As it turns out, they have worked, but far less well than in the past. There's much more drag from other systemic problems today, not the least of which is Treasury supply.

When stock prices sink in spite of Fed pumping is the day the markets would be in really big trouble. So far it hasn't happened.

The liquidity line bottomed in the week ended 2/4/09, and upticked gradually until 3/11/09, concurrent with the stock market bottom. As the line accelerated upward, stocks went along for the ride.

Why wasn't the September 2008 spike in liquidity bullish? It's because the market was under much greater stress at that time. The liquidity supplied was in the form of emergency loans to stabilize a rapidly deteriorating situation. On the other hand, today's liquidity injections come in the form of direct cash purchases which reduces the leverage on the PDs balance sheets and allows them to use the cash to re-leverage in an environment where direct stresses are temporarily reduced.

Fed Funds Rate



Source: NY Fed

Fed funds plunged last week after being in an uptrend for several months. It suggests another large influx of deposits.

History The official target remains little more than smoke. Bernanke claimed that the Fed has lost control of Fed Funds in his 12/1/2008 speech, intimating that it wasn't deliberate that rates had fallen below the target. So what did the Fed do? It pretended that that was part of the plan all along, and it lowered the target to where Fed Funds already were—effectively zero.

On 11/5/08 the Fed raised the interest rate it paid on reserves. It had started paying interest on reserves in October, causing banks to deposit hundreds of billions of dollars at the Fed, versus typically $10-12 billion before the inception of this program. The rate on excess reserves had been set at the Fed Funds target, which was 1.5%, less 35 basis points. The Fed then removed the 35 basis point discount and was paying interest at 1%. That caused even more deposits to come in to the Fed since banks could borrow funds at 0.25% or less from the Fed, or could borrow T bills and short them at virtually no cost and then deposit the Funds at the Fed and earn a 1% return.

The Fed then funneled this cash back to the markets mostly through its alphabet soup programs and currency swaps with foreign central banks. With the cut in the Fed Funds target to 0-0.25 on December 16, 2008, the Fed ended that little game. The question now is what will become of those deposits. My guess at that time was that the banks would pay off the underlying loans, rather than invest the money elsewhere. This would run counter to the Fed's desired aim of reflating. Instead, the banks used the proceeds of their subsequent securities sales to the Fed to pay off the alphabet soup porgrams and left the deposits at the Fed. See http://wallstreetexaminer.com/2009/08/25/much-ado-about-reserve-growth/

(Late 2008) - Lowering the target rate effectively to zero could actually hasten the deflationary disaster the Fed has been trying to avoid. Investors dependant on returns from money market fund investments to pay their living expenses will now have no choice but to draw against principle. This will reduce the funds available for investment in commercial paper and CDs. As investors try to withdraw their cash, it will also severely test the ability of the MMFs to meet the redemption requests.

When the Fed started paying interest on reserves it sucked a lot of money that had been sitting in T-bills yielding close to zero into these accounts at the Fed. Where did those deposits come from? …the Fed's alphabet soup programs. It was a circle jerk. The Fed lent money to the banks, brokers, and various and sundry other institutions and the banks then re-deposited that money at the Fed. How does that help anything? It simply sucked capital out of the financial system to be parked in this circular track from which it never escapes. Meanwhile the bills kept coming due, so the players had to keep selling in order to pay up. It was a vicious cycle, and until the Fed and the Treasury woke up and reversed course, we were in a deflationary vortex that sucked in everything in its path.

There were signs in Bernanke's decision in March 2008 to buy Treasuries on top of buying mortgage paper, that they might have been beginning the process of attempting aggressive monetization and reflation. That idea was reinforced with the FOMC announcement of March 18, 2008 that the Fed would increase their buying of Agencies, MBS, and begin buying longer term Treasuries.

The outcome of the Fed's quantitative easing policy depended entirely on the market response. If market actors simply hoarded the cash it would continue to disappear into a black hole as prices plummeted. If they began to lend the funds or used a portion to speculate, we could end up with the severe inflation that so many were counting on. We had no way to know at that point what that outcome would be. We did know, however, that price is the one and only arbiter. Changes in price trends are the first clues as to what is going on. That's where we must stay focused for the first signs of real change from a deflationary environment to an inflationary one. Securities and commodity prices themselves give us the first sign, well before other data makes clear what's going on.

As it turned out, the players didn't lend, and there has been no economic inflation. But they did use funds to speculate, and that speculation was in the direction of inflation. There's just one problem with that. The underlying deflationary forces were still at work. Therefore the rallies in commodities and gold were based on a false assumption. As the Fed withdrew its support of Primary Dealer speculative activities, the inflationist crowd could face a reckoning. That's not to say that they'll be wrong in the long run. I don't have a crystal ball on that. But I do see the conditions for a severe testing of the belief in the ultimate result being a raging inflationary environment.

Continued on next page

Other Policy Tools and Total Fed Credit

7/17/12 The Fed had another "practice" term deposit on Monday, July 16. The $3 billion operation just moves a small amount of reserves into a fixed term account for 4 weeks. It has no impact whatsoever on anything. Interest in this program is diminishing. It's too small for most big banks to be bothered.

Term Deposit Facility									
Auction Date	Settlement Date	Maturity Date	Amount Offered	Amount Tendered	Amount Awarded	Stop Out Rate	Bid/ Cover	No. of Bids	No. of Bidders
6/14/10	6/17/10	7/1/10	1.00	6.14	1.15	0.27	6.14	194	109
6/28/10	7/1/10	7/29/10	2.00	11.14	2.12	0.27	5.57	181	107
7/12/10	7/15/10	10/7/10	2.00	7.40	2.12	0.31	3.70	143	94
10/4/10	10/7/10	11/4/10	5.00	13.61	5.00	0.27	2.72	108	74
11/29/10	12/2/10	12/30/10	5.00	14.66	5.00	0.26	2.93	88	62
2/7/11	2/10/11	3/10/11	5.00	12.62	5.00	0.26	2.52	61	41
4/4/11	4/7/11	5/5/11	5.00	10.99	5.00	0.26	2.20	59	43
5/31/11	6/2/11	6/30/11	5.00	10.86	5.00	0.259	2.17	54	40
7/25/11	7/26/11	8/25/11	5.00	6.34	5.00	0.280	1.26	54	37
9/19/11	9/22/11	10/20/11	5.00	12.06	5.00	0.265	2.41	62	43
11/14/11	11/17/11	12/15/11	5.00	12.62	5.00	0.260	2.52	61	41
1/9/12	1/12/12	2/9/12	3.00	13.56	3.00	0.260	4.52	66	46
3/19/12	3/22/12	4/19/12	3.00	11.41	3.00	0.255	3.80	63	36
5/14/12	5/17/12	6/14/12	3.00	10.87	3.05	0.255	3.62	51	30
7/16/12	7/17/12	6/14/12	3.00	8.34	3.04	0.255	2.78	43	22
Note: Amount Awarded included non- competitive bids in addition to amount offered. Bid/cover includes only competitive bids.									

(8/8/11) The Fed threw a term deposit auction on July 165, and not only did I not notice it last week, apparently neither did anyone else, as only $6.34 billion was tendered for the $5 billion facility. These operations are meaningless, transferring $5 billion from existing reserve deposits of over $1.5 trillion to a fixed rate account for 4 weeks.

(2/13/11) It's interesting that the Fed is doing this now. They are apparently getting prepared for the possibility that they will need to increase the size of these operations and raise the rates in order to keep the reserves locked up. In the meantime, it simply shifts a tiny sliver of the mountain of the existing reserves on its balance sheet to a different type of account. I still find it unlikely that there will be a need to make practical use of this facility, unless the Fed decides to raise interest rates because commodity price inflation finally convinces them too. In other words, Bernanke would have to give up his cherished delusion that soaring commodity prices don't matter.

(9/17/10) On September 8, The Fed announced expanded offerings of the Term Deposit Facility.

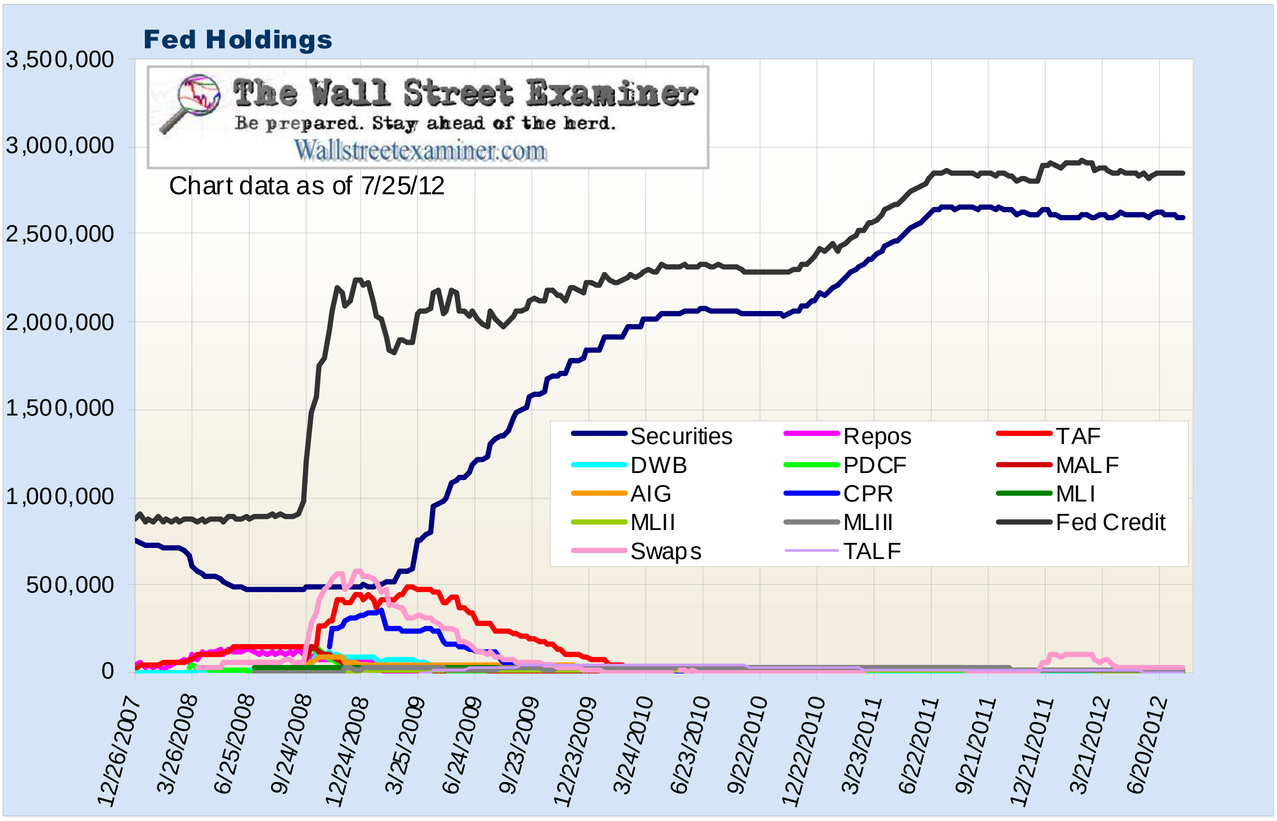
> "The terms and frequency for these auctions may evolve over time, but the Board currently anticipates that TDF auctions will be held about every other month. Following this approach, two auctions will be conducted over the remainder of this year on October 4 and November 29; the corresponding settlements will occur on October 7 and December 2, respectively. Each of these auctions will offer $5 billion of 28-day deposits; the modest increase in the offering amount from the $2 billion offering amount at auctions held in June and July is intended to encourage broad participation by depository institutions at the upcoming auctions. The schedule, amounts, and other terms for small-value auctions to be conducted in 2011 will be announced at later dates."

More than $1 trillion in excess bank reserves are currently sitting in deposits at the Fed with no incentive other than the minimal 20 or so basis points interest. The longer term deposit rates should be only minimally higher than the overnight rates for deposits that are not locked up. My guess is that the Fed will never need to use this facility after the trial period, any more than it will need to use the expanded reverse repo counterparties that it announced last year. Excess reserves should disappear by themselves over time as asset deflation progresses.

The Fed announced on February 18, 2010 (http://www.federalreserve.gov/newsevents/press/monetary/20100218a.htm) that it was raising the discount rate from ½ % to ¾ % and taking other steps to normalize policy as it continued to wind down emergency operations. These included reducing the term of discount window borrowings to overnight from 28 days, raising the minimum rate on TAF operations to ½ % and holding the last TAF operation on March 8.

The purpose of these changes was to force those remaining institutions using these programs back into the private credit markets. The effect will be to reduce the Fed's balance sheet. The Fed stated, however, that these changes did not reflect a policy tightening. In other words, the effect will be to reduce the growth of the Fed's balance sheet, so it was in fact a tightening, but since the Fed said that it was not a policy tightening, we're supposed to believe what they say and not what they do.

On April 99 the Fed adopted a rule creating a term deposit facility as another tool to control reserves and interest rates. This type of program has long been used by the ECB. The Fed will pay interest on deposits for a variety of fixed terms. These deposits would not be applicable as reserve balances. It is a way to absorb the trillion in excess reserves currently sitting on the Fed's balance sheet, and about which the Fed is extremely nervous. I do not think that the tool will be needed since the banking system is too weak to deploy this cash as a basis for loans and will remain so indefinitely. However, the structure is now there, so should the need arise, it can be used to keep interest rates and bank lending under control.



This chart reflects the size of all of these programs individually. Total securities holdings including the Treasuries in the SOMA plus the Agencies, MBS and other securities which the Fed may choose to buy are also shown on the left scale. Total Fed credit is shown on the right scale. The chart begins in December of 2007 when the Fed began the nonsense of the alphabet soup du jour.

	7/25/2012	Change
Total Fed Credit	2,849,108	7,100
Securities	2,595,823	(6,915)
Repos	0	0
TAF	-	-
DWB	123	(7)
AIG	-	-
CPR	-	-
MLI	2,081	53
MLII	61	43
MLIII	7,155	991
Swaps	27,232	(3,320)
TALF	3,570	(868)
TALF LLC	845	-
Alico/Aurora	-	-
Total Soup	41,067	(3,108)

Total Fed credit fell last week as securities holdings and swaps fell. The total size of the Fed's balance sheet is little changed from where it was a year ago.

4/1/12 Meanwhile, the amount of cash the Fed is pushing through Primary Dealer trading accounts is far more important to the markets than the total size of the balance sheet. That will begin to decline over the next few months as MBS paydowns recede.

(10/30/11) The Fed's new program of replacing the MBS that get paid off from its balance sheet with purchases of MBS instead of Treasuries, as it had been doing from July through September, results in delayed settlement of the purchases. Instead of the new Treasuries being reflected on the Fed's balance sheet the day after the trade as under the prior program, the new MBS purchases take a month or two to settle. That means that the funds do not become available to PDs immediately, although I assume they can use the when-settled securities for financing purposes. Since early October the Fed has purchased approximately $21 billion in new MBS which will not begin to show up on the balance sheet until November (specific dates not specified). As a result the balance sheet will reflect securities holdings of less than the target of $2.65 trillion until November. This should have no material impact on the system.

(10/10/11) The Fed intends to keep its total securities holdings right around $2.65 trillion. Neither Operation Twist nor the increased MBS purchases will have any impact on the size of the balance sheet.

(9/22/11) Contrary to popular belief, by holding the size of the balance sheet steady, Fed policy is tight, not easy. In the absence of capital flight out of Europe flooding the Treasury market, yields would be rising. The Fed is doing exactly as we expected, sitting and watching while pretending to tweak, and pretending that it still has weapons. When the pressure becomes too great to be ignored, it will react more aggressively. However, market participants have lost confidence. Under the circumstances, the unintended, negative consequences of any new round of QE could overwhelm the Fed's intended consequences of providing a boost to the financial markets and economic activity.

(8/8/11) The Fed may have to increase its POMO purchases next month to offset possible acceleration of MBS paydowns due to increased refi activity spurred by record low mortgage rates. That won't be enough to stabilize the markets. To do that, the Fed would need to return to purchasing the equivalent of all new Treasury issuance. Such a move would renew the commodities stampede, something that the US and world economy simply cannot handle given the financial fragility. The Fed's hands may be tied.

(7/30/11) I've been expecting occasional minor shrinkage of the Fed's balance sheet, but the fact that it did not have a bearish impact initially was a result of the fact that private capital had begun flowing into the US from the rest of the world, offsetting the loss of Fed support. That temporarily allowed the market to remain stable.

As we watched this phenomenon, I emphasized that it would be temporary. These flows were not driven by the US being a great place to invest. I warned last week that the situation in the US was deteriorating so rapidly that these flows could dry up at any time. It appears that this was the week that they did. At this point, even if Congress now moves with record speed to enact an increase in the debt ceiling, thereby avoiding default and radical spending cuts, or a Constitutional crisis, I suspect that enough damage has been done to cause investors all over the world to permanently question US credibility as a safe haven. The damage has been done.

As a result, I believe that the Fed now stands alone as the last potential prop for the US markets. Under this pressure Bernanke's behavior is likely to become even more erratic, more insane. Any period of severe weakness in the US market is likely to be met with another bizzarro policy response. There's really no way to guess what the Fed might try, but if and when the market weakens substantially, one night or weekend you can be certain that the Fed will launch a surprise move against bearish positions in the market. It won't be a problem for those already short from higher levels, but the short term risks to leveraged short positions will increase disproportionately into any decline. As far as shorts are concerned now, the only thing we have to fear, is the Fed, itself.

(6/26/11) Historically, it is extremely rare that the Fed has not grown its balance sheet for any period of consequence, even if only by a 4-5% rate. They did it for a few weeks in 2010 and the market immediately plunged, which scared the pants off Bernanke who immediately responded first with QL1.5 and then QE2. The last time they did it before that was in the second and third quarter of 2007. That led to the collapse in 2008 when they grew the balance sheet, but shrunk the System Open Market Account (SOMA) driving the Primary Dealers into de facto bankruptcy.

This time, they'll hold the SOMA level, but I believe that that's wholly insufficient. It is like withdrawing life support from a comatose patient completely dependant on that support for his existence. It's another one of Dr. Bernankenstein's sophomoric experiments, necessitated by the abject and foreordained failure of the previous crazy experiment, QE2. This is what the Fed does, careening wildly from one massive policy blunder to the next countervailing blunder designed to undo the damage of the last one. Each has unintended, and often completely foreseeable, negative consequences.

(5/1/11) At the end of April, the value of certain legacy alphabet soup programs rose due to quarterly "fair value adjustments," according to the Fed. The numbers are insignificant in the big picture, but they raise other questions about similar accounting for larger pools of Fed assets, in particular the MBS portfolio, a large chunk of which is likely worthless. The Fed likes to play "make believe," and the market has been totally willing to play along. Some day, that will no longer work.

(4/18/11) The Fed has been auctioning about a billion of AIG Maiden Lane II assets each week. These are drains from the system, but wholly insignificant. The Fed will continue to auction this paper in small chunks which will not materially affect the Fed's balance sheet or systemic liquidity.

(1/21/11) While the Fed has closed out its AIG holdings and loans it is still sitting with $38 billion in AIG bad paper and $26 billion in Bear Sterns bad paper. When will it face the music and take the writedowns? Right there is almost enough to wipe out Fed capital. So, the likelihood is that if they recognize it at all, they will do so over many years.

(1/26/11) Total securities holdings are still well short of the Fed's goal of $2.654 trillion in securities holdings in June. The Fed reaffirmed that target in the January 26 FOMC statement, as it steadfastly refuses to acknowledge that the money printing is causing damaging commodities inflation, or even that this inflation exists.

I had suspected that we might see some language in the FOMC statement that would at least pay lip service to the problem, with the announcement of a possible tilt toward either a lower goal, or a longer time frame for reaching that goal or both. The Fed could simply declare victory and start pulling in some of its line. But instead the Fed simply pretended that the problem does not exist. Will it become so overwhelming by the time the March meeting rolls around, that it can no longer be ignored? Stay tuned.

(10/3/10) The alphabet soup programs have mostly gone away. The remaining programs mostly revolve around the Fed's ownership stakes in AIG and the remnants of the Bear Sterns portfolio. Those should remain stable as the Fed refuses to take any writeoffs on any of the paper it holds. Like most of the banking world, the Fed has made extend and pretend into an official policy.

(9/10/10) While the Fed may catch up on the drop in MBS and GSE paper, it won't make up for the fall in alphabet soup. Those programs will continue to disappear without replacement, and the Fed's balance sheet would continue to shrink slightly until the alphabet soup programs are all paid off. At that point the balance sheet would plateau.

(8/14/10) The Fed has been enormously profitable lately, and those profits get distributed back to the US Treasury, lately at the rate of $5-7 billion per month, a drop in the bucket relative to the deficit. Here's a thought. Maybe the Fed should buy up another $10 trillion or so of bad paper and send us $50 billion a month in profits.

All alphabet soup programs except the FCB swaps have ended. Most of the money that remains in the soup represents the Fed's holdings in AIG and the Bear Sterns portfolio along with TALF. No doubt that a large proportion of these figures will eventually be written off, with the issuers having been paid in full by the American people.

(8/14/10) We should expect more emergency actions in the months ahead. However, we are now in a different environment, one in which, at best, market participants question the effectiveness of central bank actions to stem the bleeding. At worst, the players lack any confidence in those actions. That would lead inevitably to a complete collapse.

This is the unavoidable endgame about which I have voiced my strong concern since the Fed and Treasury first began transferring private risk, indeed trash assets, onto the public ledger by buying worthless securities and providing loan guarantees to a wide variety of private financial entities backed by fictitious capital. That could only work as long as investors were willing to suspend disbelief and buy into the con. We have probably reached the point where that will no longer work and the Ponzi pyramid collapses, leaving the public via its government proxies as the bagholder.

(Q1 2010) Most of the growth in the Fed's securities holdings has been in MBS, severely impacting the quality of the Fed's holdings. MBS growth has outstripped the growth of Treasuries and GSEs, accounting for more than 2/3 of the expansion of total securities holdings since the beginning of 2009. The Fed's packing of its balance sheet with this toxic waste is almost incomprehensible.

Furthermore, the Fed's MBS purchases create no net new credit as the total outstanding credit in that market shrinks along with deteriorating credit quality.

In terms of systemic impact, the transfer of MBS assets from private balance sheets to Ben's was a zero sum game. All that is being transferred is the risk. No new credit or new liquidity was created because the mortgage credit market wasn't growing.

In case the Fed hasn't noticed, it's shrinking as old loans get paid off or written off, and the new loans that come on the books are smaller. Furthermore the mortgage industry has delayed declaring defaults and foreclosures to the nth degree so that they can avoid taking the write-offs. So the MBS credit pool will shrink a lot faster at some point. In fact it has already imploded, and the Fed and the other players are just trying to prevent, or at least delay the recognition of the issue. This is a ticking time bomb. The fact that the Fed now holds so much of this paper does not comfort me. In fact, it scares the hell out of me. These debts were scary enough when they were private. Now that they are public obligations, they are downright horrifying.

In a lengthy note on its H41 for the July 169, 2009 week, the Fed explained that it had recognized more losses in the Maiden Lane partnerships MLs 1, 2, and 3, which are the old portfolios of Bear Stearns, and whatever it was that the Fed took off AIG's hands. The Fed ended the note with the statement that it expects to eventually realize the balances in these partnerships in full. It has been marking down the value of these partnerships on a quarterly basis. Slowly but surely, we are eating the bad debts the Fed has acquired on our behalf.

After marking the Maiden Lane partnerships to market and taking losses there, the Bear and AIG related values stabilized. That's probably a mirage. Wait till next quarter. The Fed has gone into elaborate details on the ML partnerships and the writedowns, with tables and fancy pie charts here, http://www.ny.frb.org/markets/maidenlane.html, for those who are gluttons for punishment.

Those losses come directly out of our pockets. They accrue to the Fed's bottom line, reducing the Fed's surplus (akin to retained earnings) and other capital accounts. Each fiscal year, the Fed's surplus is returned to the US Treasury. So when the Fed loses, we lose. It's not a lot in the overall scheme of these bailouts, but it is the first admission that we won't be getting our money back, and that our kids will have to pay for it, on top of paying our expenses when we are drooling away our final days sitting in wheelchairs watching The Price is Right.

We are in uncharted waters here, and if there's enough debt extinguishment, this may still at some point rapidly devolve into a deflationary collapse which the Fed may be powerless to stop.

Other Fed Balance Sheet Items - Liabilities

The Treasury withdrew a net of $20.4 billion from its checking account at the Fed last week. This brought its deposit balance to $38.2 billion in the week ended Wednesday. That's cash that got spent into the banking system and created, or represented, economic activity.

7/10/12 We expect to see bank reserve deposits rise when Treasury balances fall as bank depositors deposit checks from Uncle Sam and the banks immediately put the funds into their own cash reserves at the Fed. In essence these are just pass-through deposits from you, me, Warren Buffet, Apple, Exxon-Mobil, and the rest of us. Likewise, when the Treasury raises cash through tax collections and debt sales, it looks like a reserve draw down, but it's really just a temporary transfer from bank checking accounts into the Treasury's reserves. The cash will return to the Fed's bank reserve accounts in the following week or at most two.

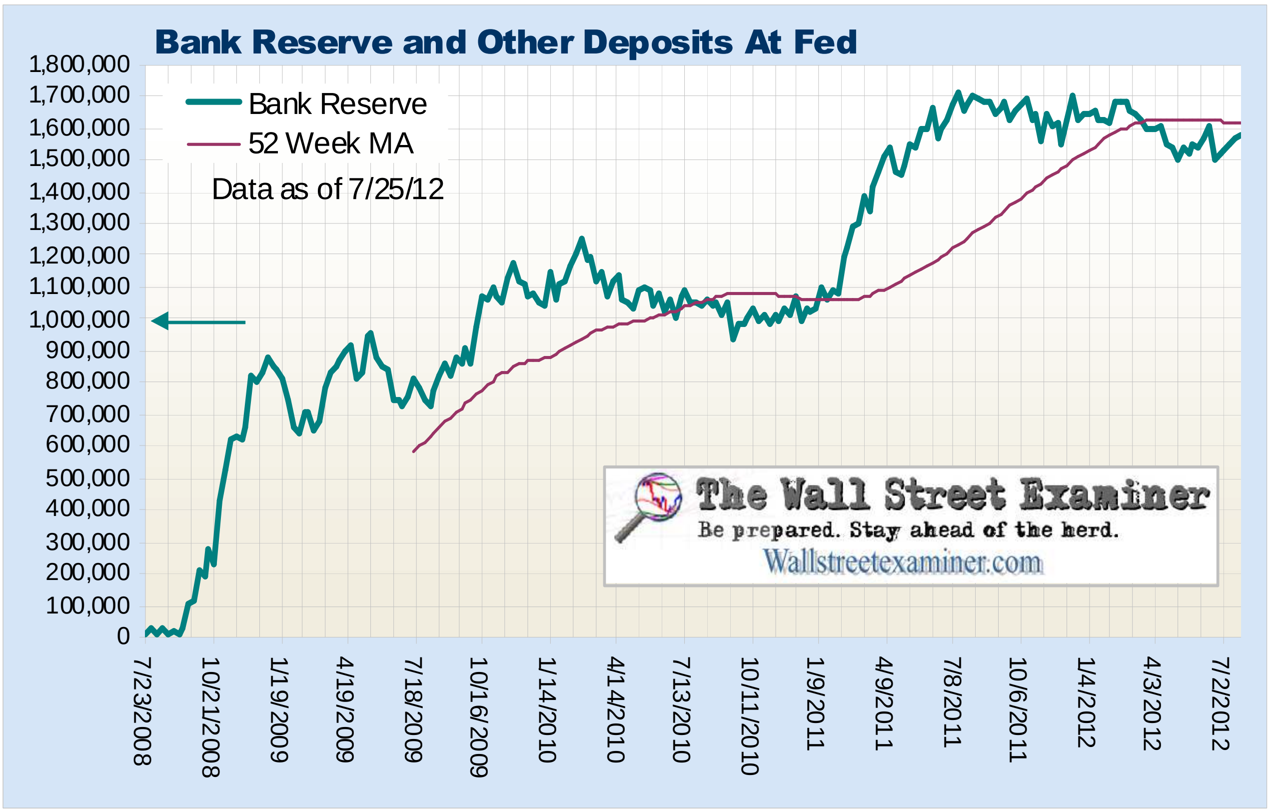
That spending and those transfers represent the creation of economic credits that show up in the economic data for that week. When the Treasury sucks up all the cash the economy slows for a few days, but when those checks go out, things pick up again. Given the lately stronger tax collections and election year spending, I would not be surprised to see the economic data start to pick up again.

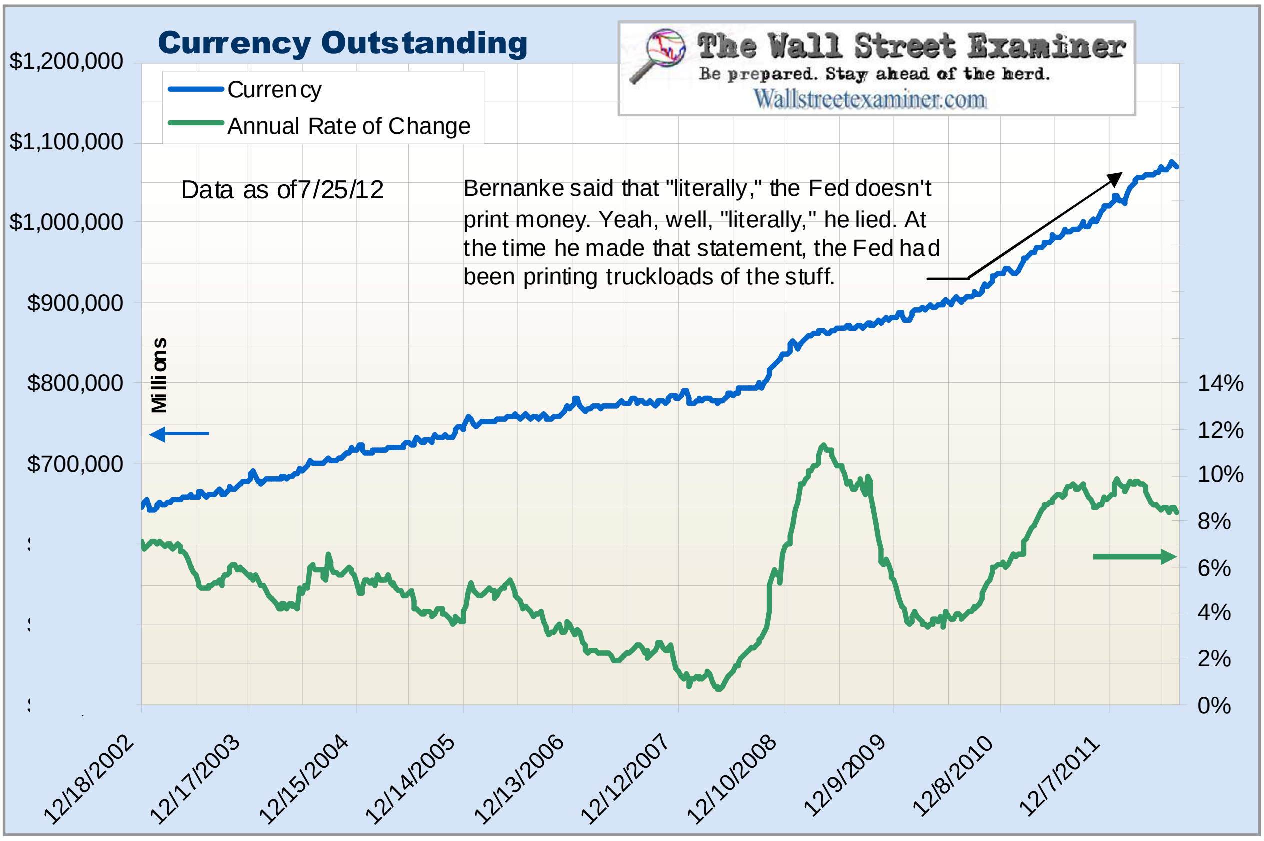
Banks deposited a net of $30.6 billion to their accounts at the Fed last week. The mysterious "Other" deposit accounts (GSEs, and unnamed foreign official organizations and government entities- People's Bank of China?) saw withdrawals of $21.6 billion, leaving combined bank and "Other" deposits up by $9 billion. Other liability items had only minor changes resulting in a drop of $9 billion in total liabilities, matching the decline in assets. The transfers appear partly related to the MBS paydowns flowing out of the accounts of Fannie and Freddie (Other deposits) reducing the Fed's asset base.

4/24/12 In the end, it always balances. That's Rule One of double entry accounting and the reason why that $1.5 trillion in reserve deposits is so "interesting." What will be the offsetting entry or entries should the time ever come for those reserves to start being withdrawn? Time will tell.

2/24/12 The Fed gives absolutely no information on the inflows and outflows from the Other deposit accounts. There are UFO's (Unidentified Financial Organizations) with deposit accounts at the Fed. We don't know who they are or what they are. So much for "transparency."

Continued on next page


Bank Reserve and Other Deposits At Fed
Bank Reserve
52 Week MA
Data as of 7/25/12
1,800,000
1,700,000
1,600,000
1,500,000
1,400,000
1,300,000
1,200,000
1,100,000
1,000,000
900,000
800,000
700,000
600,000
500,000
400,000
300,000
200,000
100,000
0
7/23/2008
10/21/2008
1/19/2009
4/19/2009
7/18/2009
10/16/2009
1/14/2010
4/14/2010
7/13/2010
10/11/2010
1/9/2011
4/9/2011
7/8/2011
10/6/2011
1/4/2012
4/3/2012
7/2/2012
The Wall Street Examiner
Be prepared. Stay ahead of the herd.
Wallstreetexaminer.com


Currency Outstanding
Currency
Annual Rate of Change
Data as of7/25/12
Bernanke said that "literally," the Fed doesn't print money. Yeah, well, "literally," he lied. At the time he made that statement, the Fed had been printing truckloads of the stuff.
The Wall Street Examiner
Be prepared. Stay ahead of the herd.
Wallstreetexaminer.com
Millions
$1,200,000
$1,100,000
$1,000,000
$900,000
$800,000
$700,000
14%
12%
10%
8%
6%
4%
2%
0%
12/18/2002
12/17/2003
12/15/2004
12/14/2005
12/13/2006
12/12/2007
12/10/2008
12/9/2009
12/8/2010
12/7/2011

2/20/12 I noted last week that the Treasury made an enormous withdrawal and that the Fed seemed to need to jump through hoops to fund it since not the entire Treasury's spending made it back to the Fed's balance sheet in the form of bank reserves. Since the Fed didn't liquidate any assets to offset the funding gap, it needed to increase a different liability, and one of the things it did was to debit currency outstanding by a whopping $8 billion. We don't know whether the Fed initiated the currency transfer on its own or the Treasury or somebody else requested it. It's just another of those things that's hidden behind the Fed's wall of obscurity and obfuscation.

Much to my surprise, the Fed did it again this week, dispatching truckloads of cash totaling $7.2 billion. Although something similar happened in February 2011, this 2 week printing spree was a new record. Again, we don't know who initiated the "job", but we do know that the "request" did not come through the NY Fed. The biggest chunk of it was issued in Cleveland and Richmond of all places, followed by Atlanta and San Francisco. OK, Richmond is just down I-95 from DC (and CIA HQ in Langley), but Cleveland?

This week, the asset side of the balance sheet looked like the culprit behind this, as the Fed increased its securities holdings by a net of $18 billion while liquidating $7.7 billion in undefined "Other" assets and around a billion of other "stuff." That left a $9.6 billion increase in assets that had to show up in liabilities, but only a little over $2 billion of it appeared as deposits. The rest was cold, hard cash. Currency outstanding has now increased by 10% in the past 12 months. How and why does that happen in an economy that has only grown by 2.5%?

In fact, from 2003 until 2008, currency outstanding grew at a compound rate of 2.75%. Then from September to December of 2008, the Fed added 6% to the amount of currency outstanding. There was a similar surge from September 2010 and January 2011 and it's been pretty much pedal to the metal ever since. The last 2 weeks looks like an even greater acceleration. I don't know what to infer from this, but maybe it relates to confidence issues in some quarters. Perhaps it is related to the European financial crisis, as some players seek the "safety" of US dollars in safe deposit boxes rather than bank accounts, stocks, bonds, or gold. It certainly isn't due to a rapidly growing economy with a high demand for cash.

12/24/18 I've been saying for some time that in terms of the impact on the financial market, the movement of funds between these accounts on the balance sheet is mostly a matter of pushing the spaghetti around in the pot. However, there's some evidence of these reserves reaching the economic stream through an uptick in Commercial and Industrial loans. There has also been a rise in financial lending, particularly in bank repo and fed funds with non banks, in other words, securities based financing. But that appears to simply be a movement from the commercial paper market where financial company commercial paper dropped by almost the same amount from May to December.

(July 16011) Without QE, total bank deposits and Other deposits should remain stable around these levels. These deposits can shrink only if the liability items of Treasury Deposits or Reverse Repos increase, or if the Fed sells assets, and we know that that will not happen.

(8/29/11) The Fed describes these as follows. "U.S. law allows a number of government-sponsored enterprises (GSEs) to maintain deposit accounts at the Federal Reserve. Like the U.S. Treasury, these GSEs use their accounts to receive and make payments, which include receipts from issuing debt and payments for redeeming maturing debt. An increase in the line "other deposits" typically reflects a transfer of funds from depository institutions to one or more of these GSEs; thus, an increase in "other deposits" ordinarily is matched by a reduction in deposits held by depository institutions."

That sounds benign enough, except for the fact that the total of $68.5 billion, reached the week ended August 24, is unprecedented, and I can't see where previous large increases in this item are associated with previous refi waves and a temporary cash bulge at the GSEs. Instead, there's this additional hidden gem buried about 6 layers down on the Fed's website:

Other deposits at Federal Reserve Banks include balances of international and multilateral organizations with accounts at FRBNY, such as the International Monetary Fund, United Nations, International Bank for Reconstruction and Development (World Bank); **the special checking account of the ESF (where deposits from monetizing SDRs would be placed) [emphasis mine]**; and balances of a few U.S. government agencies, such as the Fannie Mae and Freddie Mac.

So it is possible that with the stock market on the verge of collapse, this account reflected deposits into the Exchange Stabilization Fund under the control of the Plunge Protection Team of the Treasury/Federal Reserve Joint Commission on Market Rigging, Propping, and Fixing. Or it could be something perfectly innocent and mundane. That seems unlikely under current circumstances.

(9/22/11) Regardless of the source of these Other deposits, be it foreign official organizations, central banks, or Fannie and Freddie, who may have decided that rather than hold their balances within the US commercial banking system they will hold them at the Fed, the growth of these deposits represents a drain on the banking system. In that sense, they are no different from banks depositing their excess cash at the Fed. Accordingly, as these deposits have grown in importance, I am now including them in the chart of total reserve deposits at the Fed.

It will be interesting to see if there's any meaningful decline in total deposits at the Fed in the months ahead. If not, it will signal that most of the Fed's QE printed money remains locked up in its vault. As the Treasury removes cash from the financial pool through debt sales and then spends that cash in subsequent weeks, banks would, in theory, have ongoing opportunities to redeploy funds through loans or investments. If they don't do it, it suggests that they are unable and unwilling to do so.

The question would then become how the Fed would fund such withdrawals of reserve deposits without having to tighten by selling assets. I don't have the answer. In practice, I think that the likelihood of these funds leaving the Fed is close to nil, as most banks are capital constrained from lending and furthermore see few opportunities to make sound investments.

That is an even bigger problem now that investment spreads are increasingly inadequate to compensate for risk. As a result, the monetary picture, while appearing to be loose, with explosive monetary growth, will remain, in reality, tight, with continuous pressure on financial markets as the need by sovereigns to sell ever increasing amounts of debt should only grow. Eventually, this Ponzi structure must collapse. As the pace of the crisis picks up, that time seems to be growing closer.

The paragraphs below describe earlier situations that may have changed since the date of the entries, but they are still relevant to establish a timeline of events showing how this situation has evolved and changed.
(9/6/11) Another line item was called to my attention in the week ended 8/31 by an article by Ambrose Evans Pritchard in the Telegraph. He incorrectly identified the item as foreign official deposits at the Fed. They are actually reverse repo agreements, where these counterparties essentially make short term dollar loans to the Fed collateralized by securities held by the Fed. In a reverse repo, the Fed sells the securities to the counterparty with an agreement to repurchase them at a fixed date, typically in the very short term. The counterparties can be Primary Dealers, third party institutions who are on the Fed's approved list, or foreign official accounts or international organizations.

All of the currently outstanding reverse repos are in the foreign official accounts category. This item rose to a record $104.5 billion in the week of 8/31, up $5 billion. This effectively drains dollars from circulation around the world. However, the amounts are not large in relation to the bank deposits at the Fed. I will monitor and report this item only when there are major changes that appear to have the potential for a major impact on the system. A change of several billion per week is essentially a rounding error.

(7/12/11) Once again, POMO and more ended up getting locked up in the Fed's vault as banks refused to or were unable to deploy it. As has been the case throughout QE, little or none of the cash remained in the financial market pipeline. Unless it comes back, which seems extremely improbable given the banks' condition, I expect the markets to come under severe pressure. We've already seen intermittent episodes of that in Treasuries and stocks, as they alternate taking the pipe.

Treasury spending is the mechanism for POMO to be translated into economic activity. With POMO ending and government spending cuts coming, this should translate into reduced economic activity.

(7/16/11) As of the end of QE2, Bank reserve deposits at the Fed were up by $624 billion since January 19, the week before the January Fed meeting. The Fed had printed $551 billion since then, which meant that the banks sucked $73 billion more out of the economy than the Fed printed over that time. Either the banks were sent a message after the January meeting, or they heard something they didn't like, or they're just broke and have no choice but to hold the extra cash.

(5/1/11) I suspect that the surge in net POMO appearing to make it into the economy in the second half of April was just an illusion due to tax collections as cash poured out of bank accounts into the Treasury account at the Fed. The Treasury spent this money and sent it into the economic stream over the ensuing weeks. But it's doubtful whether from that point forward, the banks will continue to reduce reserves. I suspect that they will quickly renew the process of building cash. I believe that as long as the Fed is creating mass quantities of money, the banks will have problems placing it anywhere but in the vault.

(2/27/18) The PDs who, remember, get the cash first, are still diverting some of it to the hot commodity of the moment. So while the banks are getting more tightfisted overall, their Primary Dealer subsidiaries and affiliates have no qualms about putting risk capital to work in the areas that will do the most harm in both the short and long run- commodities, particularly oil and food.

(7/16/11) From the inception of QE2 in November to the end of the program, the Fed's money printing boosted reserve deposits by $705 billion. Total QE2 was $777 billion, meaning that just $72 billion, or less than 10% of the money the Fed has printed since November remains in circulation in the economy, and all of that was pumped in during the early days of the program. The banks started hoarding the funds in late January. Some of it was forcibly injected into the economy through tax collections and subsequent government spending in April and June, but the total amount of POMO in the economic stream never recovered above the peak level hit last January.

It is no accident that the stock market made an interim peak 2 weeks after net POMO in circulation peaked in early February. That peak also coincided with the peaks in several economic data series, and notably also the peak in certain commodities, including soybeans and copper.

(6/16/11) The question is what happens when POMO ends. Reserve deposits will drop each time the Treasury settles the new debt it sells at mid month and the end of the month. They will drop especially sharply on September 15 when the Treasury collects quarterly taxes and settles new debt at the same time. It will then spend all that cash and it will re-enter the banking system in the ensuing weeks.

What we don't know is whether those reserves will be used to support investment, whether in Treasuries or more speculative investments including direct lending, or even purchases of equities. I don't have the answer, although I suspect that the banks are so weak that they will have no choice but to continue to sit on this pile of reserves. Any net withdrawal would require a concurrent increase in another liability or decrease in assets on the Fed's balance sheet. In either case, that would seem to require that interest rates rise as liquidity tightens and/or the Fed's balance sheet shrinks.

Since we are heading into the great unknown and I don't have a crystal ball, rather than speculate on what might happen, I will monitor these balance sheet items, and related market technical indicators closely in looking for early clues as to where the trend is headed.

(3/3/11) Before February 2, the money was getting into the economy and creating activity. That cash was also responsible for spurring the unintended and unwanted consequences of the Fed's actions—soaring commodity prices—as well as the intended consequence of a new stock market bubble. However, all of that stopped right after the late January FOMC meeting.

(3/12/11) As a result, the stock rally has stalled out and commodity prices have experienced some air pockets. The economy is on a parallel track, only we don't get the data on that for another month or so. But make no mistake, if the financial markets and commodity markets are stalling out, then so is the economy. This stall will show up in the economic data within weeks. That could then feed into a self reinforcing financial and economic plunge.

(2/4/18) Bernanke refuses to take responsibility for these consequences, while at the same time taking credit for the rise in stock prices. It is this kind of delusional thinking and behavior that has caused the destruction of the US economy, and will wreak untold havoc going forward.

(1/7/18) The POMO money is flowing into the economy, mostly via massive government deficit spending, almost all of it now printed by the Fed. It alone is keeping the economy afloat and making the economic numbers look much better than they would be in the absence of this Fed pumping. Bernanke's claims that the economy is now on a self sustaining growth path are hogwash. He is attempting a con job. The truth will only be known when the propping stops. There is no doubt that he is creating a raging commodities inflation though.

There is no increase in private investment. This is a classic case of the Fed putting lipstick on a pig. The mainstream media is lapping it up. This will continue only as long as the Fed continues to pump, and maybe not even that long. The spreading systemic rot could begin to undermine the Fed at any time.

(2/4/18) The Treasury's SFP "rainy day savings account" held $200 billion until February 2. The Treasury announced during the previous week that it would begin withdrawing $25 billion a week from that account to repay the outstanding CMBs that funded them, in order to provide a little more headroom before hitting the debt ceiling and triggering a political crisis. That money will flow back into bank accounts.

(1/30/11) The issue then is how much of it will flow toward other short term paper, sending rates to absolute zero, how much into bonds, suppressing yields, and how much into stocks, boosting stock prices. There's another alternative, given the low returns. It could just continue to sit there as cash, in which case the banks will simply boost their reserves on deposit at the Fed even more. These line items on the H41 will carry increased importance in the weeks ahead. The closer the increase in bank reserves is to this $25 billion a week (after adjustment for other items) the less impact the payoff of these CMBs will have on the market.

The website ZeroCred in particular has been hysterical about this, moaning and groaning before the fact that this cash infusion is likely to send the market skyward. Certainly that could happen, but it's not a given. It just depends on how the holders of this paper are predisposed. The holdings were a low return substitute for cash in the first place. The incentive for these holders to put the money at risk is likely to be low. It is possible that almost all of it will remain in cash. In addition to the bank reserves, rates on very short term commercial paper could also be a tell. If they move toward zero, then this money is opting for low risk alternatives. If the stock market is to be a beneficiary, we should begin to see the effects there by Wednesday.

(Early 2010) The Treasury's regular account balance came down from a whopping $185 billion at the beginning of 2010, which the Treasury confirmed had come from TARP repayments, just as we had surmised. The Treasury announced on February 19 that it would sell more TARP warrants over the next few months. That raises additional cash, boosting the Treasury's bank accounts, and propping the Treasury market. But that cash comes out of private bank accounts, much of it involving the sale of other securities. So we saw it as a wash for the system as a whole.

The Treasury pulled $185 billion out of that account in October 2009 to pay off expiring CMBs from the Supplementary Financing Program. Those CMB paydowns propped the stock and bond markets at that time.

The first TARP warrant sale was priced on Thursday, March, 4, 2010. It raised only $1.5 billion. Sales have continued from time to time in this size range. These sales arenot material to the big picture. Nor have other TARP repayments had a material impact.

The bulging reserves had the Fed on edge early in 2010. That's one reason why they raised the discount rate and tightened the terms of discount window borrowing, atop shutting down the TAF and other alphabet soup programs. These steps did reduce the excess reserves held at the Fed. Now the Fed has gone into a holding pattern is it waits for the other shoe to drop.

The MBS do not begin to mature for 10 years. Prepayments would have reduced holdings before that. As the MBS disappeared, there would not be enough growth in the housing market to grow the pie. **The balance sheet of the Fed, and of the banks, would continue to shrink over time, unless the Fed engaged in a second round of direct purchases of Treasuries.** The bigger worry would be a deflationary spiral, a market rejection of Federal debt, and an outright collapse.

It seems that the more the Fed pumps into the system, the more the banks hold the cash on reserve at the Fed rather than putting it to work by lending it out. Thus the Fed's pumping has no inflationary impact, other than the asset inflation that results from speculative activity. Such speculation is often based on erroneous assumptions, such as the assumption that the Fed's balance sheet expansion mandates the return of inflation at some point. In my view, we have exactly the opposite problem, but don't tell that to the leveraged speculators.

What are the banks doing with these massive excess reserves? They certainly aren't lending it. No one wants to borrow, save, or invest when the best return that they can expect is near zero. So they pay off high interest rate debt. The Fed's zero interest rate policy has been exacerbating the credit collapse.

	Totals in Billions		
	Fannie	Freddie	Total
Owned Portfolio	676.1	581.3	1,257.4
M/M Change	-	(10.6)	(10.6)
Y/Y Change	(70.7)	(105.4)	(176.1)
Ch. Since Peak	(141.7)	(224.1)	(365.8)
Total Book	3,184.2	2,012.2	5,196.4
M/M Change	-	(4.2)	(4.2)
Y/Y Change	(30.1)	(125.6)	(155.7)
Ch. Since Peak	(56.5)	(238.3)	(294.8)

(7/16/11) Bank loans outstanding declined by $44 billion over the course of QE2 from November 2010 through early July 16011 when the program wrapped up. Bank loans outstanding fell by $25.6 billion to a total of $7.045 trillion in the week ended July 18 (after revisions). The renewal of the uptrend from the April 2011 low is now threatened. 7/24/12The latest surge was mostly due to residential mortgages, mostly from the refi wave paying off Fannie, Freddie and FedHo (FHA) loans. Bulging deposits have been forcing banks to make loans (and buy some from non banks from time to time), given the low returns and inadequate spreads available from securities investments. 4/1/12 Somehow, I don't think that this signals economic expansion and a strong credit environment. Furthermore, any gains in bank lending since 2011 have come largely at the expense of shrinkage of lending in nonbank segments such as commercial paper and GSE lending. Private sector credit as a whole appears to be shrinking again.

1/21/12 The recent gains in bank lending are not indicative of similar increases in total private lending. Much of the gain in bank loans is from residential mortgage refinancing which simply moved loans from non banks to commercial bank balance sheets. The refis do help to improve household balance sheets and that has some benefits to the economy. The repo and Fed Funds increases seem to have simply been a movement of funding from the commercial paper market to the bank repo market. In other words, there's a lot less to this increase in bank loans than meets the eye. Only the gain in C&I loans is substantive, especially since it accompanies a massive increase in non-financial commercial paper outstanding. Businesses appear to be rebuilding leverage.

(9/22/11) Inflows of cash into US bank accounts (including large cash flows into checking accounts of US domestic branches of foreign banks) could have driven the increase in loan balances. Some of the increase may have resulted from revaluation of loans under fair value accounting as a result of lower interest rates. Since loan balances began rising, the bulk of the increase has come from Fed Funds and Reverse Repos with non-banks, in other words, securities loans, and "other loans" which also include financing of securities and non-bank financial institutions and governments. These loans to nonbank financial entities accounted for 2/3 of the increase. Commercial and Industrial Loans, and a reduction in loan loss reserves accounted for most of the rest of it. I do not need to tell you that the reduction in loan loss reserves is wholly inappropriate. There was a small increase in consumer credit.

(6/26/11) The world financial system cannot sustain private credit growth so it transfers risk to the sovereign and tries to prevent the system from imploding. The only thing that achieves is to put the sovereigns at the center of the implosion where they will finally be sucked into a black hole, taking us with them.

(4/1/11) Customers continue paying down loans and banks are not replacing them. We know that the reduction in loan balances is not the result of writedowns. Banks have actually been reducing loan loss reserves since mid 2010. Even though they are not increasing reserves, they are still barely able to show profits (see discussion at end of report) and they continue to hoard the increased reserves— except for the $6-8 billion that they added to speculative trading accounts since QE2 started, causing massive dislocations due to the huge increases in commodity prices that this deployment of trading capital has spawned.
I have moved the historical background from 2008-09 here

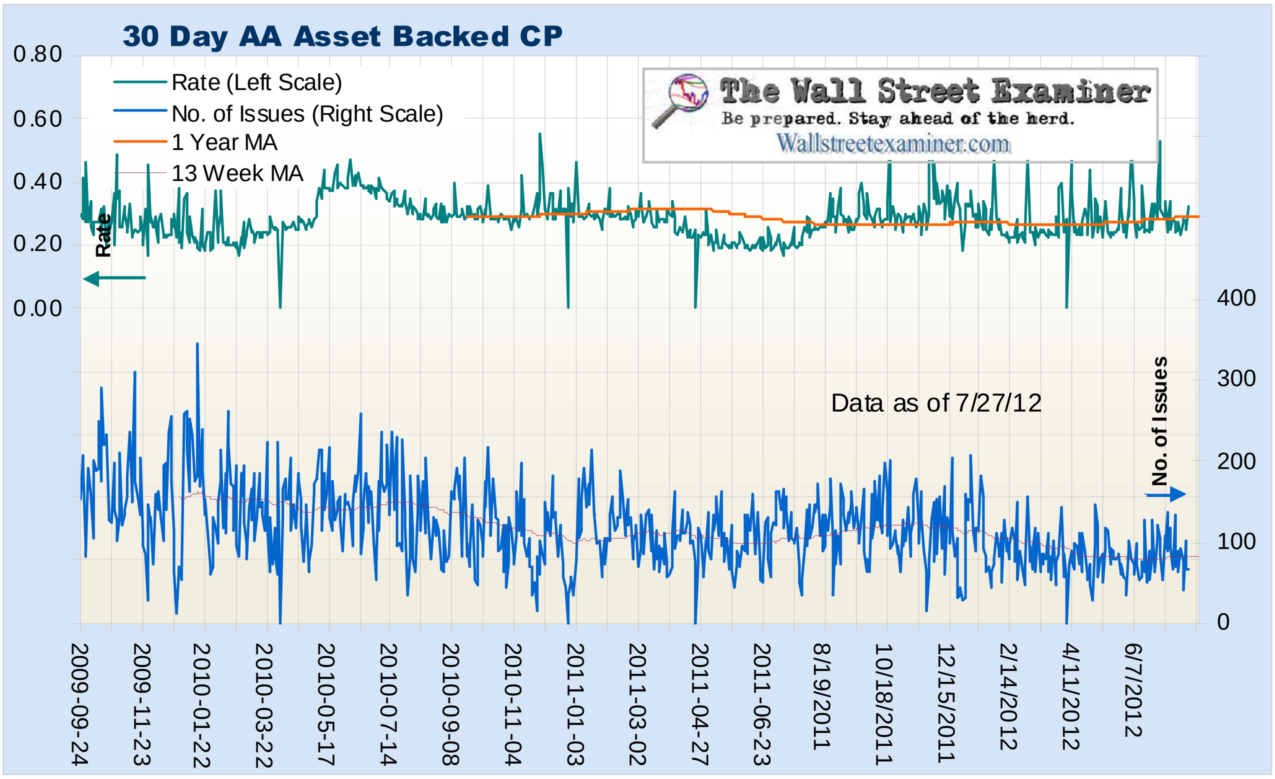
http://wallstreetexaminer.com/money/fed2008-09.pdf . This is important material, and if you were not a subscriber at the time, it should be of interest to you in setting the stage for the current environment.

Foreign Central Banks See http://wallstreetexaminer.com/money/treasury072812.pdf for latest update

The Dollar See http://wallstreetexaminer.com/money/treasury072812.pdf for latest update

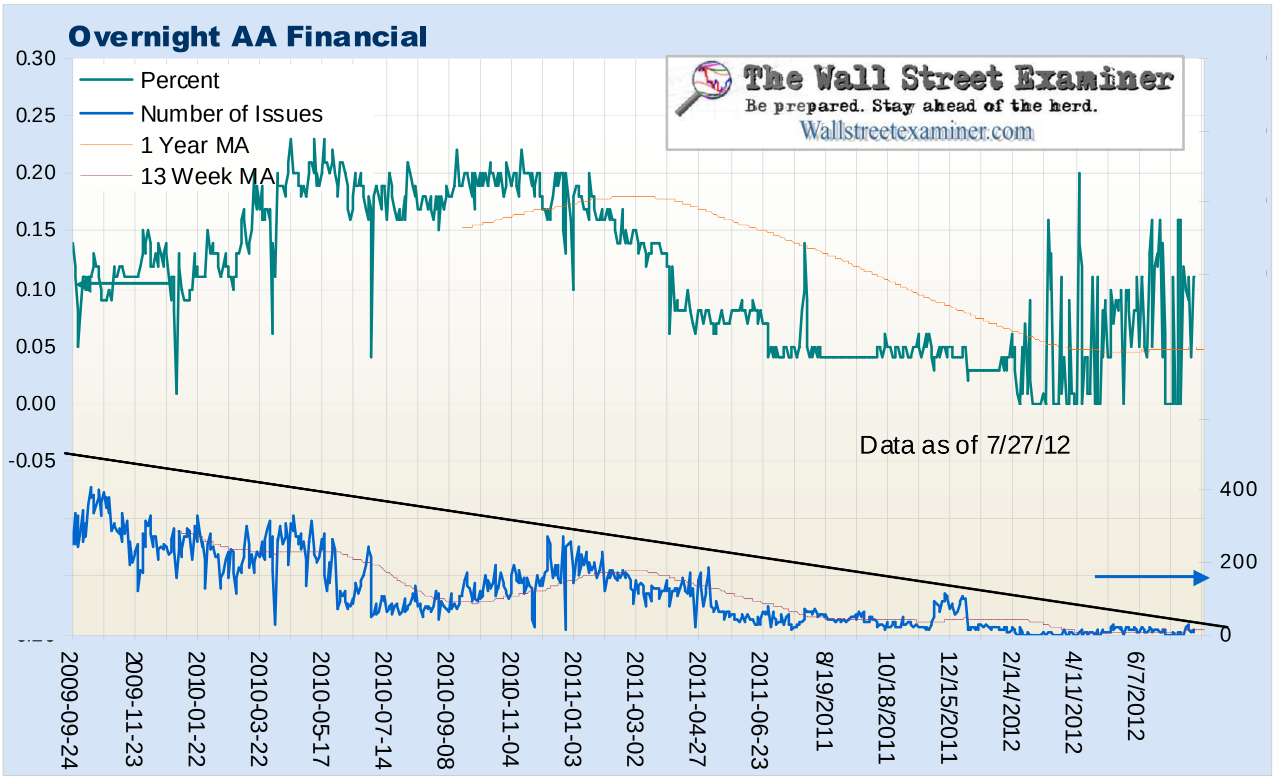
Commercial Paper

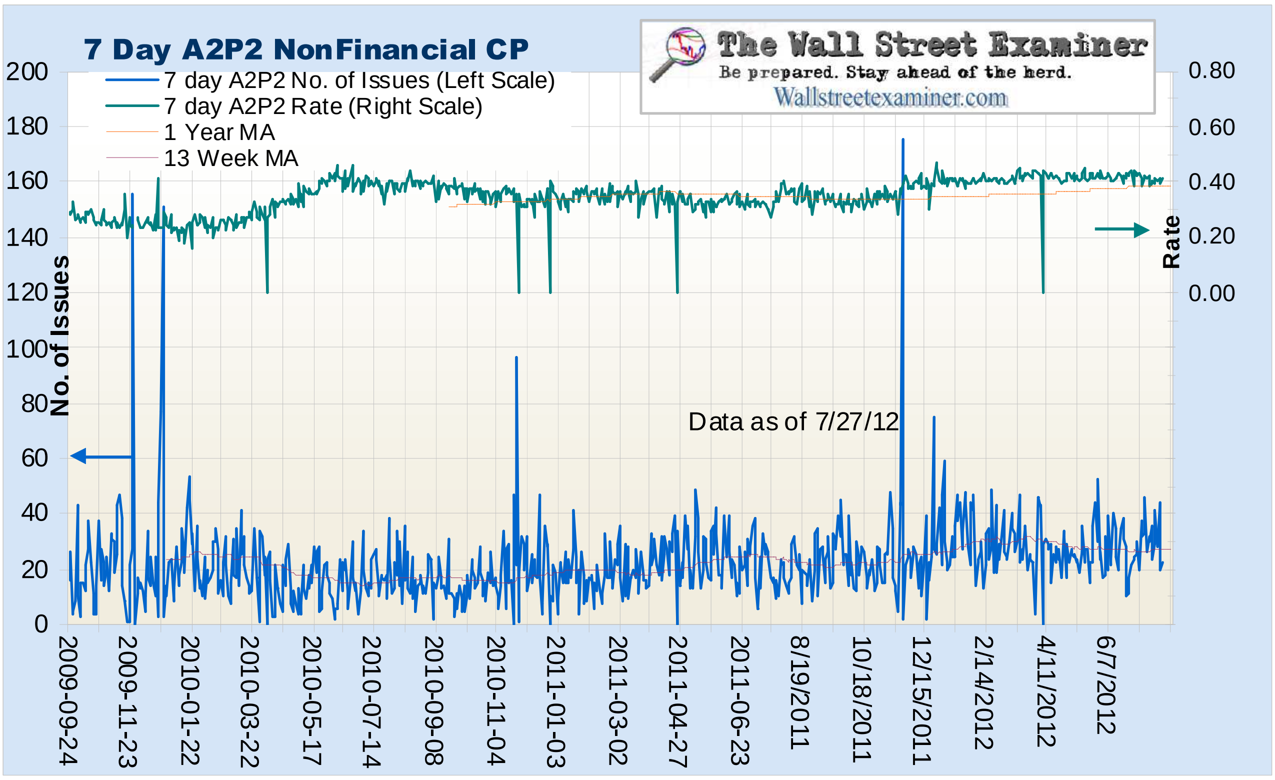
Volume in ABCP has been moribund. This is another sign of the trend toward paying off debt. Since February, rates have moved up from around 0.20-.21 to .28-.42.



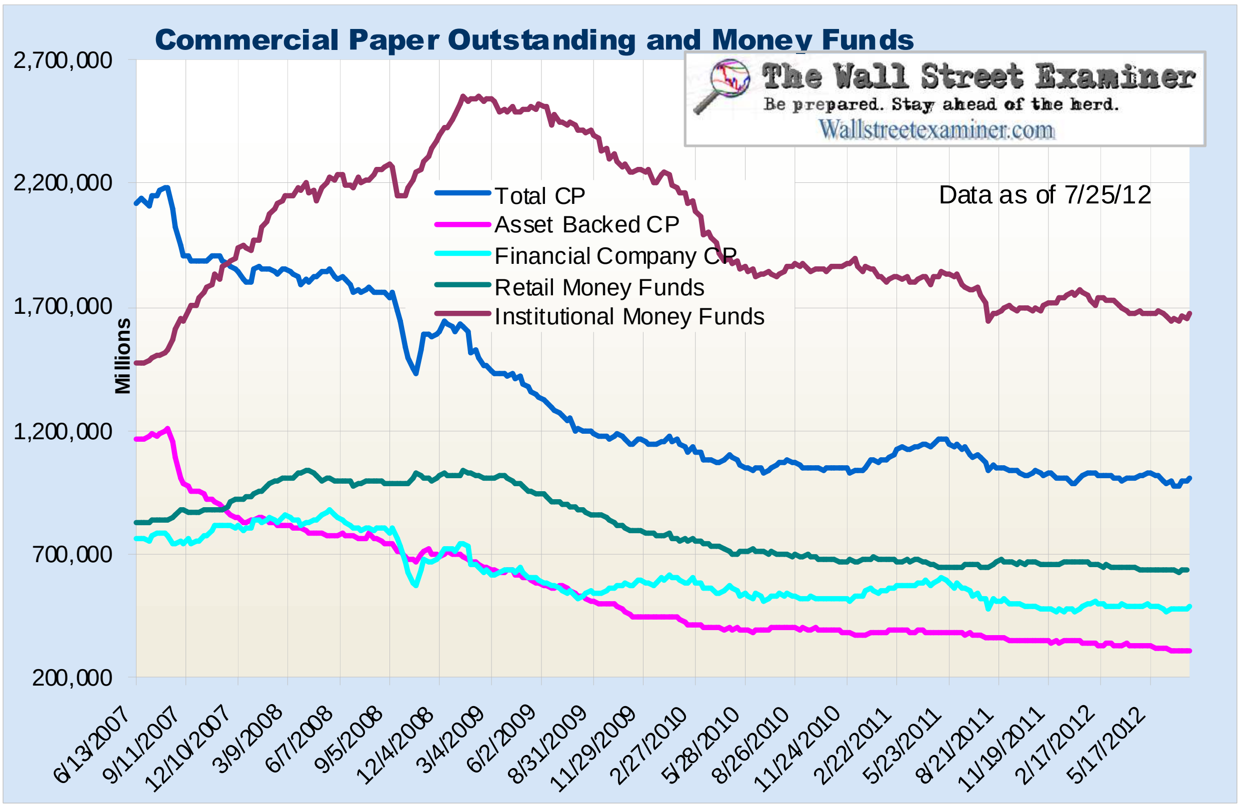
The rate in overnight AA financial paper (chart next page) has tracked Fed Funds. The Fed has been successful at keeping the short end of the money market at a near zero interest rate. My thought has been that this is counterproductive because it forces investors to liquidate their money market funds and other assets to meet current obligations, whereas normally interest income would have been sufficient for that purpose. Thus zero interest rates can and do have a deflationary effect.

Volume in overnight AA financial paper has been declining since 2008 and it became virtually non existent in July. Rates have risen from around 10 basis points in February to around .16 to .20, staying around the Fed Funds rate.





7 Day A2P2 NonFinancial CP
The Wall Street Examiner
Be prepared. Stay ahead of the herd.
Wallstreetexaminer.com
7 day A2P2 No. of Issues (Left Scale)
7 day A2P2 Rate (Right Scale)
1 Year MA
13 Week MA
No. of Issues
Rate
Data as of 7/27/12
200
180
160
140
120
100
80
60
40
20
0
0.80
0.60
0.40
0.20
0.00
2009-09-24
2009-11-23
2010-01-22
2010-03-22
2010-05-17
2010-07-14
2010-09-08
2010-11-04
2011-01-03
2011-03-02
2011-04-27
2011-06-23
8/19/2011
10/18/2011
12/15/2011
2/14/2012
4/11/2012
6/7/2012



Commercial Paper Outstanding and Money Funds
The Wall Street Examiner
Be prepared. Stay ahead of the herd.
Wallstreetexaminer.com
Data as of 7/25/12
Total CP
Asset Backed CP
Financial Company CP
Retail Money Funds
Institutional Money Funds
Millions
2,700,000
2,200,000
1,700,000
1,200,000
700,000
200,000
6/13/2007
9/11/2007
12/10/2007
3/9/2008
6/7/2008
9/5/2008
12/4/2008
3/4/2009
6/2/2009
8/31/2009
11/29/2009
2/27/2010
5/28/2010
8/26/2010
11/24/2010
2/22/2011
5/23/2011
8/21/2011
11/19/2011
2/17/2012
5/17/2012

CP outstanding extended a tiny rebound from a low set the July 4 week. There's no sign of recovery of the CP market. Non-financial paper has been strong for 3 years, but hasn't made much of a dent in the overall totals.

	Total	Asset-backed	Financial	Nonfinancial
7/18/2012	1,000,577	313,264	480,552	206,376
7/25/2012	**1,005,496**	**310,117**	**489,300**	**205,568**
Change	4,919	(3,147)	8,749	(808)
In billions				

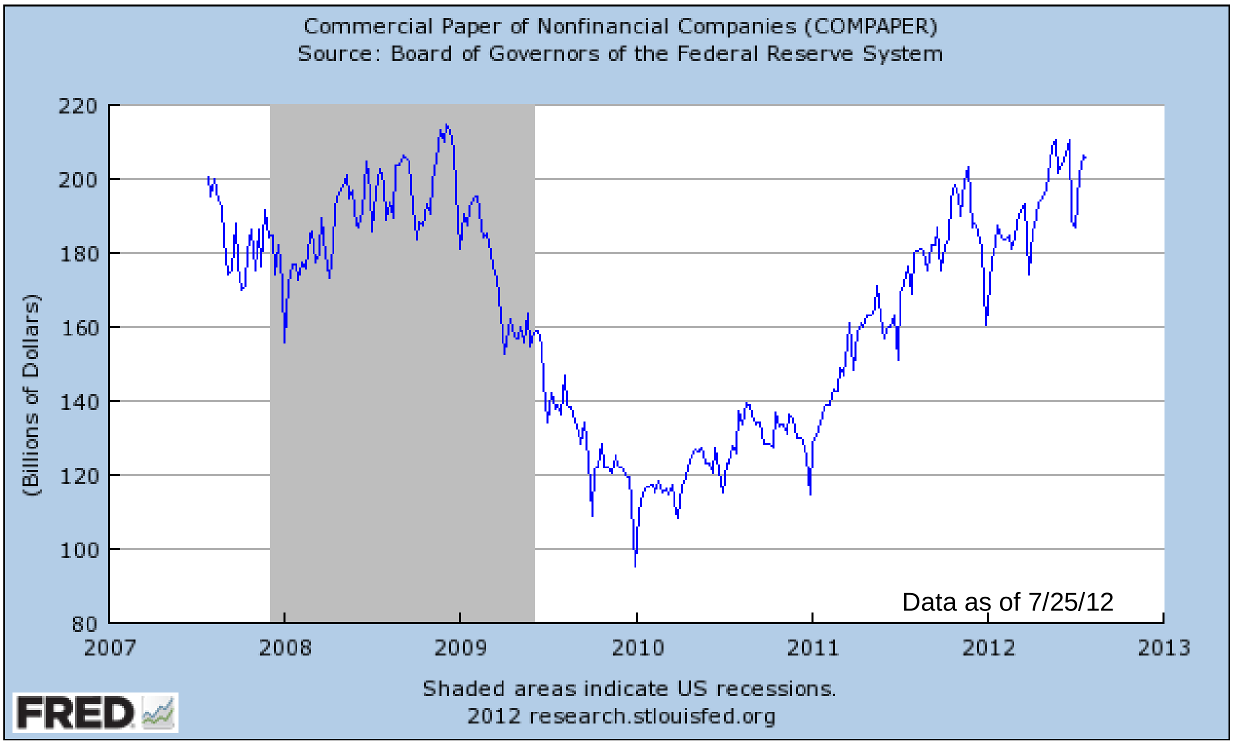
2/24/12 It's notable that the market for overnight financial company paper (Chart previous page) has ceased to exist.

(9/2/11) Financial company paper outstanding had been plunging due to the well publicized problems of European banks and Bank of America. Fears about the safety of financial paper had been driving many investors into the non financial paper sphere as corporate paper is seen as less risky than financial paper.

(9/22/11)The run on institutional money market funds had been making less cash available in total, and what cash there was, had been focused on corporate paper. The run on institutional money funds appears to have stabilized in early August, with US Government money market funds showing gains.

(7/12/11)This run on the commercial paper market could be the trigger for exposing Bernanke's lies that the Fed's actions averted the financial collapse. In fact that collapse was not averted, just temporarily papered over with future taxpayer obligations. The time to pay the piper has probably arrived, the focus made sharper by the debt ceiling issue and the collapse of the government finance Ponzi scheme in Europe.

(4/18/11) There still appears to be a buying panic in non-financial paper. This could mean a shortage of other types of CP, or to some extent be a sign of investors reaching for yield, given the lack of viable alternatives. Total CP outstanding has been uptrending since shortly after the inception of QE2 as the excess cash filters into vehicles other than short term Treasuries or bank accounts. CP outstanding has increased by $100 billion, a gain of about 10% since the inception of QE2 last November. This has not been matched by a gain in money market funds. Other players, possibly banks stuffed with cash, have been responsible for the increase.



(2/13/11) The recent uptick in commercial paper demand should have put upward rate pressure on the CP market especially with the shrinkage of money funds, but rates haven't budged. Even though the Fed has created conditions where the cost of renting liquid capital is essentially zero, credit demand remains extremely weak.

The CP market had been moribund as market participants of all stripes reduce their borrowing. Further contraction would be deflationary, and normally goes hand in hand with falling financial asset prices. The data beginning the week ended 9/29/08 showed the start of a collapse in institutional money market funds reflecting the beginning of the run on the funds triggered by the Lehman bankruptcy and the general systemic meltdown then under way. That was the first step in the recognition of the "non-existence" of the fictitious capital conjured up during the bubble. This forced the Fed to act, putting into effect the massive bailout programs for the CP market and money market funds. Once the Fed instituted those programs, money flowed back into the funds.

The chart shows the related collapse in commercial paper outstanding in October 2008. The panic didn't spread to retail MMFs. But another problem was looming with the collapse of institutional MMFs. Those funds had been the source of much of the buying of short term Treasuries that enabled the Treasury to fund the bailouts. This could have led to a steep rise in the government's borrowing costs and was another reason why the Fed and Treasury had to prop up these funds.

It was the collapse of commercial paper and institutional money market funds that spurred the Fed to create the massive bailout programs for this market in 2008. However, unintended consequences included the freezing out of all other asset classes as capital fled those markets seeking Fed and Treasury bailout funded markets. Meanwhile, the Fed became not just the lender of last resort, but the lender of only resort in many cases as private capital fled.

The rise in institutional money market funds in late 2008 looked to me like the kind of blowoff that is often seen at the end of a bubble. I wrote that if we start to see a sharp break to the downside, I would be extremely concerned, as it could mark the onset of a massive collapse. That was forestalled by other Fed emergency actions, but the potential still exists.

Fannie and Freddie

	Totals in Billions		
	Fannie	Freddie	Total
Owned Portfolio	676.1	581.3	1,257.4
M/M Change	-	(10.6)	(10.6)
Y/Y Change	(70.7)	(105.4)	(176.1)
Ch. Since Peak	(141.7)	(224.1)	(365.8)
Total Book	3,184.2	2,012.2	5,196.4
M/M Change	-	(4.2)	(4.2)
Y/Y Change	(30.1)	(125.6)	(155.7)
Ch. Since Peak	(56.5)	(238.3)	(294.8)

7/10/12 While bank lending has been on the rise, GSE lending has been declining. Fannie and Freddie's retained portfolios dropped by $16.7 billion in May. Fannie's retained portfolio continued a decline that began in June 2010 that has cut $142 billion from its holdings. However, its total book of business, which includes the MBS it guarantees, has declined by just $56.5 billion since its peak. It has shed loans from its owned portfolio, while increasing its loan guarantees. The US taxpayer is on the hook for any losses. So far the GSE's have come to the taxpayers for reimbursement of approximately $170 billion in losses.

Freddie's retained portfolio fell in May and its total book of business also declined. Its total book has declined by $234 billion since the peak. Both GSEs continue to refuse to recognize collateral value writedowns. Corelogic estimated in February that 22% of loans nationally were under water. While not all of them will default, many will.

Fannie and Freddie's books continued to grow for more than 2 years beyond the peak of the housing bubble. Since peaking at the end of 2009, they've dropped by a combined $291 billion, or just 5.3% of the peak outstanding loans and loan guarantees in 2009. These numbers continue to be way out of synch with the total loss of collateral value since 2007 which could ultimately be as much as $1.3 trillion. As these losses are slowly recognized or incurred, the GSEs could come to the US taxpayer for reimbursement for years to come.

The market continues to "buy" the now de facto, government guarantee rolling over Fannie and Freddies maturing paper with no issues. Meanwhile, the taxpayers have repeatedly been called upon to fund the billions in paper losses as the guaranteed MBS and their direct debt come due. The recent refi boom and short term housing price uptick has taken some of the pressure off as it has enabled the GSEs to at least temporarily generate enough cash flow to absorb the losses rather than passing them on to the taxpayers. This will only last as long as mortgage rates are so low that large numbers of buyers are refinancing. Once that stops, the losses will reappear.

(3/2/11) Approximately 39% of Fannie and Freddie's books are collateralized by loans in the most troubled states of California, Florida, Nevada, Arizona, and the Midwest. In the fourth quarter of 2010 Fannie Mae's recovery rate on REO sales was 55%. Its REO inventory grew from 86,155 units at year end 2009 to 162,489 units at the end of 2010. Meanwhile the game of extend and pretend goes on.

(10/29/10) These reductions are infinitesimal relative to the peak values of these portfolios. As collateral values underwent massive contraction with the implosion of the US housing market, Fannie and Freddie's portfolios continued to grow through 2009, and since then they have declined only minimally. If the US government truly intends to back these loans, trillions in losses have thus been transferred from private hands on to the backs of US taxpayers.

My earlier guess of a 35% loss factor in the $5.4 trillion of guaranteed and owned loans in Fannie and Freddie's portfolios may be light. The better loans are being paid off, and the proportion of trash loans held by Fannie and Freddie is growing. The bulk of Fannie and Freddie's lending was in the heavily populated high growth states of California, Florida, Nevada, and Arizona, which have suffered far greater losses than the rest of the country. Losses to the taxpayer could be as much as 50% of the guaranteed amounts or more. That would be $2.7 trillion.

Some of that will be mitigated by putbacks to the originators like Bank of America, but who do you suppose will pay for that? The government has shown no willingness to force bondholders or even shareholders of the big banks to take a loss. It always comes back to us, the American people, to bear the burden. They will soon be forced to realize that our backs are already broken.

Inevitably, as better quality loans get paid off, the loss ratio will rise. Further shrinkage of the loan portfolios both by paydowns and writeoffs is inevitable. Savings deposits in money market funds, and eventually in the banks, will continue to disappear in payment of the better quality obligations. The deposits that remain will have no collateral backing.

The Federal Government apparently wants to make good on trillions in losses. There are many who believe that the Fed will inflate us out of this bind. I don't know if that's possible. I suspect that the Treasury will instead attempt to spread the loss recognition over a 10-20 year period, so that few will notice it. But it must borrow the money to make good on those guarantees. This will be just another factor in the budget deficit keeping the supply pressure on the market. As the asset base of the system shrinks, a point of impasse will eventually arrive and the system will face collapse.

Money Supply and Fund Flows

With the ending of Federal Government guarantees of money market fund assets announced on September 10, 2009, flows from money market funds into the banks should have increased, providing more cash for the Treasury market.

MZM and M2 both increased in the week ended 7/16/12 (charts on page 95). The quarterly growth rate has come down from 15% on MZM and 12.6% on M2 to around 0-1% over the past month, while the annual growth rate has declined from over 10% earlier this year to 7-8% now. If the M's go negative on a quarterly basis, that might give the Fed a green light to act more aggressively. But with Euro capital flight cash still flowing into US banks, near term shrinkage of the US money supply seems unlikely, even though the Fed is doing its part to keep money growth slow by holding the SOMA flat.

(8/29/11) The previous surge in money supply from August of 2010 through June 2011 was due to Fed money printing. The surge since July 16011 seems to be a result of capital flight into the US. They are hot money flows, and as such are inherently unstable, and contribute to systemic instability.

		Total	Change	Qtr.%Ch.	Y/Y %Ch.
MZM	2012-07-16	11,022.4	14.9	1.10%	7.90%
M2	2012-07-16	10002.5	-6.9	0.53%	8.59%

MZM does not include bank savings accounts, but does include institutional money market funds.

Retail money fund assets have been trending down since the beginning of 2012. Normally, falling money fund assets follow rising stock prices but that has often not been the case in much of 2012. That is probably a sign of forced liquidation to meet current needs, a symptom of ZIRP Bernankecide. Institutional funds have been downtrending since December, but have edged slightly higher over the past 5 weeks and are now $38 billion above the low point reached in August 2011. Institutional investors and corporations have so much cash, that they're forced to park some of it in these funds.

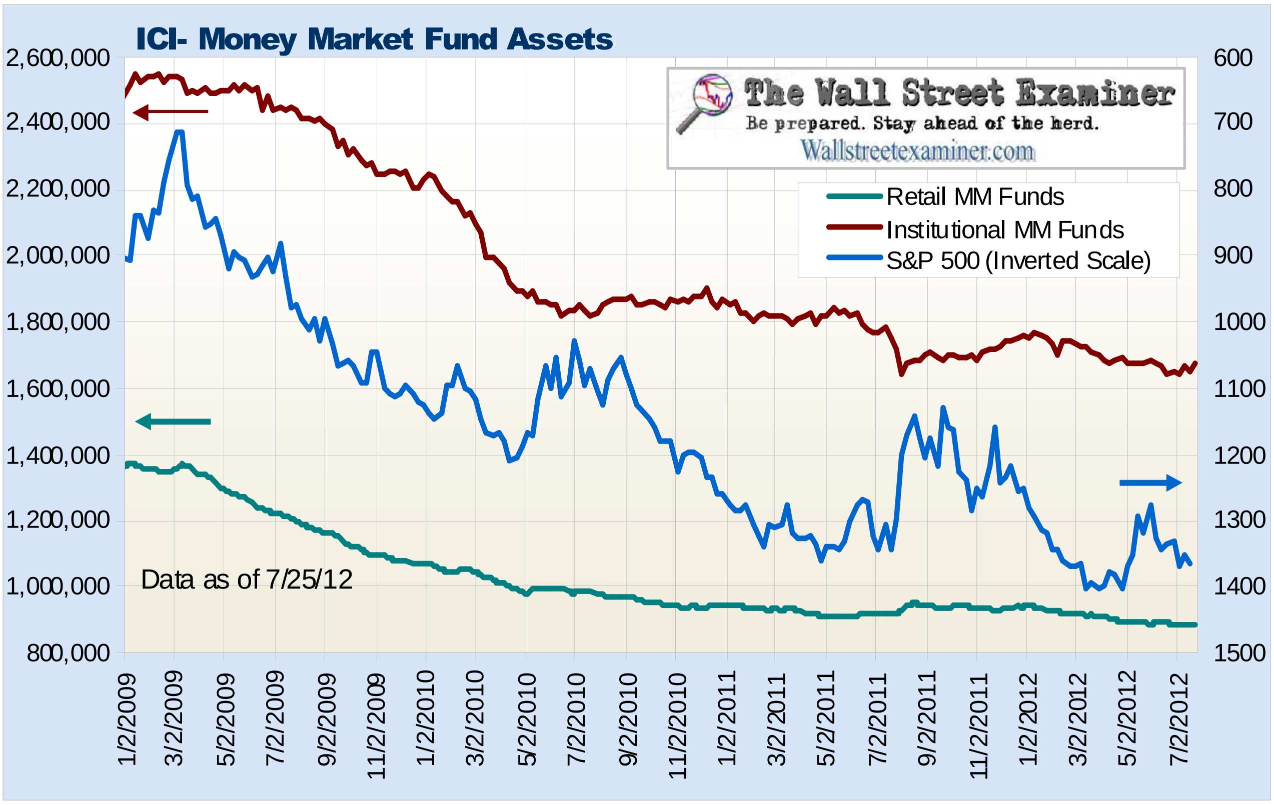
Date		Institutional				Retail		
		Total	Change	% Ch.		Total	Change	% Ch.
7/18/2012		1,653,120	-11,860	-0.71%		885,680	-470	-0.05%
7/25/2012		**1,671,500**	**18,380**	**1.11%**		**883,470**	**-2,210**	**-0.25%**
Since 9/9/09		-711,333	-29.85%			-277,818	-23.92%	
Since Peak		-34.43%	1/14/2009 peak			-35.46%	3/11/2009 peak	

(11/29/11) The forced liquidation of money fund assets is probably still going on among some fund holders who must liquidate principal to pay expenses, but it has been offset by other inflows, including those coming from outside the US.

(11/18/11) I believe that it is symptomatic of the fact that under ZIRP retail investors are forced to liquidate principal to pay the bills. Eventually, one by one, these people, especially the elderly, have nothing left. It's what I call Bernankecide, the financial genocide of America's elderly. Not only is it destroying their finances, it negatively impacts discretionary spending, not only of individuals living on fixed income, but institutions that also depend on investment income. It's the other side of the coin of ZIRP that you never hear the Fed, or economists in general, talk about. It is elder abuse, and it is a societal disgrace.

(7/12/11) As my colleague Russ Winter puts it, "Aunt Millie is comatose." (6/26/11) If you've been his accounts at Russ Winter's Actionable and in our Radio Free Wall Street podcasts, you know that the fund management companies are in full psy-ops mode, placating customers with lies to keep them marching in place rather than starting a run on their funds. I've been expecting a run on money market funds for several years. Maybe now is the time.

1/17/12 Institutional money fund assets have generally risen since early August when a run on the funds ended. Most of the gains since then have been in government funds which have seen a massive surge in assets while non government funds have fallen. Assets in non government funds have been increasing in recent weeks as these funds have effectively reduced their exposure to Europe to virtually nothing. The stigma has seemingly been removed. Institutions holding cash have nowhere else to go.



Fund flows tend to follow stock price trends with a lag of several weeks.

(10/10/11) Most non-government funds were heavily invested in bank paper, particularly European bank paper. The run on these funds is ongoing. No one is talking about this. We need to start thinking about the point in time where they get down to that portion of their assets that are fake, and can't be liquidated. The non government funds currently stand at $905 billion in assets. Where's the red line? $500 billion? $200 billion? I don't know. If you have seen any analysis of this please forward it to me at admin@wallstreetexaminer.com.

(6/26/11) Institutional investors have gotten the message and they want out. They will not all be able to get out. The cash just isn't there. I've said here for months that I expect institutional cash drawdowns to resume in a big way once the Fed stops printing money. It's starting. This will tip the balance from a system with an apparent surplus of cash to a real shortage of cash. It's a fine line in this distorted, unstable system. The Fed must constantly inflate just to keep the thing afloat and stable. When it stops, the system will capsize.

(5/1/11) The trend in institutional funds has been in only a very slight decline since last year at this time, representing a tenuous status quo. There are a couple of ways to look at this. First, unlike in 2009-10 a rising stock market has not been a sufficient enticement to be associated with a drawdown these funds. Second, the fact that the funds have remained stable even with near zero interest rates speaks to the lack of alternatives. Third, a rising tide of POMO hasn't flowed into these funds either.

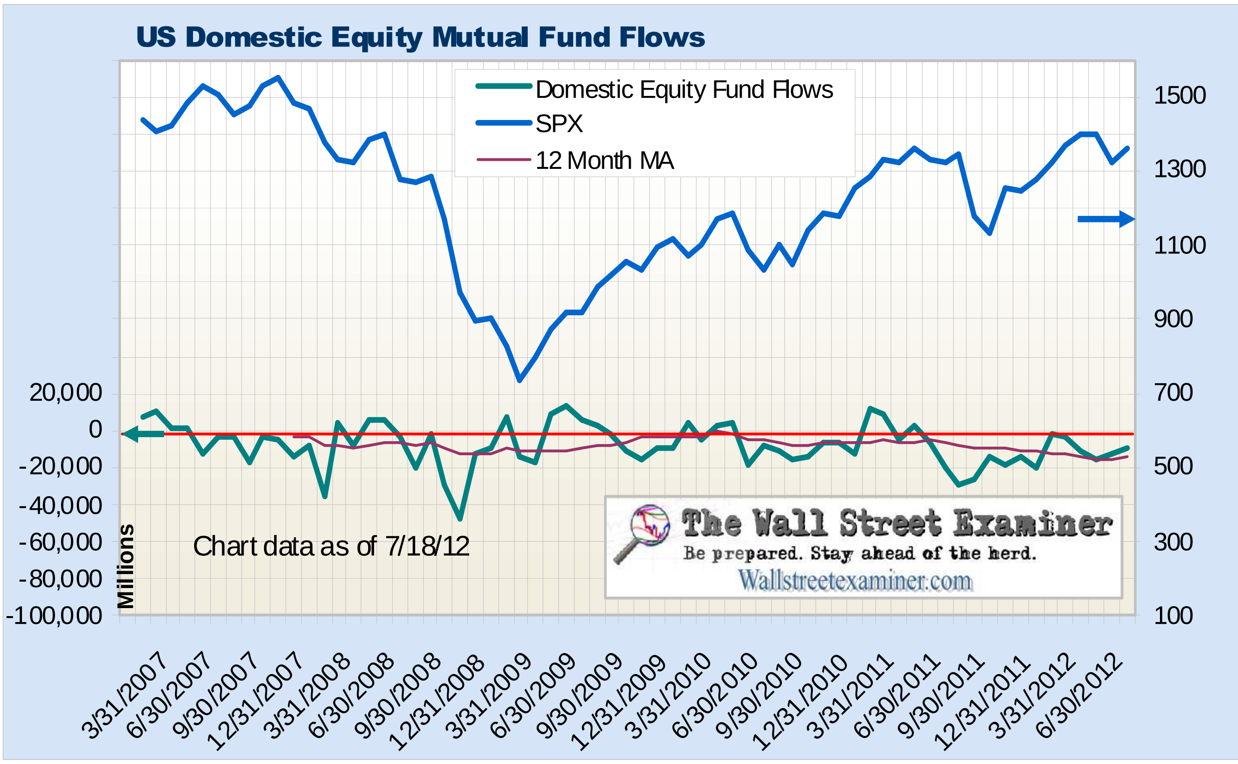
What happens next? I don't have an answer, but stay tuned, because when the graph breaks out of its recent box, we should quickly see what it correlates with in terms of market action.

(4/18/11) Institutional cash reserves are under pressure as corporate profits get squeezed. Municipalities are broke and are living hand to mouth, and will continue to draw down their cash reserves as well. QE2 isn't helping anyone in the real world. It's only a matter of time before the shrinkage of ready cash begins to impact securities prices. As the end of QE2 approaches we may see some front running of that as well.

(1/21/11) Institutional fund holders tend to be large corporations, other private and public institutions, and state and local governments. The recent action may portend the renewal of a liquidity squeeze. The problem of state and local governments running short of cash is a real and imminent threat to the economy. Many large holders of municipal bonds have attempted to downplay the situation, complaining that it's not as bad as Meredith Whitney says it is. This is a sure sign that it is.

Most other economic units, from individuals to businesses to governments, are running short of cash, thanks to the fact that they earn a zero return and their revenues are weak. That shows up in the falling retail money funds.

The ICI reports mutual fund flows weekly with a one week lag. Domestic equity mutual funds had $0.1 billion of net inflows in the week ended 7/18/12, after net outflows of $1.5 billion the week before. This was the best performance since May 30. Small investors have been fleeing the market for years, but that hasn't stopped the bull market since 2009. Flows have been improving slightly over the past two months, preventing the indicator from going to a sell signal for the time being.



Monthly data actual through June. July projected based on weekly rates.

5/1/12 This downturn continues the trend of small investor distribution that started in May of 2009, just a few months after the beginning of ZIRP. This is just another example of the effects of ZIRP—Bernankecide, the financial mass murder of America's elderly. As their investment income dwindled to zero, they were forced to begin liquidating not only their mutual funds, but their stocks as well, just to meet current expenses. Every month, every week, and every day that this outrage goes on, another elderly person becomes destitute, reliant upon younger family members, charity, or the state itself for their support. More often than not, the government no longer has the funds to care for them, so that the burden falls on the family. Bernanke has never adequately addressed the negative effects of the lost income that must be directed to the eldercare industry, that offsets the short term gains of the banks in its economic effects, and devastates the lives of millions.

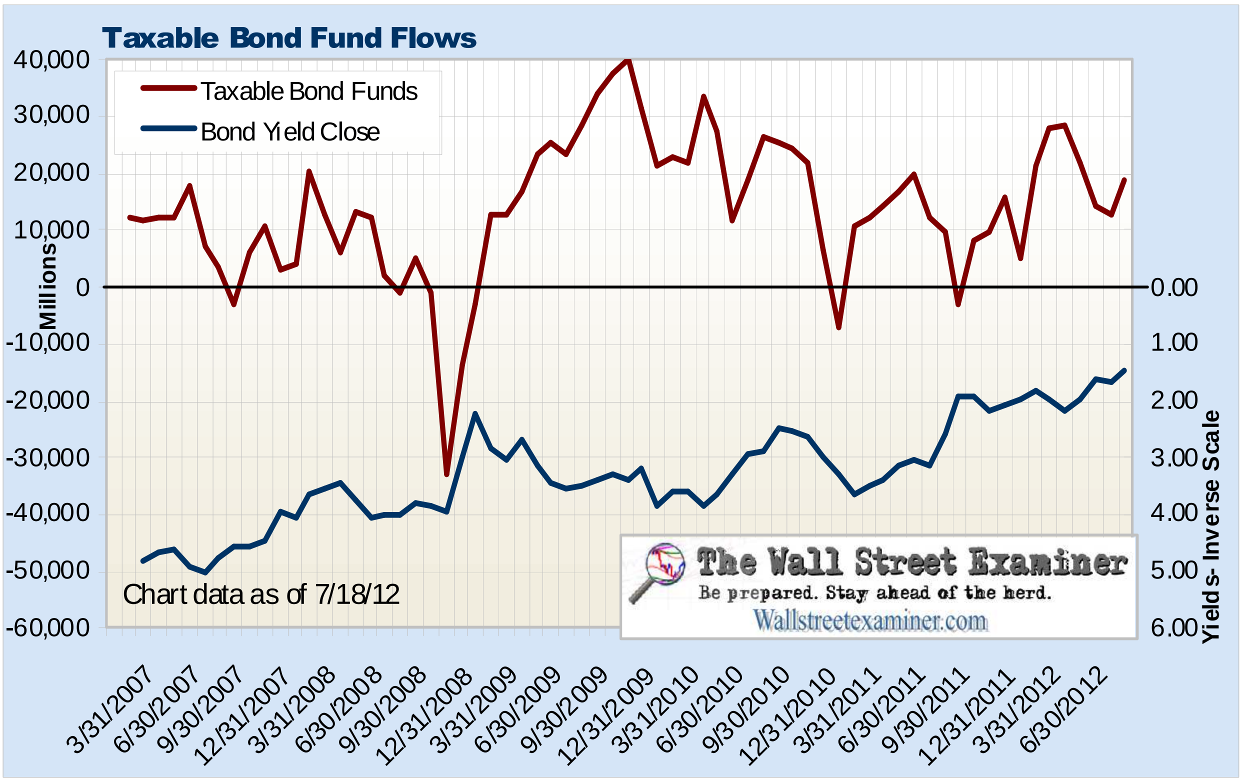
(10/18/11) August had massive outflows at the beginning of the month. Then these flows began to moderate. The upturn on the chart represents the reduction in outflows since then. It was a precursor to the current stock market rally, but the correlation and the lead times in this indicator are haphazard and unreliable as a stand alone indicator. The indicator led the ultimate March 2009 low by 6 months. It also led the downturn in 2011, when it turned down in March 2011 and made a lower high in April, several months before stock prices turned lower. I don't see the current uptick as having lasting bullish implications. Let's see how things go in October.

(8/29/11) Heavy outflows should not be taken as a contrary indicator. The withdrawals force fund managers to liquidate holdings. Furthermore, these flows have a good history of leading the market. Inflows should begin to increase a month or two before the market bottoms, if past history is any guide.

(8/8/11) Apparently some small investors are the most astute market observers out there, cashing out heavily as the S&P meandered above 1300 in June and July, redoubling their efforts as the end of the month approached. The estimated net withdrawal for July came to $26.4 billion, while June finished with net withdrawal of $20.8 billion. $47 billion saved is $47 billion earned, in this environment. Congratulations to those who took the cash and ran.

(6/26/11) The selling of domestic equity funds has been an ongoing trend and it has been accelerating. A negative divergence began to develop versus stock prices in March, preceding the current downturn. I've always felt the Primary Dealers were the only players that mattered. But when any segment of investors is net selling of $5 billion a week, that matters. If the dealers are out of the game, and the banks and FCBs are out, and retail investors are out, who's left?

(5/99/11) The 2007 market top was preceded by a period of 6 months where equity fund flows weakened and turned negative before stock prices began falling. However, a large negative divergence also developed in 2009-10, and the market continued to move higher. Clearly, mutual funds do not drive market performance, but this data taken together with other negative indications is part of a larger picture of a market where demand drivers have been steadily weakening.



Monthly data actual through May. June projected based on weekly rates.

Investors put a net of $5.1 billion into taxable bond funds in the week ended 7/18 versus $5.2 billion the prior week. These were the biggest weekly inflows since May 16, but still well below the record $9.1 billion of inflows the week of April 4. Buying remains well below those levels in a sign that investors may be losing the will, if not the ability, to continue buying at that pace. Domestic equity funds saw a tiny inflow in the July 18 week, in a change from the usual patterns of outflows.

6/9/12 The drop in bond fund buying has not translated to any meaningful increase in stock fund purchases. Small investors remain in a forced march out of the markets thanks to ZIRP Bernankecide. They have no choice but to liquidate to pay the bills.

4/7/12 These huge inflows followed on the heels of Bernanke's pledge to keep short term rates at zero until hell freezes over. The unbroken string of inflows is now up to 25 weeks. The buying panic by fund investors has been intensifying. The March 7 data may represent the final blowoff of that panic. But for as long as it lasts it will help to keep a bid under Treasuries.

3/17/12 These inflows are now running at about a quarter of total monthly Treasury supply or more if the rate of the first week in March is sustained through the month, so that their impact can be significant as long as they are running at these levels. Weekly flows at these levels are almost as high as primary dealer or FCB purchases in some weeks, although at other times the PDs and FCBs are far more significant. There's no doubt that bond fund inflows have recently been a stabilizing factor as the trend of FCB buying has waned. However, I doubt that the buying can be sustained at this level for long. This seems like a buying climax.

(10/18/11) Any breakdown in positive bond fund inflows would be a sign that the last group supporting the bond market had finally lost confidence. That would almost certainly be the final nail in the bond bull market's coffin.

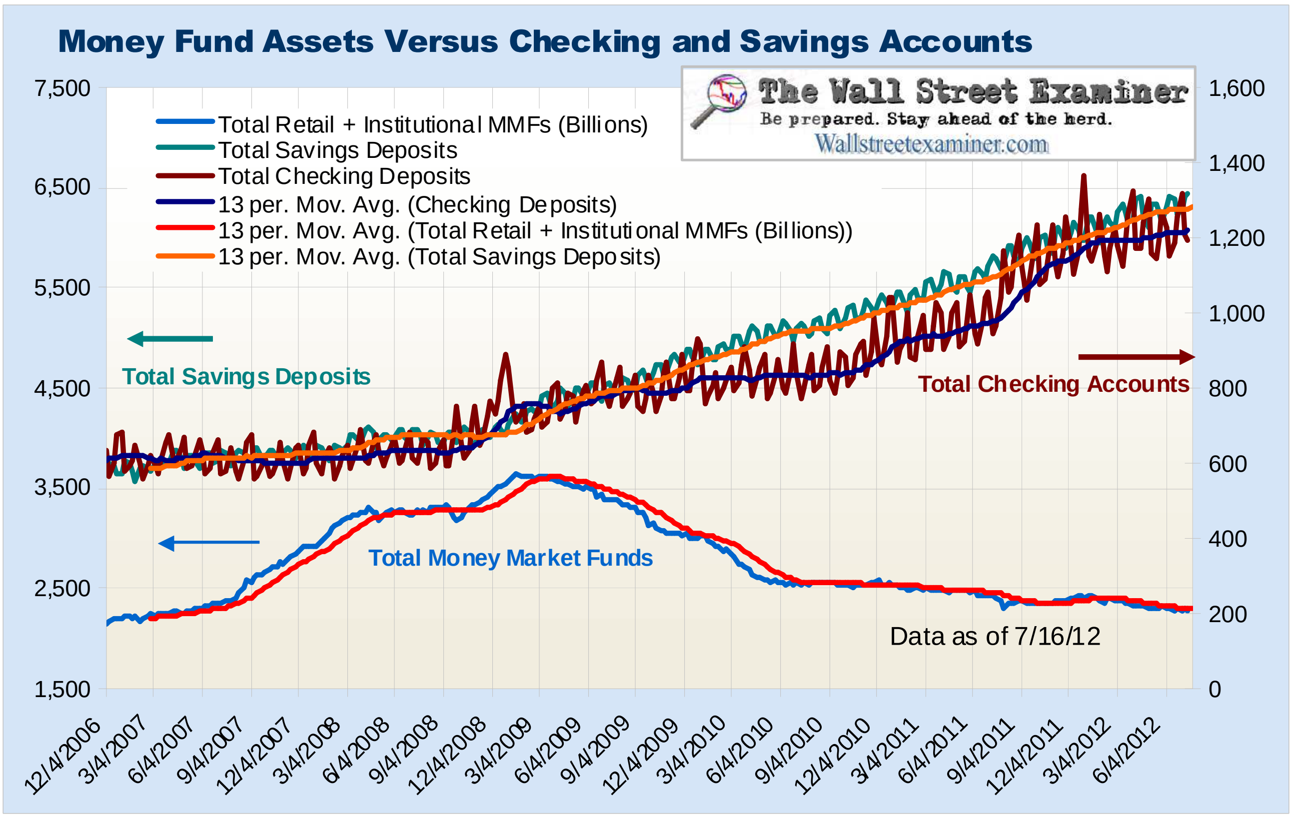
(2/25/11) The correlation between this data and market performance is haphazard. The small investor's actual impact on the market is less than a rounding error relative to the amount of institutional trading, and in relation to the amount of market pumping done by the Fed.

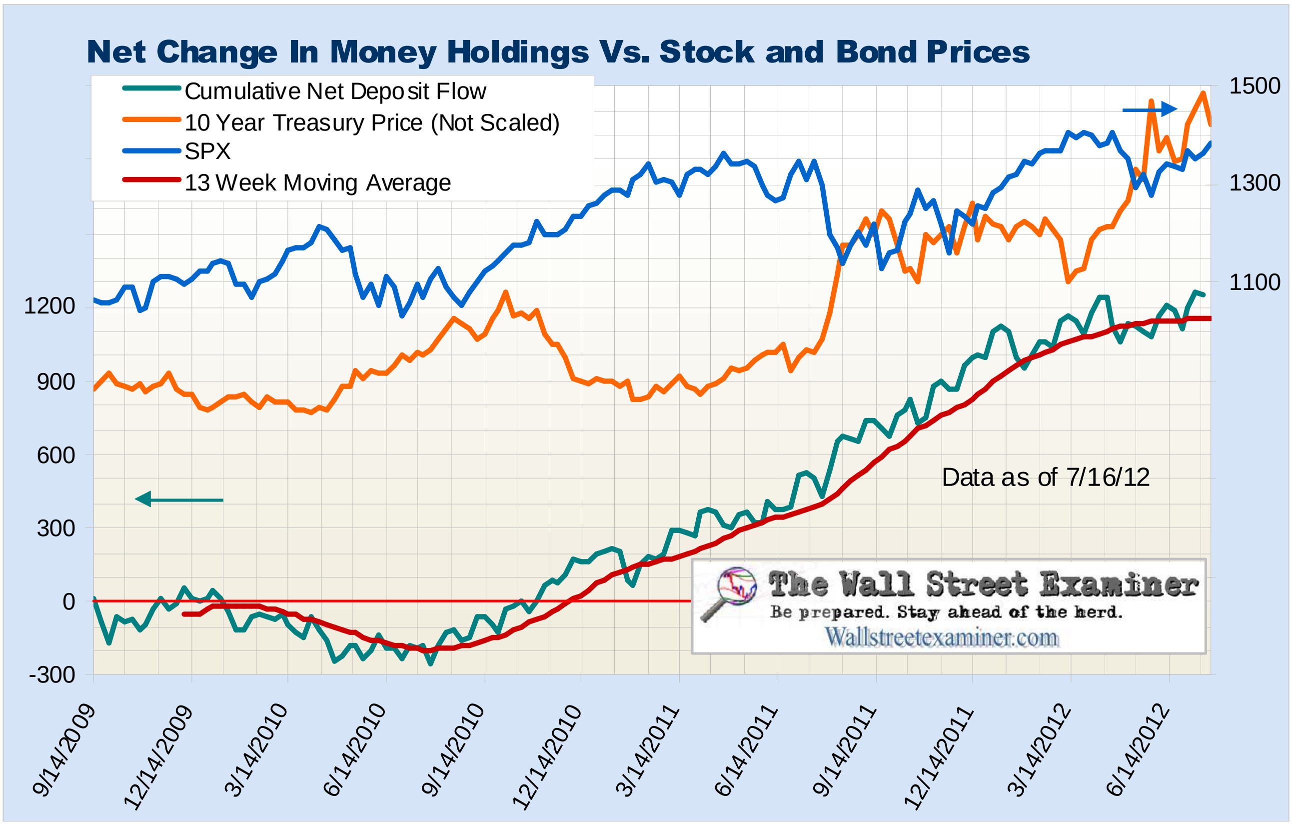
(1/7/18)Taxable bond fund outflows ran at a monthly rate of $2.8 billion in December versus inflows of $9.9 billion at the end of November and $22 billion at the end of October. This would be the first time in 2 years that taxable bond funds saw net monthly redemptions. Taxable bond inflows peaked at $40 billion per month in October 2009 (second chart below). This drop in public buying of bond funds is another reason the Treasury market has been having problems. The bubble has ended. This has the earmarks of the beginning of a bear market in bonds.

(10/3/10) As long as investors have no alternative for income, they will continue to be forced to buy bonds. Much of this is from cash fleeing money market funds. That's how the Fed wants it. When investors make choices because they have no choice, it's guaranteed that this too will end badly.

The underlying question is the ability of investors to continue buying at the pace necessary to keep yields under downward pressure. They are earning minimal returns and they still have the same bills. Demand for government paper at these prices should diminish as the attraction of paying down debt rather than investing for yield grows. Other market participants, particularly small savers in retirement, will continue to simply run out of cash. This is the underlying secular trend. As long as the Fed keeps interest rates at zero, this creeping decay should eventually undermine the market's foundation and cause it to collapse.
(2/5/11) The table below summarizes other money supply changes (charts follow). WSE Alt M includes only checking accounts and money market funds.

(4/18/11) Alt M (total money market funds and checking deposits) has been flat since May 2010. That followed a 14 month decline. There has been no rebuilding of these "ready cash" assets, but instead money has just been moved from money market funds to somewhat less liquid savings accounts. The beginnings of this process corresponded with the March 2009 stock market bottom. It is an artifact of zero interest rates. This shift of funds out of ready cash accounts has funded both the increase in bank savings accounts, and a portion of the rally in stocks.


Money Fund Assets Versus Checking and Savings Accounts
Total Retail + Institutional MMFs (Billions)
Total Savings Deposits
Total Checking Deposits
13 per. Mov. Avg. (Checking Deposits)
13 per. Mov. Avg. (Total Retail + Institutional MMFs (Billions))
13 per. Mov. Avg. (Total Savings Deposits)
The Wall Street Examiner
Be prepared. Stay ahead of the herd.
Wallstreetexaminer.com
Total Savings Deposits
Total Checking Accounts
Total Money Market Funds
Data as of 7/16/12
7,500
6,500
5,500
4,500
3,500
2,500
1,500
1,600
1,400
1,200
1,000
800
600
400
200
0
12/4/2006
3/4/2007
6/4/2007
9/4/2007
12/4/2007
3/4/2008
6/4/2008
9/4/2008
12/4/2008
3/4/2009
6/4/2009
9/4/2009
12/4/2009
3/4/2010
6/4/2010
9/4/2010
12/4/2010
3/4/2011
6/4/2011
9/4/2011
12/4/2011
3/4/2012
6/4/2012


Net Change In Money Holdings Vs. Stock and Bond Prices
Cumulative Net Deposit Flow
10 Year Treasury Price (Not Scaled)
SPX
13 Week Moving Average
Data as of 7/16/12
The Wall Street Examiner
Be prepared. Stay ahead of the herd.
Wallstreetexaminer.com
1200
900
600
300
0
-300
1500
1300
1100
9/14/2009
12/14/2009
3/14/2010
6/14/2010
9/14/2010
12/14/2010
3/14/2011
6/14/2011
9/14/2011
12/14/2011
3/14/2012
6/14/2012

Money Supply Components in Billions					
Week Ended	WSE Alt. M Total	Total Checking	Currency	Total Savings	Checking + Savings
07/09/12	3,504.9	1,205.0	1053.9	6,419.2	7,624.2
07/16/12	**3,477.2**	**1,190.6**	**1050.6**	**6,433.5**	**7,624.1**
Change	(27.7)	(14.4)	(3.3)	14.3	(0.1)
				Change since 9/7/09	2235.4

Week Ended	Total MMF	Retail	Institutional
07/09/12	2299.9	634.9	1665.0
07/16/12	**2286.6**	**633.5**	**1653.1**
Change	(13.3)	(1.4)	(11.9)
Change since 9/7/09	-985.0		

Weekly Change in Difference between MMF's and Bank Deposits	**(13.4)**

The government announced that it would end its guarantees of money market funds on September 10, 2009. I use that as the benchmark for measuring the total gain in checking plus savings accounts versus the decline in money market funds.

(10/10/11) Gains in bank accounts stopped being fed from money market fund withdrawals or from Fed monetization back in July 16010. They started coming from money entering the US banking system from elsewhere, expanding the supply of investable cash for the US market.

The difference between the two measures reflects how much more cash has entered bank accounts than has left money market funds since the government guarantee on the MMFs was lifted. It is a measure of net cash creation over that time frame.

Banking system net money flows showed an outflow of $13 billion in the week ended July 16, pulling back from a nominal new high, while the 4 week moving average upticked slightly from being flat. None of these changes seem material yet. The indicator has barely emerged from the range it has been in since March. Stocks have gone nowhere during this time.

A downturn from this point would be a bearish indication. If the indicator breaks out to a new high, the trend would be bullish.

(9/6/11) Until May, the more that bank inflows have exceeded money market fund outflows, the more bullish it has been for stocks. In the past, such an upmove would normally have been bullish for the stock market, but since May the Treasury market has become the black hole sucking up all available liquidity. That came, in part, at the expense of stocks. Therefore this indicator was not working as it has in the past as an indicator of stock prices.

(8/29/11) I've added a representation of bond prices to the chart. Since May, bond prices have been tracking with deposit creation while stock prices have not. As long as net money holdings continue to gain, one of these investment markets should be gaining with it. But if these deposit flows reverse, one or both markets should decline in value.

As a measure of total systemic liquidity this indicator cannot discern when investor liquidity preferences shift from one asset class to another. It's up to us to identify those shifts and recognize the change in meaning for the markets. That begins and ends with technical analysis of those markets themselves. Unlike with the last two market turns, this indicator is no longer leading stock market turns. It only shows that massive cash flows are entering the US system, not how they are being deployed.

(6/26/11) The change in cash created has led the change in stock prices by about a month in most cases. However, I suspect that if there's a run on money market funds, this indicator may not "work." It may follow, rather than lead, as falling stock prices destroy bank balances through lower margin balances and lower transaction prices, and thereby destroy liquidity.

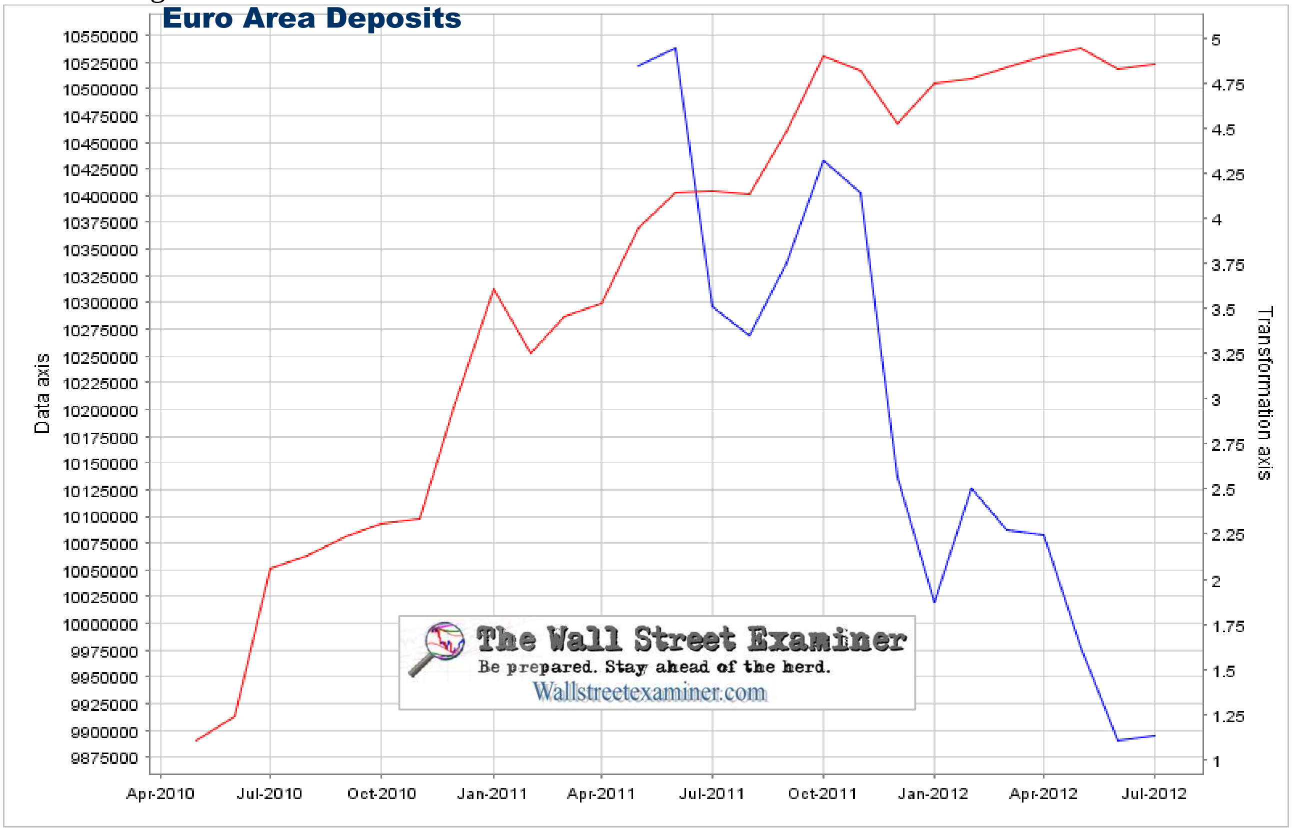
(12/28/10) Until the week ended November 8, the gap between the two numbers was reversed, with more outflows from MMFs than there were inflows to savings accounts. The direction of this change continues to correlate with a bullish stock market. That's correlation, not cause. The cause of both is the Fed's buying of Treasuries, which began, not coincidentally, after November 8. Given the correlation, we will want to watch closely for any sign of a change in direction (chart below).

(12/3/10) The negative gap had reached $249 billion more money fund outflows than bank inflows in July, but it steadily closed as deleveraging essentially stopped between July and November, pre QE2. The Fed's direct monetization of Treasuries under QL1.5 appears to have been effective at increasing cash in the system. QE2 could have a much greater impact, given the much larger size of the program.

This is one partial measure of the net money extinguished by debt paydowns and writedowns or, conversely, created on balance by money printing. When this line is declining, it signals paydowns and deleveraging and essentially the disappearance of money. That's bearish. Since July, more money has been created than destroyed. That trend is bullish for stocks (chart below).

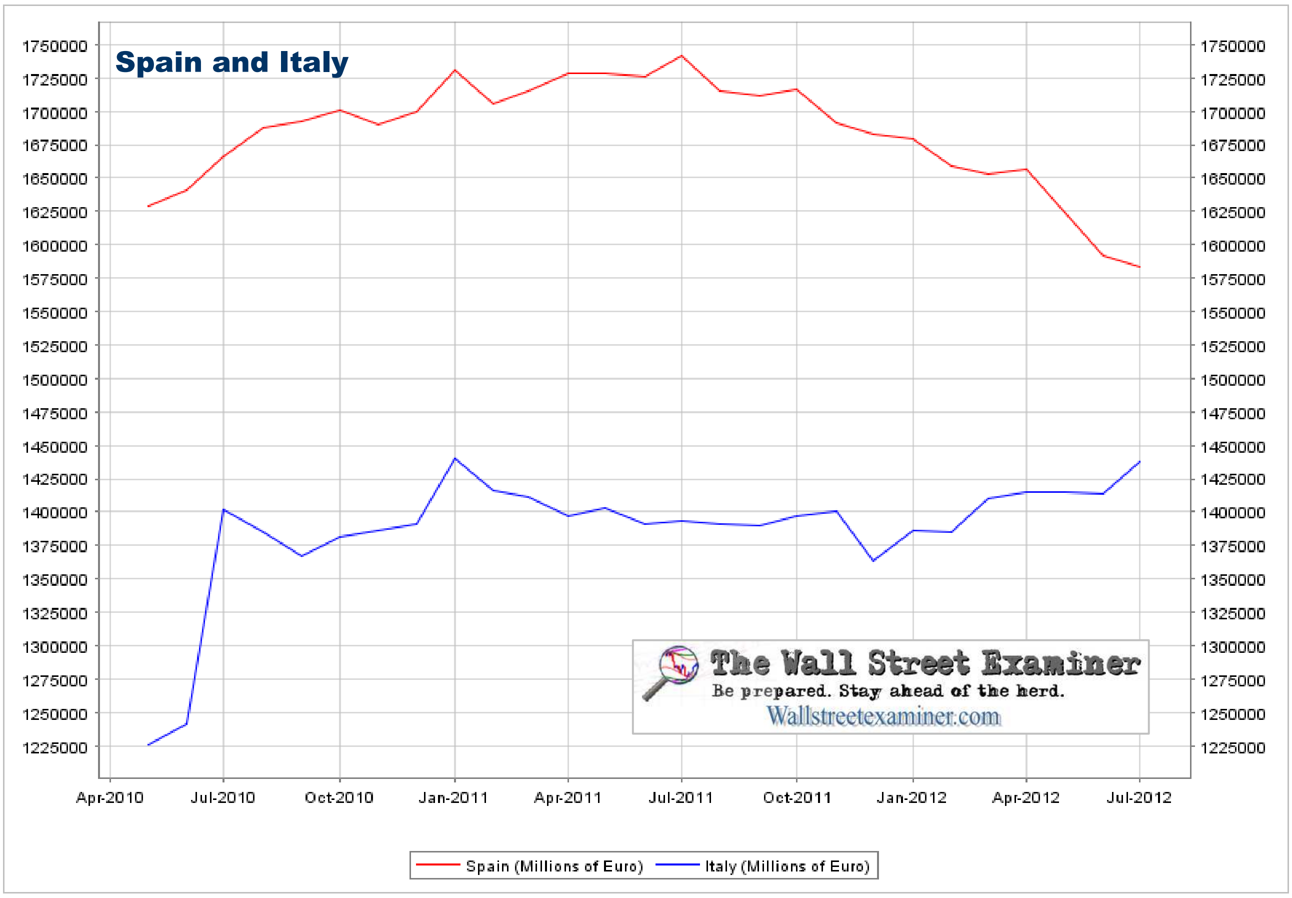
The evidence suggests that a widening of this gap correlates with a falling stock market and vice versa, often with some lead time. That's perfectly rational. Stocks are a liquidity sink for market players who need or want to pay down debt. This could be a very good indicator for us. Let's watch the chart below. If the cyan line heads lower it signals that more money has gone to its eternal home. It should be a sell signal for stocks.

The following chart shows the ECB data on bank deposits for the Eurozone as a whole for the period through June 2012. Deposit growth has stalled since October 2011. The right axis shows the 12 month rate of change.

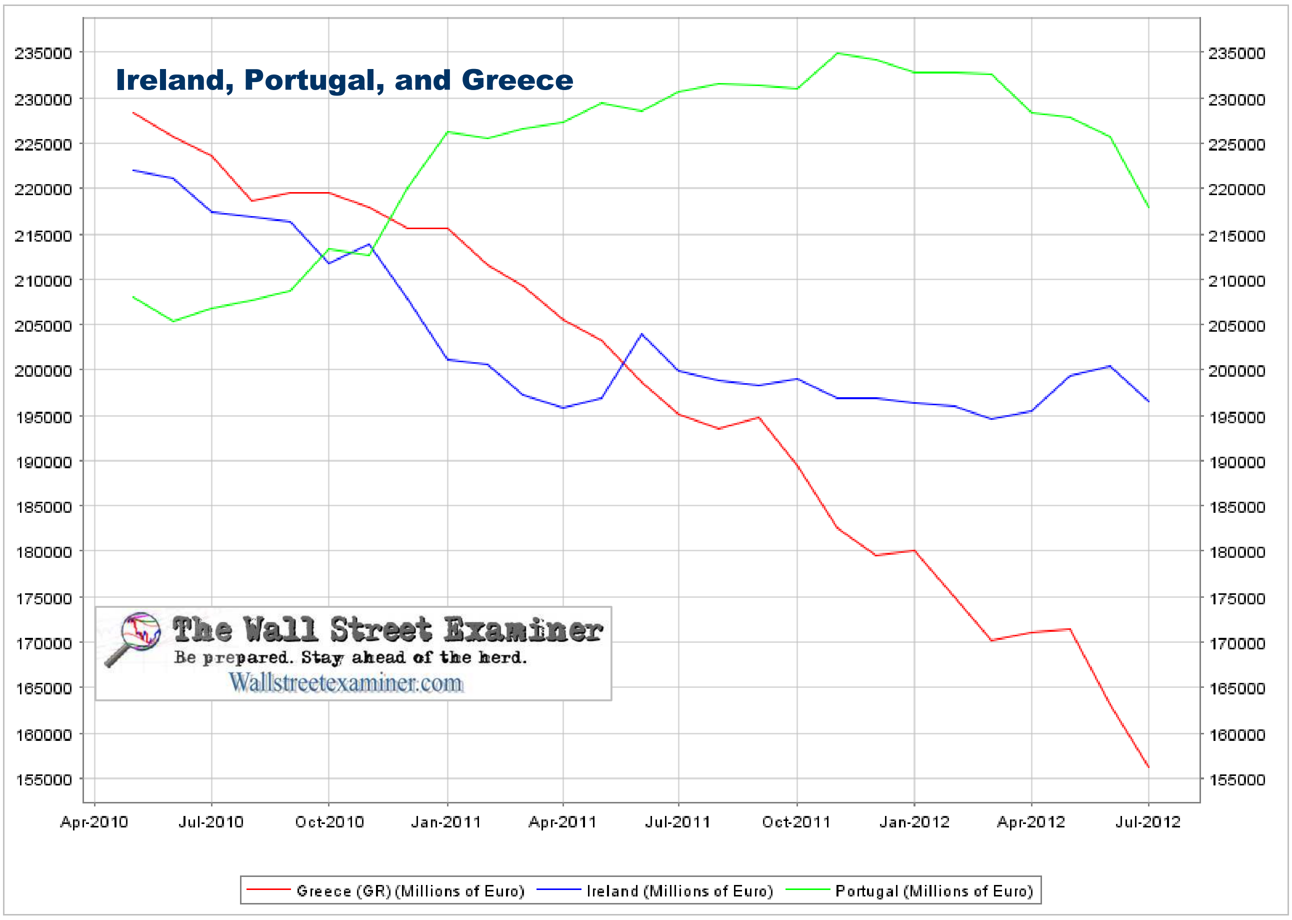


The charts of the problem countries are shown below. Outflows continued from Spain in June. Italy's deposits are growing again. Portugal has now joined Greece in complete collapse and Ireland returned to outflows.

The correlation of European bank outflows with US bank inflows, strong Treasuries, and modest increases in US economic data suggest that, contrary to the conventional wisdom, what's bad for Europe has been good for the US. It has funded money into the US Treasury Ponzi scheme economy that has kept US economic activity afloat. The ending of these outflows, whenever they occur and for whatever reason, should be bearish for the US markets and economy.



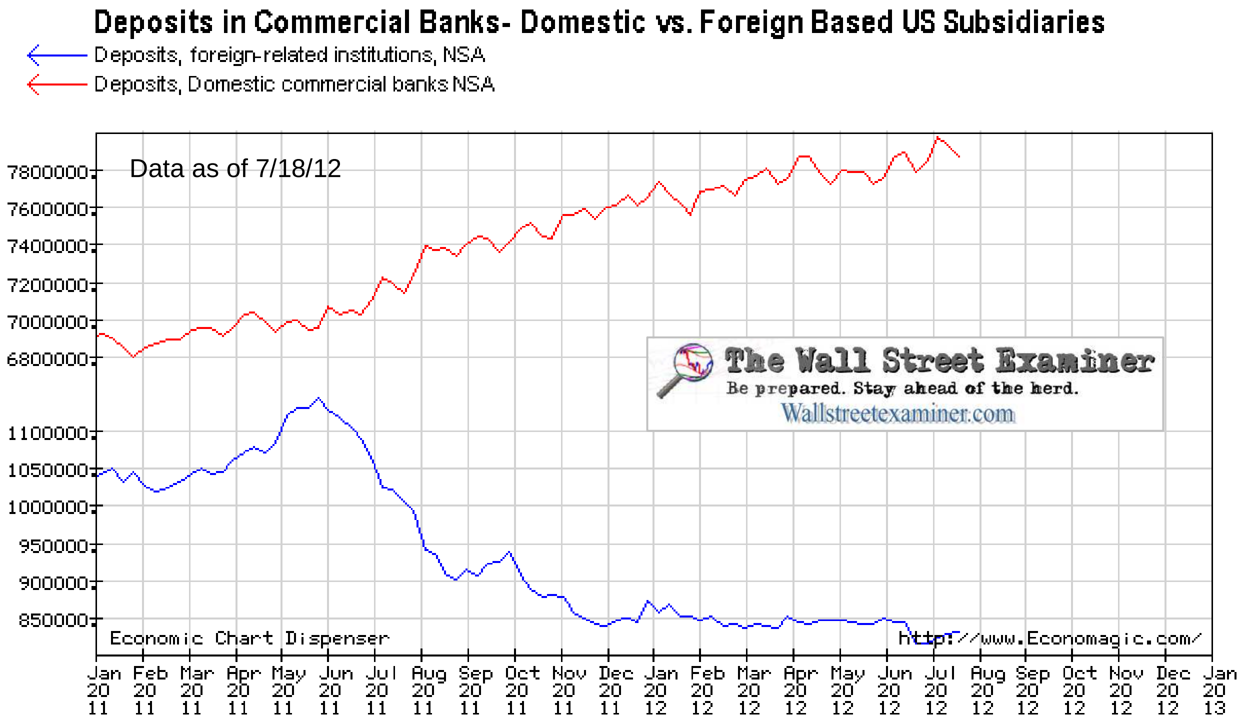
Continued on next page



Continued on next page

Deposits in US subsidiaries of foreign banks are available weekly with a lag of about a week. They had been in a flat trend since December but they dipped to a new low in mid June before upticking slightly in July. Declining deposits in US branches of foreign banks are not a good sign for Europe, but it means that more capital is probably pouring from the Eurozone into US banks. Domestic deposits surged to a new high in early July but have pulled back over the past two weeks as foreign branch banks in the US gained back some deposits. As long as US domestic deposits are uptrending at the apparent expense of European banks and their US branches, the US Treasury Ponzi will continue as the Last Ponzi Game Standing, enabling the US economy to continue to look relatively good compared to the rest of the world.

4/1/12 The decline in deposits of US subsidiaries and branches of foreign banks from June to December 2011 was essentially a mirror image of deposit growth in US domestic banks. The panic seemed to stabilize for a few weeks after the big ECB Long Term Refinancing Operation in December, but then the leaking resumed before stabilizing again in mid February. There has been little reaction since the second LTRO operation. The run has subsided, but deposits haven't rebounded.



Note: The surge in deposits in the week ended January 31 was exaggerated by $47 billion due to a conversion of thrifts to commercial banks

Recent History (2008-2010) The collapse of money fund assets is a story that has gone unreported in the mainstream media.

Cash was flowing out of money market funds and into bank accounts on almost a dollar for dollar basis until April 9010. Since then bank account growth has failed to keep pace with the decline in money fund assets, signaling that money was being extinguished as holders elected to pay down debt or, to a lesser extent, the debt was written off. If the truth were known, it would be apparent that a significant percentage of money market fund liabilities to depositors can never be repaid because the collateral backing the paper assets does not exist.

The Fed's plan to get money out of the MMFs and into the banking system worked for a while, but crashing bank loans and commercial paper show that much of those funds have been applied to debt paydowns.

I felt that these withdrawals should have caused dislocations to money market funds, but so far, they have not, or if they have, it has somehow been quietly papered over. To the degree that they knew the ending of the government guarantee was coming, fund managers could have prepared by holding a greater proportion of their assets in cash. So far, whatever they have done has worked. There have been no disruptions reported.

We know that some of the paper at the bottom of the barrel is no good and cannot be liquidated. But even before they reach that point, if the run resumes, some of the paper that is good would need to be sold at a discount, forcing the funds to break the buck (sell at a net asset value of less than $1.00). If the funds delay withdrawals or break the buck, we could see panic. In the short run, that would drive Treasury rates to zero, and possibly cause some yield suppression at the long end. That depends on how the overall market reacts to a money market panic.

But because it has been a slow motion panic, the funds have been able to handle it. Whether this can be carried through to a final conclusion without a major financial disruption is questionable.

The ICI provides the Fed with its Money Market Fund data. ICI updates the data weekly in real time. The Fed's data is 10 days behind.

There was probably a measure of intent behind this move by the Treasury. If it spurred more holders of funds to move into bank accounts, then, in theory, that would force the banks to buy more Treasuries. And there might be more direct buying of Treasuries by MMF depositors. It could all be part of the plan. The question in my mind is whether it could be managed. So far, it has been.

As of the end of January 2009 the rise in institutional money funds stuck out like a sore thumb. Over the previous couple of months we saw similar spikes in demand deposits at commercial banks, as well as non-transaction deposits. Clearly, economic units were opting to hoard cash. That raised two questions. What was the quantity and quality of assets backing that "money?" And secondly, what would happen if there was an increase in withdrawals? We may get an answer soon.

I began forecasting early in 2008 that money market funds would eventually break the buck, triggering runs on the funds. In mid September 2008 we saw two major funds shut down due to runs on the funds triggered by the Lehman bankruptcy which resulted in the Reserve Fund, the originator of money market funds, breaking the buck and suspending redemptions. Then Putnam was forced to close its institutional money market fund as a result of a run on its assets.

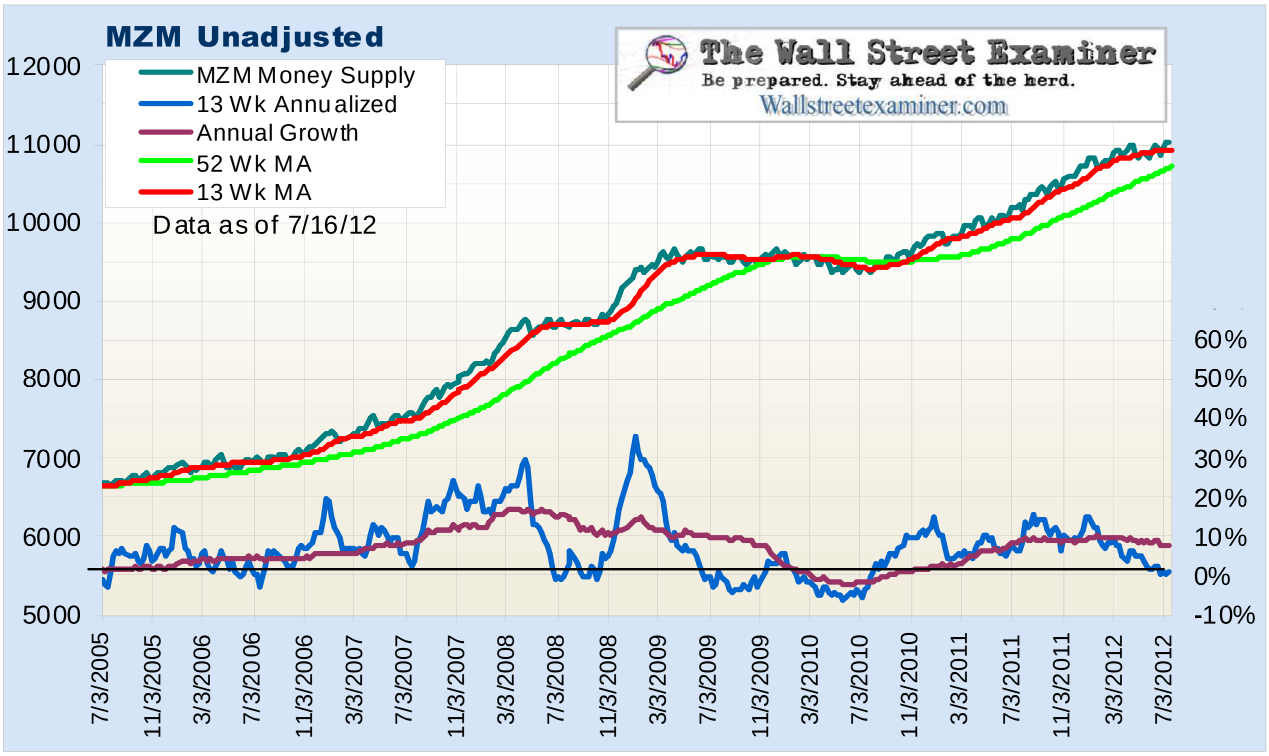
The Fed's action in indirectly converting ABCP to Treasury backed assets through the MMALF stabilized this market, but at what cost? At the peak of the crisis in October 2008 there were only institutional panics. I speculated at the time it might only be a matter of time before individual investors begin to make runs on retail money market funds regardless of the government's assurances. A crisis of confidence in government could be brewing. Things quieted down with the addition of CPR and the announcement of Federal guarantees on money market funds. Whether that restoration of confidence will be durable remains to be seen.

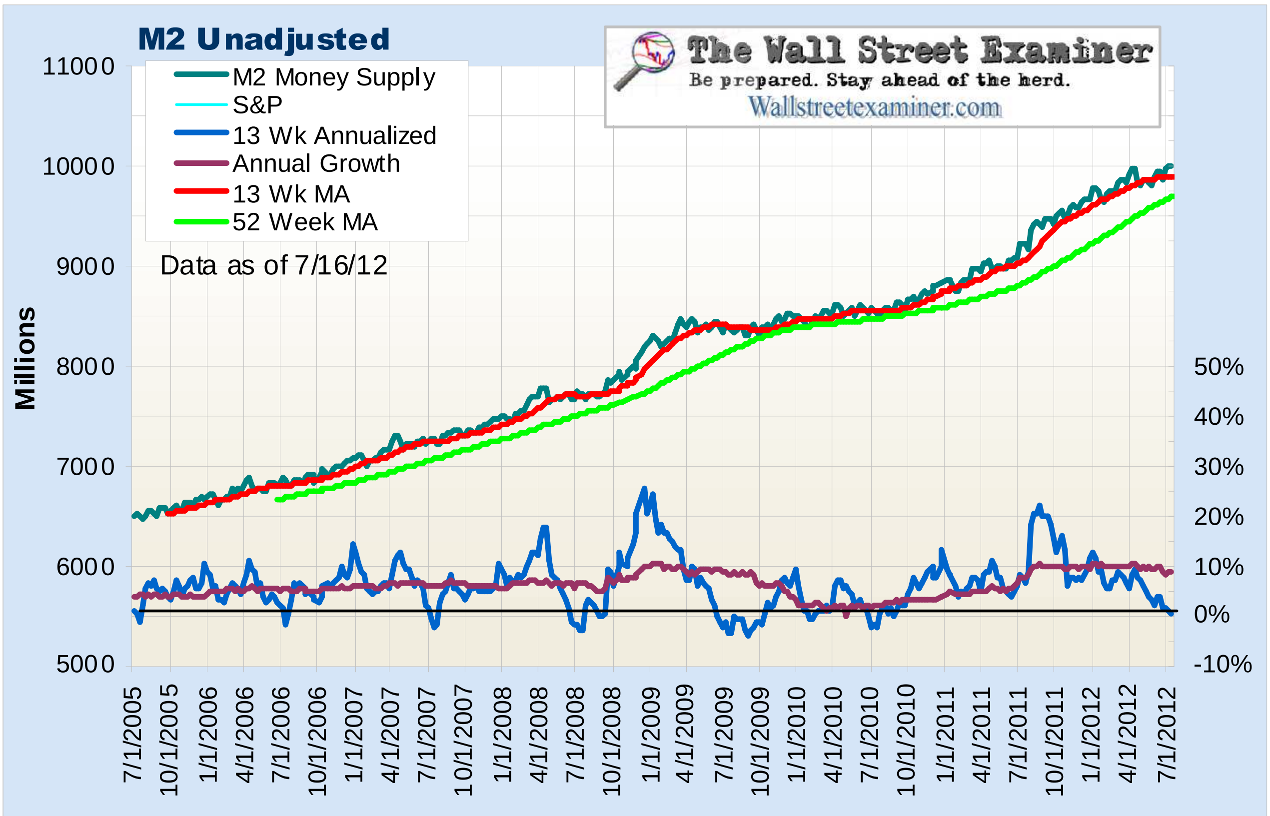
In theory, "all of that cash on the sidelines" was supposed to be the catalyst for the next stock market rally. In the week ended 2/23/08 a total of $24 billion came out of the money market funds, but the S&P lost about 100 points during that period. So much for that theory. In actuality, the money was coming out of the funds to meet economic needs. And if the outflows increase, there's going to be a problem because the assets are insufficient to meet large withdrawals. Even with government guarantees, the potential still exists for a run on the funds that could trigger the immediate and total collapse of the financial system, or at least the prohibition of withdrawals from money market funds.

Half of the ABCP market has disappeared between July 16007 and October 2008. Much of that was in the form of cash which investors fleeing the market took with them and invested in T-bills, sending rates plunging, or in bank accounts, putting downward pressure on the Fed Funds rate as some banks found themselves flush with funds, and unwilling to lend to their counterparts. My guess had been that much of the ABCP that remains on the books is fictitious, and that whatever cash was forthcoming from this market would be steadily diminishing. The money supply data should have begun to collapse in recognition of the reality that the money didn't exist.

That was unthinkable of course, so the Fed had to step in and prop that market. At this point, failure is not an option because there are no more backstops. Any loss of confidence now would result in chaos.
If it doesn't exist, it can't be cashed out. If it can't be cashed out, it can't flow into Treasuries or bank accounts, or institutional money market funds. In the meantime bills will come due that have to be paid. At some point the flood of cash that pushed T bill rates to zero and kept some downward pressure on Fed Funds, should begin to reverse, causing interest rates to soar. We saw the impact in the non-government end of the money market when rates rose to 5-6% in September and October 2008, forcing the Treasury and Fed to intervene. Only the Treasury market was still getting the benefit of the panic out of commercial paper, and out of non-Treasury MMFs. That forced the government into setting up a contraption that recirculates that cheap money back into the private sector with a taxpayer subsidy. The bill will come due some day.

Continued on next page





The Fed's money supply data has mirrored the total size of the Fed's balance sheet. I have remained skeptical about the money supply being even flat given what alternative measures show.

Even as money funds were collapsing in 2009 and 2010, M2 held up and has been within a hair of making a new high. M2 does not include institutional MMFs but does include savings deposits (CDs) and these have risen as institutions have shifted holdings from institutional funds to bank instruments. MZM, which includes institutional money funds which have been collapsing, has declined only modestly since peaking in December 2009. This gives the appearance that money supply is growing when in fact it is not. The money supply data still hides the reality that the money supply is really collapsing.

This flat trend also overstates what can really be accessed, because it includes an undetermined amount of fictitious capital as real money, when in truth, it has no collateral backing. As long as everyone is convinced that the con game is real, then it doesn't matter.

Since the Fed can make up its own numbers, I thought I'd try my own numbers too. So to construct an alternate measure of liquid money supply I added Institutional and Retail MMF totals and Total Checkable Deposits, all from the Fed's component data, to arrive at my own adjusted version of money supply.

I continue to believe that the money supply has actually declined sharply over this period due to the decline in collateral, but as long as people want to play make believe, the government will continue to post, and people will continue to not question, these absurd money supply numbers.

"Well, what about the "lag" factor?" I say that it's just another Wall Street misdirection play from the high priests of economics. It's a meaningless shibboleth that certainly can't be proven empirically. If you look at MZM, or any other measure of money supply, as on this chart since 2005, you see massive stimulus in the form of rapidly growing money supply. Yet inflation as measured by CPI was practically non-existent over this time, and other asset classes, particularly real estate and equities, rapidly deflated. Many commodities also went back to their 2005 level, before rallying on the expectation of inflation. The question is if the speculators will be proven wrong yet again.

I guess you could say that we follow money supply, not for what it is, but for what it isn't, wondering when, if ever, it will reflect reality. In the meantime, it is essential that we understand the misdirection play.

The Fed, and everybody else, needs to keep believing the con or else, because it's now the government that's on the hook for trillions in government guarantees. They stopped the last run on the funds. The next time, they may find that their bag of tricks is empty.

The recent leveling of this series does not appear significant yet, but I remain skeptical that this data resembles anything close to the real level of money destruction that has occurred. These mountainous graphs of money supply growth are built on a foundation of quicksand.

Does the surge that began in November of 2008 mean that there's really more money around? That surge was first caused by an increase in institutional money market funds, but that ended on January 21, 2009. Bank savings deposits then started growing while money market funds stayed flat. Now money market funds are declining.

Bank savings accounts have been in a strong growth trend. Depositors are opting for bank accounts given the low yields in MMFs and the increase in FDIC insurance in bank accounts.

Many commentators have expressed the belief that this "cash on the sidelines" is bullish. I doubt it. The increased savings rate along with risk aversion is likely to be with us for a long time. I don't see animal spirits returning in a sustained way, although as the stock market action of March 2009-April 9010 shows, zombies can and do get up and run around from time to time. But in the longer run, the problem is that at near zero rates, savers are not able to pay expenses from their investment income. They need to liquidate to pay the bills. Unless rates rise enough so that economic units can earn a fair return on their cash assets another wave of liquidation seems likely at some point.

Could the system withstand any more systemic shocks which might cause an increase in withdrawals? Since the asset backing of those deposits is inadequate, the government backing could be severely tested in the event of another run on any major money market fund or banking institution. Any loss of confidence in the government as the guarantor of these deposits would be the greatest catastrophe.

The appearance of money is only as good as the confidence that depositors have in the guarantor. The guarantees and programs instituted in the wake of the run on institutional money funds in 2008 are fragile. Down the road, any sign that the US government is having any problem issuing debt to back all these programs is likely to cause an even bigger crisis than we have already seen, because at that point, there will be no backstop.

The run-up in reported broad money supply from 2005 through 2007 was entirely based on fictitious capital. Money that can't be accessed and can't be spent because it has no backing is not money. As that recognition dawned on investors it triggered a run on the funds which was nipped in the bud by government action. That action converted the fictitious assets, not into real assets, but into fictitious assets backed by the future earning power of the American people through the revenue collection power of the US Government. If that earning power, or the government's ability to raise enough funds to cover the risks it has assumed should ever be questioned by the market, at that point it would be game over. Who would come to the rescue of the US government?

In my view, the money supply data as represented on this graph is meaningless. We know that all of the money represented there is backed only by confidence that the US government will pay when the time comes. That's an unproven assumption, and if and when confidence in the assumption of payment falters, these graphs will collapse.

The Treasury had been optimistic that the market could absorb massive waves of Treasury supply without the Fed's help. Since late 2009, their reports specifically mentioned the ability of the banks and household sector, which includes hedge funds, to absorb more. But the government's tacit policy of forcing cash out of money market funds into bank accounts did not motivate the banks to buy Treasuries to the extent that would be necessary when the FCBs pull back. Finally, the banks began to increase their buying in July 16010. However, the Fed became convinced that the market needed more help, and they announced Quantitative Leveling Version 1.5 on August 10, 2010.

Continued on next page

Bank Holdings of Treasuries and Bank Condition

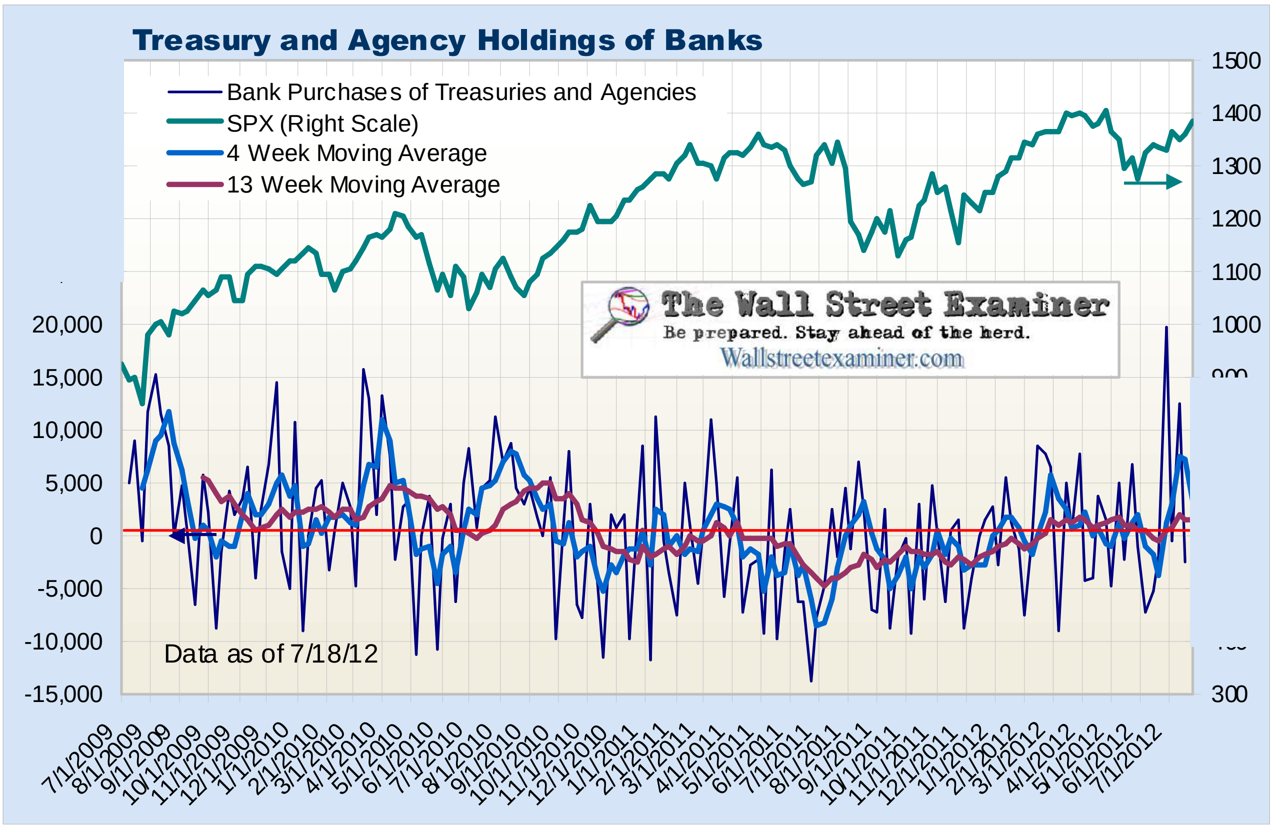
The Fed reports bank trading activities weekly with a 10 day lag in its H8 report on Friday evening.

Commercial banks' Treasury and Agency (GSE) holdings dropped by $2.5 billion in the week ended July 18. That followed a jump of $12.5 billion the previous week, and a record surge of $19.8 billion in the week ended June 27. That was a stunning and mysterious reversal in the typical pattern of small sales or purchases each week. I did not think that this buying surge was sustainable, but perhaps I'm wrong about that. It's too soon to know for sure. Given what happened in the market on Friday, with bonds taking a huge hit, I have to wonder if that surge somehow marked the final blowoff of the bond market buying panic. We should have an answer from the technical indicators soon.

6/17/12 The idea that somehow US banks can or will buy large quantities of Treasuries has been and remains a myth. They simply are not major players at the Treasury auctions, or apparently in the secondary market either. The massive influx of deposits from Europe has forced the banks to maintain only a minimal level of buying Treasuries, while their capital shrinks and loan volume remains flat.

Past intermediate buying cycles have run 6-9 months from low to low and peak to peak. The last peak was in August, so an intermediate cycle downturn has been due. The last low was in January. This suggests that the next low is due between now and September.

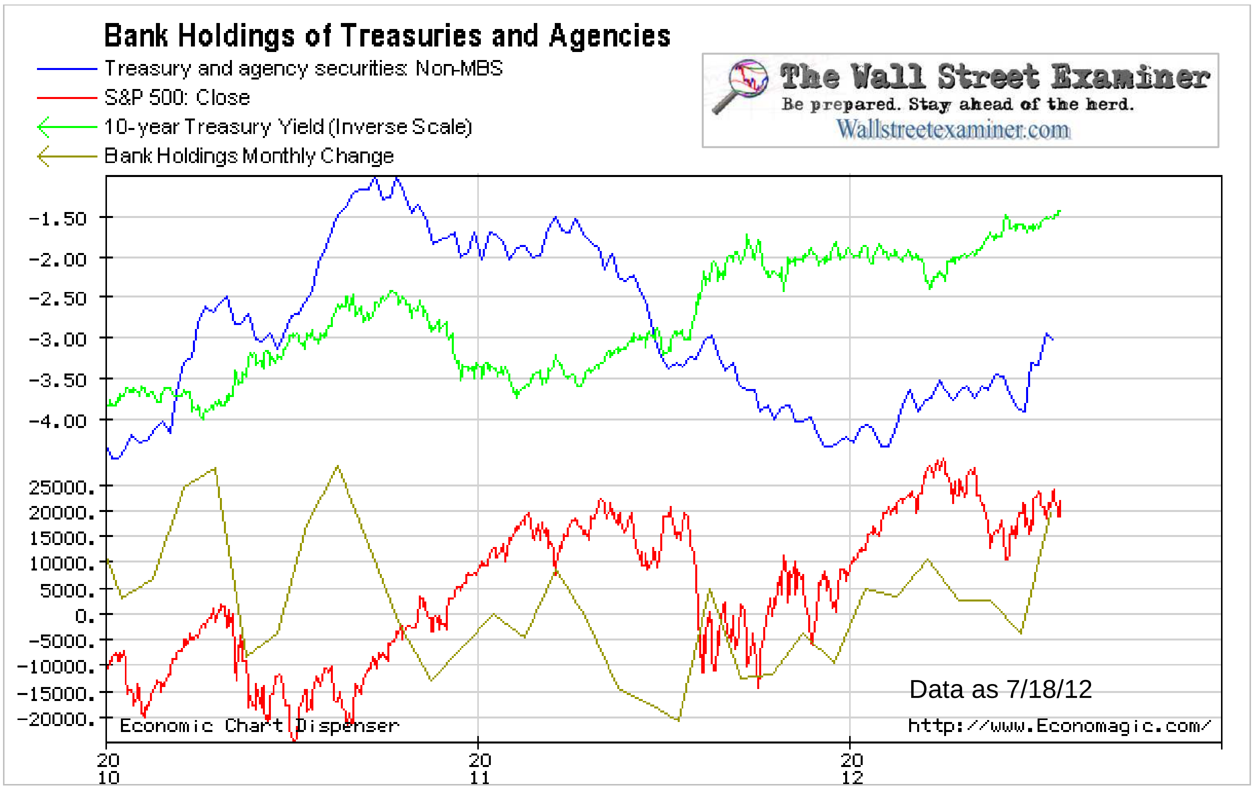
3/19/12 After being net sellers for most of the past year, banks were heavy buyers in this market in February. That was part of the "as good as it gets" conditions that I pointed out then.



3/2/12 The whole thing has a bad smell to it. Banks and fund investors are likely to end up as bagholders once again. The end will come when overleveraged, overloaded Primary Dealers are forced to liquidate and there's no one to sell to. We've seen it all before. In the end everybody loses, and the taxpayers bail out the dealers, so we lose too, even though we weren't players, and never agreed to cover the losses of others. That's just the way it is under the laws of crony capitalism.

This indicator is included in the composite liquidity indicator.

1/30/12 The banks are so flush with cash that they are desperate to put it somewhere and earn a return, but as yields drop, the margins become squeezed to the point that there's no incentive to buy, and in fact there's a disincentive. Bernanke's gambit could backfire. The market may have reached the point at around 1.80 on the 10 year in yield, that it simply can't go any lower. They need higher yields in order to earn a profit on the spread, and they may refrain from investing their cash until they see those yields higher.

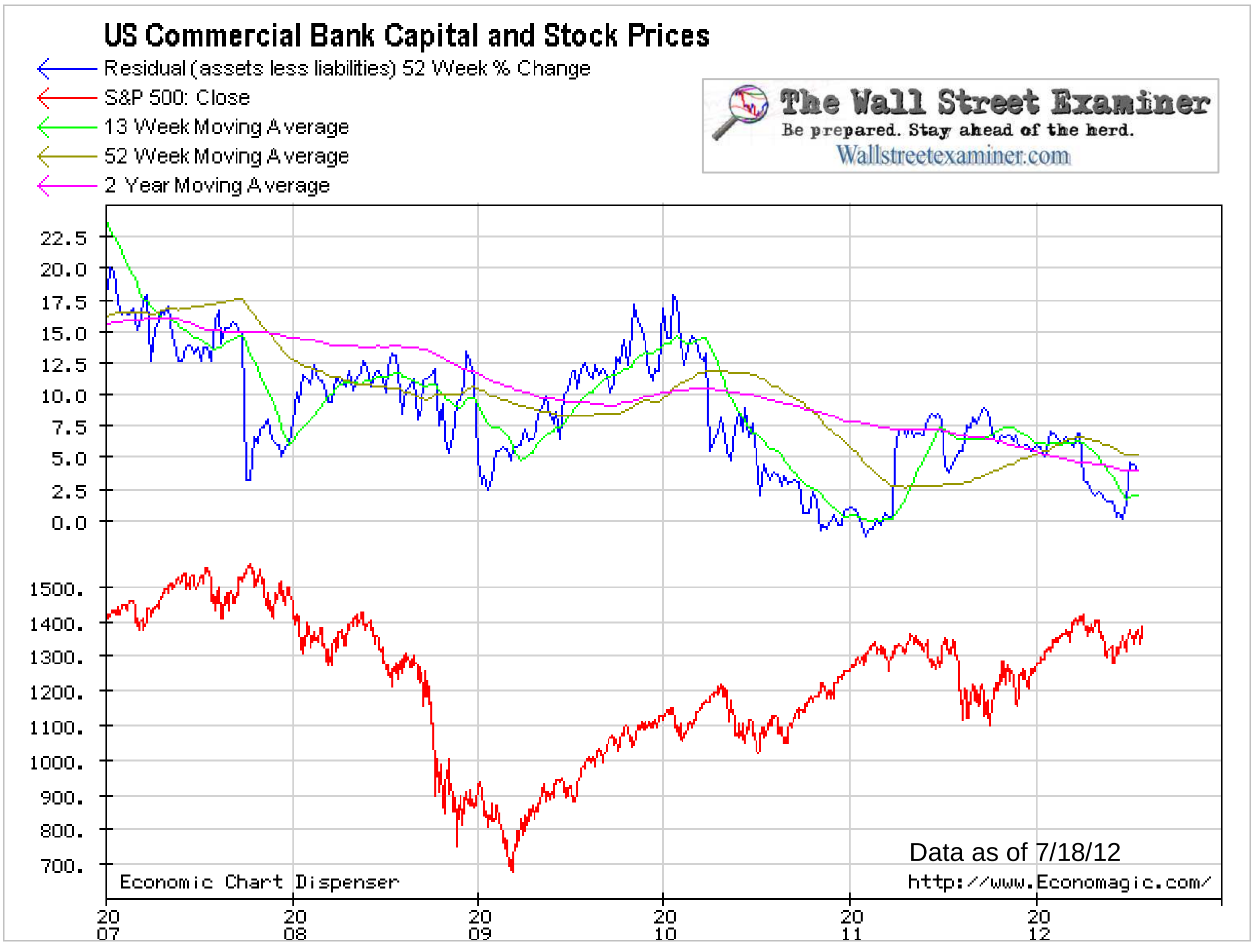


Note: Treasury yield on inverse scale to better show the correlation. The green line thus represents the direction of Treasury note prices. Continuous data unavailable before July 16009 due to change in Fed reporting.

(3/12/11) Banks have dramatically reduced their purchases of Treasuries since September of 2010. We know, based on anecdotal evidence that they are having great difficulty with their mortgage portfolios, with REO rising, recovery rates falling, and increasing problems in disposing of that inventory, not to mention the cost of the lawsuits. We also know that instead of increasing loss reserves, they have been reducing them since June of last year. The problem is getting worse and they are refusing to recognize the losses.

(5/1/11) In March I introduced a new indicator to these pages, the 52 week rate of change in bank residuals (assets less liabilities), which is in essence a measure the profitability of the entire US commercial banking system over time. While banks can and do lie about their earnings and balance sheets individually, the more I study this indicator and its relationship to market performance, the more convinced I am that it is a good barometer of the relative level of disease within the US financial system. It has been a good leading indicator for stock prices over the past 10 years.

Continued on next page



7/17/12 Somebody added a big slug of capital to their balance sheet in the July 18 week. This follows the mysterious surge of bank Treasury holdings the week before, and is coincident with a big jump in bank non-Treasury trading assets. While I have taken note of these events, I have no clue yet what they mean or what the implications are.

5/8/12 The bank residual indicator has crashed to a new low. While I look at this as an indicator of bank profits, David Stockman reminded me that the decline could also reflect stock buybacks and increased dividends. In neither case is healthy growth suggested.

This marks more than 2 years in a bearish trend of bank capital. I have to view that as ultimately bearish for stocks. However, in 2010 and 2011, stocks mounted a major advance in the face of a bearish trend in this indicator. It's an interesting peripheral indicator and it's extremely bearish. There's now apparently less bank capital than a year ago, which is unprecedented. However, this has not been a primary determinant of the liquidity that drives markets. The stock market has at times bucked the trend of this indicator for many months. But both the long term and intermediate trends must be taken as deeply negative signs.

3/19/12 The bank residual indicator, which I watch but which is not included in the Liquidity Composite, has flashed a very bearish intermediate signal. Market technicians will recognize the pattern as a head and shoulders breakdown. This signals clearly that bank profits are shrinking again. The euphoria over the bank stress test results is grossly misplaced as were the tests themselves. They tested for everything but the one greatest risk that faces them—rising bond yields.

The direction of the net residual of the banking system has to be seen as a warning sign that a stock market decline does lie ahead. But it will only happen when rising inflation forces central banks to stop printing. That will come very late in the game because the Fed focuses on the slowest and least responsive of all inflation indicators, the core PCE, which strips out all of the elements of inflation that move first and move most. Furthermore, it is data that is only released quarterly, well after the fact. The Fed is doomed to being way behind the curve by the very rules it sets for itself to judge inflation.

(6/26/11) This week's H8 was rebenchmarked to the March call report and the Fed also made major revisions affecting the numbers going back to 2004. The Fed explained the revisions here http://www.federalreserve.gov/releases/H8/h8notes.htm#notes_20110624 It now appears that bank performance in 2010 was far worse than it had previously appeared, meaning that the apparent weak recovery in the first 6 months of 2011 came from a much lower level than originally depicted. Banks are in an even weaker position than we had thought.

Even these numbers are illusory because the banks have not taken anything remotely near adequate loss reserves. For example, they've barely written off any home equity balances, which are now essentially uncollateralized. Revolving home equity loans were carried on the books of the commercial banks at a total of $563 billion as of June 15. That number is only down by 10% since 2009, and it was steadily rising before that as housing values were collapsing. These loan balances are now $100 billion *higher* than they were at the peak of the housing bubble in 2006. These are *second* mortgages. They're now essentially unsecured personal loans. An adequate write down would be a huge hit on bank capital.

While subject to wide variance, a healthy growth rate for bank residuals appears to be between 6% and 15%. Readings over 15% suggest that the banks have become parasites on the economic host, sucking out its lifeblood and eventually committing suicide/murder. The banks weaken first followed by the market about a year later. In 1999, bank profitability collapsed but stock prices continued higher until March of 2000. A 2 year major bear market followed. The same thing has happened here in 2010-11.

(5/9/11) Bank residuals have had regular short term cycles superimposed on longer term cycles. The major cycle typically lasts 3 years low to low, with an interim cycle of varying amplitude lasting roughly 18 months to two years. That cycle tends to lead intermediate turns in the stock market by several weeks. It turned up in March-April. An intermediate peak is ideally due around June-July, which should be from much weaker than usual levels. I would expect that downturn to be a signal of an imminent bear market in stocks. I view the big negative divergence between this indicator and stock prices as a warning sign.

(7/30/11) A big problem with this indicator is that based on the Fed's enormous restatement of several years of this data, we now have proof that banks lie. Surprise. Surprise. So while we shouldn't discount the signals from this indicator entirely, I'm more inclined to believe sell signals, especially when supported by the majority of other indicators.

(4/18/11) Even without recognizing loan losses via increased reserves, bank profits have been disappearing. This "surprise" is reflected in the aggregate balance sheet of the US banking system reported weekly by the Fed.

(3/12/11) Over the long haul, when bank earnings have diverged from the direction of stock prices, it has been an early warning of impending change. The collapse of bank profits (based on the change in the equity residual as reported by the Fed) in 2010 and 2011 is an ominous portent of a dire fate for the market. Considering that the disappearance of profit came in spite of a cost of funds of zero, it is even more troubling. I think back to Mark Faber's quote that a banker would have to be an idiot not to make a profit when the cost of funds is zero. I guess this is proof that the banking system is run by idiots.

Put all these signs together with the unwillingness of banks to even invest in Treasuries in recent months, and their massive buildup of cash this year and especially in the past month, and I have to conclude that another wave of financial dislocation and even catastrophe is imminent.

(11/10/10) We've had hints that this was going on since late September when they began to cut back on their buying. I speculated that it was putting pressure on the Fed to do more. It attests to what I believe is the real reason for QE2, which is that the banking system may once again be on the verge of collapse thanks to the pressures arising from the mortgage putback issue and other bad loans such as commercial real estate. Bernanke's excuse for the program that unemployment is too high (although obviously it is) and inflation is too low, was sheer nonsense. This is just another bailout.

(12/10/10) The bank selling is part of the explanation for why QE 2 isn't helping the Treasury market. The bucket into which the Fed is pouring money is full of holes. FCBs are one hole, individual investors are another, and banks are another.

(11/6/10) Bank purchases could be reduced in the months ahead due to the pressure on bank balance sheets from mortgage paydowns, writeoffs, and putbacks. The worse this problem becomes, the faster the Fed will have to pump to keep the markets from imploding. At the new rate of $106-113 billion a month, the Fed has taken the pre-emptive shock and awe approach. It hopes that with this degree of overkill it will ignite a self sustaining bull market in stocks that will lead to economic recovery. This is not my opinion. I am paraphrasing Bernanke from his November 4 Washington Post editorial.

Composite Liquidity Indicator

(6/6/11) My experiment with a composite liquidity indicator continues. The indicator combines the key liquidity indicators discussed in this report, weighted according to their degree of correlation with market performance. Many of you have requested something like this to make it easier to visualize the overall picture. This is a work in progress, and I am still tweaking the weightings. It shows promise as a snapshot view of how liquidity flows might affect the market, but it must be viewed in the context of the analysis of the individual components.

I have tested several different moving averages for depicting smooth trends and crossover signals, and have settled on the 39 week moving average for preliminary major trend signals and the 78 week moving average for confirming signals. There are still false signals and whipsaws. This indicator is not a black box. It can't be read on a standalone or purely mechanical basis.

(8/22/11) Although I attempted to structure the composite to measure equity market flows, in essence it is an indicator of total US financial market liquidity. We've seen a wave of cash come into the system over the last month or so, preventing this indicator from breaking down when the Fed stopped QE2. Some of that liquidity funds the purchase of Treasuries. But the stock market has already broken down. The simple explanation is that the Treasury market became a black hole, swallowing up all available liquidity partly at the expense of stocks. This indicator, and the job of interpreting it, are still works in progress. In the end, it comes back to an understanding of what the components are telling us.

(9/22/11) I have adjusted the indicator to reflect the change in the tracking of deposits at the Fed to include Other Deposits, the growth of which, like the growth of bank reserve deposits, reduces financial market liquidity. The inclusion of this data has flattened the indicator somewhat since last June, which is when Other Deposits at the Fed began their sustained surge.

This is not a short term timing indicator, but rather a measure of intermediate to longer term forces that fuel the US stock and bond markets. Some of the data is from the current week and some from the prior week. Changes that occurred in the most recent week may have already superseded the changes in the lagging components. Fed and FCB data is from the current week. Bank data is from the prior week. Component changes in the most recent data were:

	Short Term	Trend
Fed Cash To Primary Dealers	Bullish	Bullish
FCB Net Purchases Treasuries and Agencies	Bullish	Neutral
Net Bank Inflows	Bullish	Bullish
Bank Trading	Bullish	Bullish
Change in Deposits at Fed	Bearish	Neutral
Bank Net Treasury/Agency Purchases	Bullish	Neutral

The composite liquidity indicator had a tiny downtick last week. The indicator has remained essentially flat for most of July, but is still firmly entrenched in a strong uptrend.

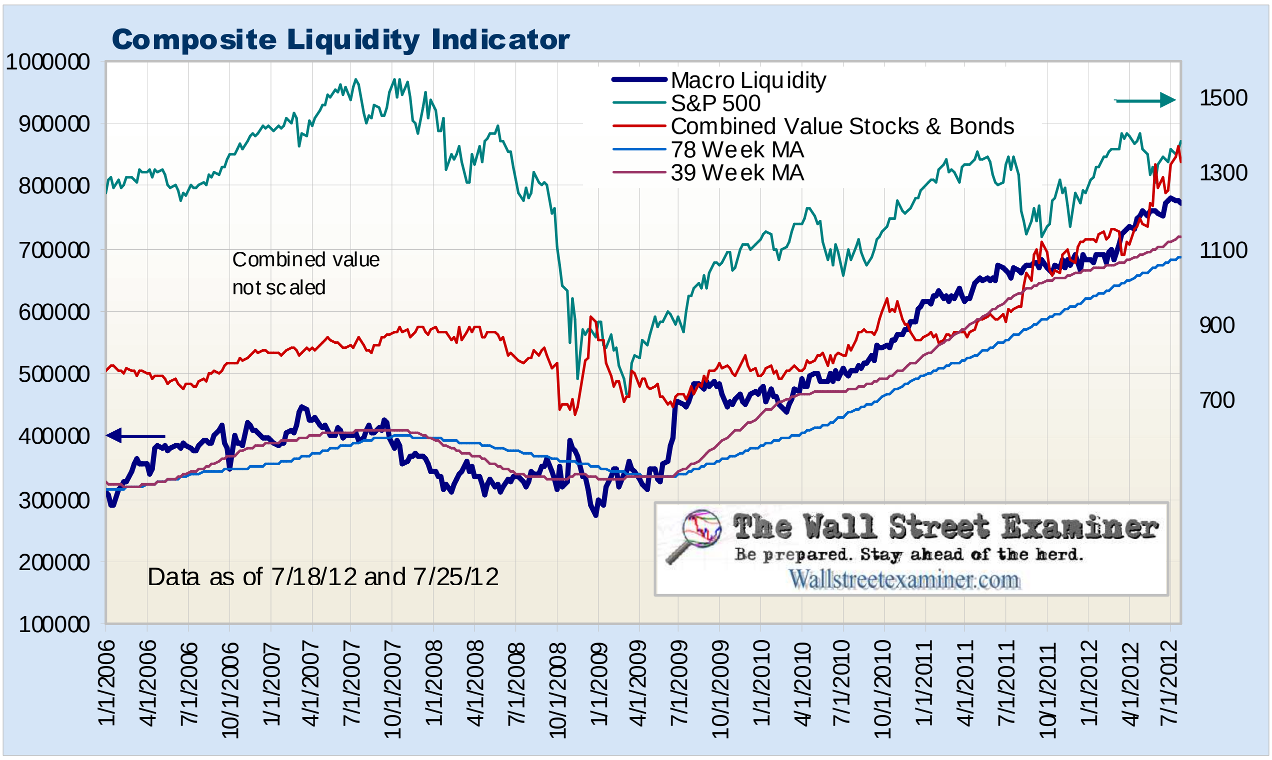
The Fed's buying of MBS and the slight tilt of Operation Twist toward more purchases from Primary Dealers than sales to them, will remain a bullish influence at least until year end. Large bank trading account patterns are still bullish while bank net Treasury purchases are back to a neutral pattern. Net bank inflows are in a slightly bullish intermediate trend, while reserve deposits at the Fed remain in a neutral pattern. Foreign central bank purchase patterns have improved from bearish to neutral.

Taken as a whole, that should be enough to keep Treasuries at very low yields and to continue to give stocks a boost. It's too soon to tell if there's a sentiment shift under way away from Treasuries. All else being equal, that would work in favor of strengthening equities, but if yields head to new lows, stocks should roll over. Liquidity, while bullish, still seems insufficient to support bull moves in both investment classes.

6/9/12 Sorting out those issues is mostly where technical analysis comes in. This indicator cannot tell where the liquidity will flow. However, in the separate analysis of the ECB versus the Fed we've seen a correlation between ECB pumping and Treasury rallies, and Fed pumping and stock market rallies. That can be of some help in understanding the environment.

Recently both the Fed and ECB have held their asset bases flat, the Fed for nearly a year and the ECB since March. Treasury prices raced higher into late May as a result of panic, not increased central bank pumping. The trend of Treasury prices has gotten way ahead of the growth of liquidity, similar to the behavior of stocks in 2007, when the Fed had stopped pumping. This is consistent with the long term momentum overextension in Treasury prices, and the fact that the whole world, including US Primary Dealers, seems to be long Treasuries. In this context, the disconnect from the growth of central bank total credit expansion seems to argue for a major reversal in Treasuries in the months ahead.

Over the course of intermediate term swings, rallies in treasuries have often been joined at the hip with declines in stock prices, and vice versa. Whether that will change when the current trend in Treasuries reverses is unknowable. If the Fed pumps and economic numbers are growing, along with inflation, stocks and commodities will rally. If the Fed simply stays the course then stocks will probably stay rangebound-- boring, but more likely than a dramatic move either way.



5/9/12 The Fed will have to decide how to extend its bond purchases in June when the MBS program expires. It must engage in some form of program in order to offset the natural shrinkage of its balance sheet from maturities of Treasuries and GSE paper, and especially from MBS paydowns. If it simply extends the current program, that will suggest a continuation of modest and irregular advances in stock prices in the context of a trading range consistent with a negative phase in the 10-12 month cycle (See daily market updates).

The Fed however, may decide to expand the program, buy MBS outright, or buy Treasuries or GSE paper outright. The decline in commodity prices would probably need to deepen in order to give the Fed the necessary wiggle room for a more aggressive pumping program. Depending on the amounts, such programs could have more bullish impacts if commodities cooperate.

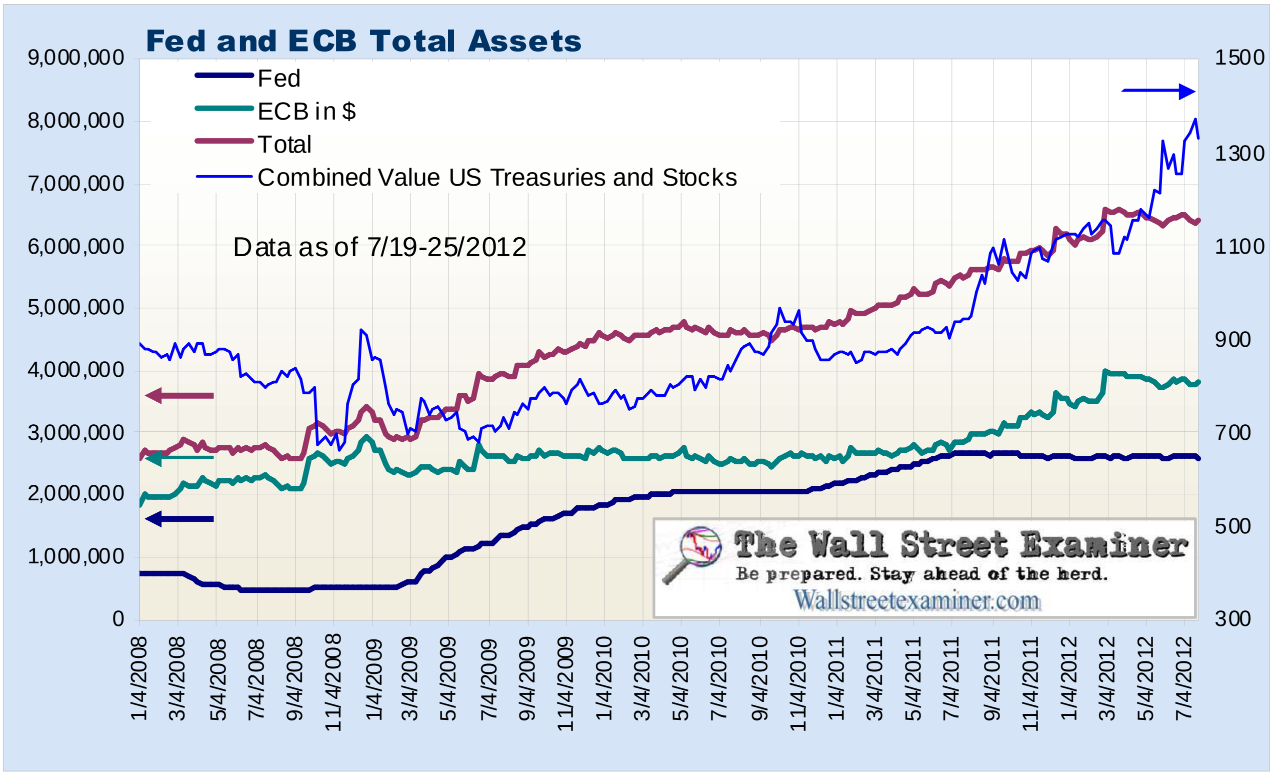
The crisis impacting European banks is a given. Now JP Morgan is a wild card. If the truth of the situation is that there are much greater losses in the Morgue, the shrinkage of capital that we've seen so far, as severe as it has been, may just be the tip of the iceberg. Some liquidity issue canaries may be about to drop dead. If that happens, the liquidity indicator may actually go into a downtrend signifying a liquidity contraction, which would be terrible for the markets and the economy. That could elicit another massive reaction from the Fed. But let's not get too far out front in speculating on this. The indicators themselves should give us sufficient notice.

4/24/12 As the Primary Dealers try to keep yields as low as possible on behalf of their primary client, the US Government, they are also giving themselves time to distribute their unusually large long positions, most of which were acquired near or above current prices. That run to 2.40 on the 10 year in March was an intolerable situation for them at the time. Now that they've put themselves in position to work off some of the inventory at better prices, at some point they will want to stand aside from taking on so much Treasury inventory and focus elsewhere. As a result, both bond and stock prices could face crucial inflection points in the weeks ahead. But in the short run, another parabolic buying panic in bonds is under way.

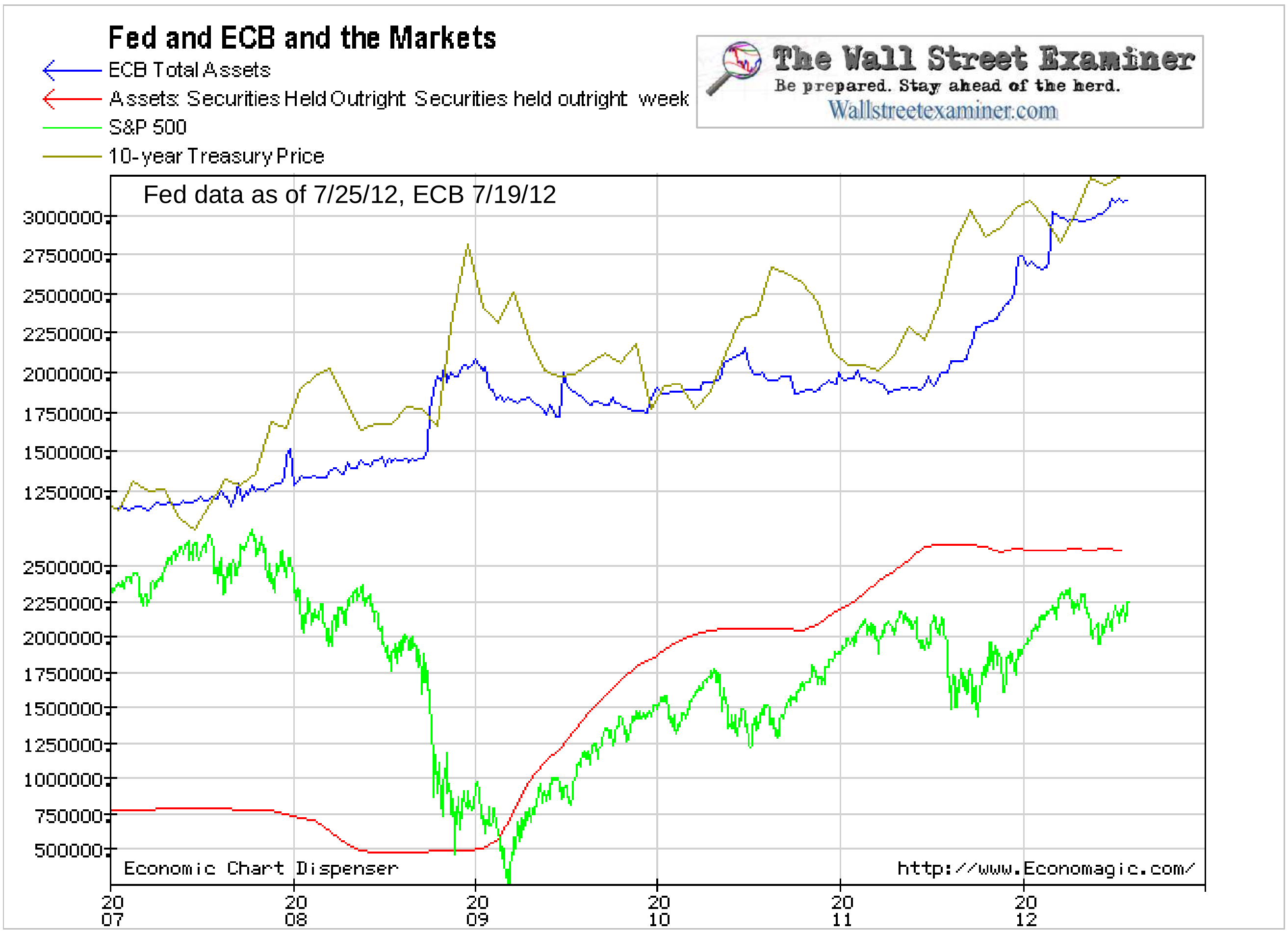
4/23/12 The Fed will contribute to a positive slope in the liquidity that matters to the markets at least until August when the last purchases in its MBS replacement program should be settling. That positive influence would diminish over time as the level of mortgage refis recedes, assuming that yields don't break down. If they do, then another wave of refis and MBS paydowns from the Fed's balance sheet would be forthcoming. That would require the Fed to increase its MBS purchases from the Primary Dealers in order to keep its balance sheet from shrinking. A vicious cycle of lower rates and more Fed paydowns could ensue. That's not a forecast, but it is a "what if" that can't be completely dismissed.

Commodity prices will be one key determinant. A weak stock market coupled with enough of a decline in commodity prices would give the Fed and ECB the excuse and the impetus to do even more printing. Should stocks and commodities hold their own, then the central banks will be hemmed in. That could make for either an extended trading range or a slow drip bearish environment for an extended period. Likewise, stronger economic data would put the market in more of a vice because it would prevent the central banks from expanding their balance sheets any more. Bull markets top out when the economic data is positive for just that reason.

3/23/12 Massive ECB lending in the form of a second huge Long Term Refinancing Operation (LTRO) showed up in this indicator via a huge jump in cash flowing into the US banking system the week after the LTRO settled in European banks on March 1. Many of the biggest European banks have large US operations. However, this may not fully reflect the influence of the ECB's actions so I have also been following the ECB's influence separately as shown on the charts below.



1/21/12 Stock prices have tracked the Fed's actions and Treasury prices have more closely tracked the ECB's moves in recent years. That stands to reason as investors in European debt have sent cash pouring into the US, particularly via purchases of Treasuries, whenever the ECB has provided the funding to do so. But it is notable that US stock prices seem to also be getting the benefit of the most recent ECB pumping operations. If another massive ECB long term refinancing operation is indeed forthcoming, as many are speculating, that could blow the roof off the US market in the weeks ahead.



Format notes - Look for text in this Times Roman font for currently updated sections. Material that is updated weekly, or within the past week will be in this font and color.

I am doing my best to prune some of the dark blue background sections which consist of older background material, but I have been fighting a losing game. Hopefully, those parts of the report will continue to help people just starting their subscriptions and long time subscribers who want to review.

If you see a paragraph that is obviously stale, please copy and paste it into an email and send it to admin@wallstreetexaminer.com. That will help me greatly to help you. If you note any typographical, syntax or factual errors, please let me know.

Lee Adler
The Wall Street Examiner
http://wallstreetexaminer.com
Toll free 561-839-3726