

This is part of a series of free Wall Street Examiner Pro Trader reports that I have been posting as I recover from my emergency open heart surgery on May 3. This report covers Macro Liquidity indicator trends and what they tell us about the outlook for the US stock and bond markets.

If you are a subscriber, these free reports will not be charged to your subscriptions. Next week I resume regular posting for subscribers only. I will credit your account for all of the downtime from the date of the last report you received. This applies to all Pro Trader services.

I thank each one of you for your patience and support! Thanks to the many of you who have written to me directly offering your encouragement! I truly appreciate hearing from you.

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Lee

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The Fed just completed its regular monthly MBS purchase settlements May 12-23, cashing out dealers by \$32.5 billion, thereby making those funds available for dealer trading. This supplements the constant inflows of central bank cash from Europe and Japan into the US markets. The BoJ, and especially the ECB, print more money and drive it to the US by penalizing depositors and investors in Europe with negative rates and the resulting negative yields. As a result, even though the Fed isn't printing, as foreign cash cascades into the US, US market liquidity has been rising at a rate of 4.6% a year. This continues a gradual rise from zero growth during the first half of 2015. This liquidity has been behind the rally in US stock prices this year.

The US Treasury had been assisting with the usual mid April paydowns of outstanding Treasury debt. Those paydowns temporarily add cash to dealer and investor accounts for a few weeks. Those paydowns are finished and the Treasury has returned to net borrowing. What had been a tailwind will now be a headwind, with the exception of the mid June tax collection period when there will be a couple of weeks of debt paydowns. These will be much smaller than in April.

Mid April through mid May were “as good as it gets,” for liquidity. Treasury borrowing has returned to drain the cash inflows that recently came into dealer and investor accounts. However, the capital flight into the US from Europe, Japan and elsewhere will remain a constant. That could prevent a classic bear market as the market floats on the massive tide of central bank liquidity, but it won’t prevent occasional big selloffs as sentiment gradually becomes more skeptical of central bank policy. Whether that sentiment will turn negative enough to start destroying liquidity faster than central banks create it, is the question.

4/3/16 Since the middle of 2015, investor, trader, and dealer sentiment underwent a slow shift toward greater skepticism of central banks to keep bull markets going, and toward a more cautious and even negative stance on both stocks and bonds. The recent rally in stocks represents a sharp rebound in sentiment that has now reached the limits of the year long downtrend in a number of liquidity/sentiment, and price measures. Any further increase in stock prices would break those downtrends, suggesting that the sentiment shift was cyclical, not secular, and that the players are ready to give the big central bank con game the benefit of the doubt again.

That would not mean a permanent shift toward never ending bullishness, but it would mean that we are not yet in a secular bear market environment where doubt and skepticism rule. It is more likely that confidence in the con is likely to alternate with skepticism and doubt.

Money tends to drive sentiment and as long as 2 of the 3 biggest central banks in the world continue to create ever more of the stuff and pump it into the US, that will tend to lift sentiment. You always feel better about things when you have lots of cash in your pockets. That’s especially true for those who make a living trading the markets. And that’s why it’s difficult for a sustained bear market to take hold regardless of deteriorating economic and investment fundamentals. In fact, recessions have always been bullish for the market because they prompt central banks to ease policy.

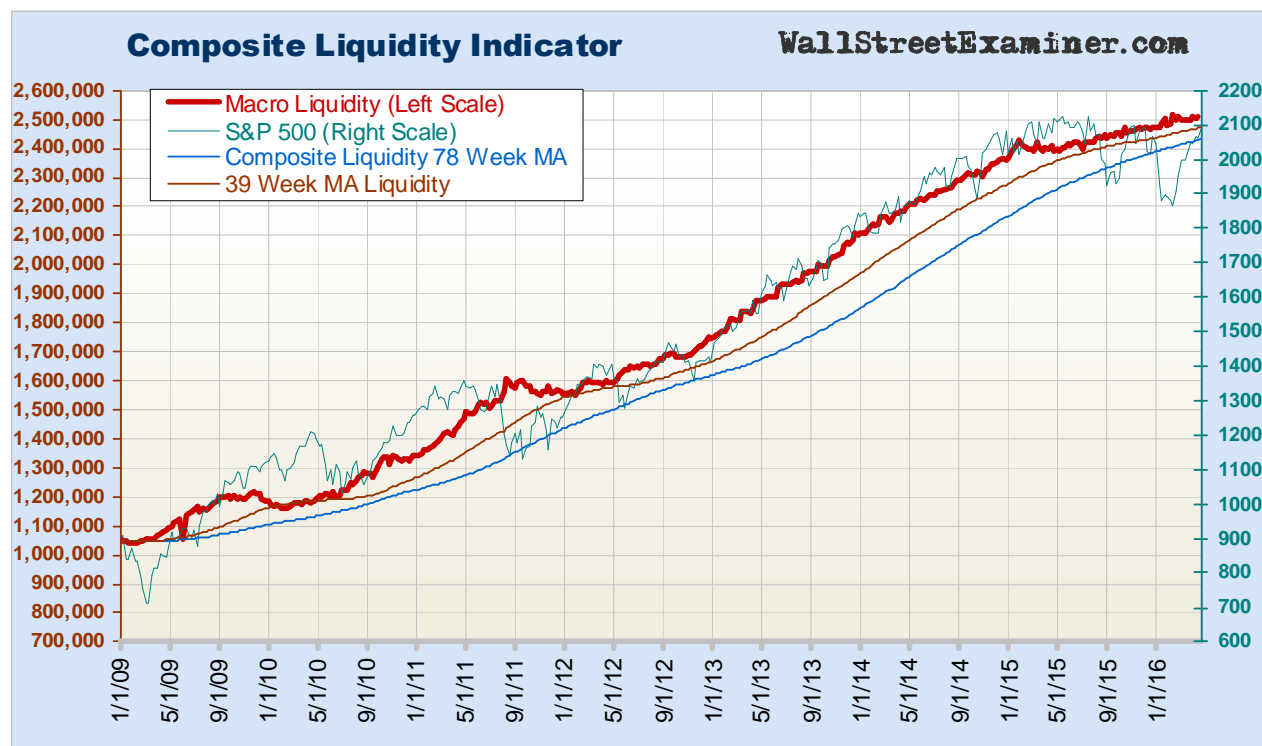
Meanwhile, as long as the Chinese stock market isn’t destroying capital, conditions should remain favorable for the US market to continue to rally. We’ll keep an eye on the trend in Shanghai. China’s market is in position technically for at least a significant counter trend rally. It has established an uptrend line that may hold a key to US performance. If China starts down again and the margin calls start again, then Chinese investors will again raise capital wherever they can in the world. That should trigger the next worldwide meltdown. Another meltdown in the US would be unlikely for as long as China stays in a bullish intermediate trend, which currently appears to be setting up.

3/7/16 During periods when China’s market is stable, things in the rest of the world’s markets, particularly in the US, can appear to be improving. But when the next leg down in China’s bear market comes, another wave of capital destruction there will have negative impacts on US markets as Chinese investors and speculators seek to raise cash wherever they can in the world. This has knock on effects, triggering selling by US investors. We’re in a quiet period now, waiting for another shoe to drop.

12/15/15 2% liquidity growth is effectively tight money when governments around the world, particularly the US, continue to sell massive amounts of debt every month to pay current government expenses. That sucks cash out of financial accounts faster than central banks are creating it, with the Fed now on the sidelines.

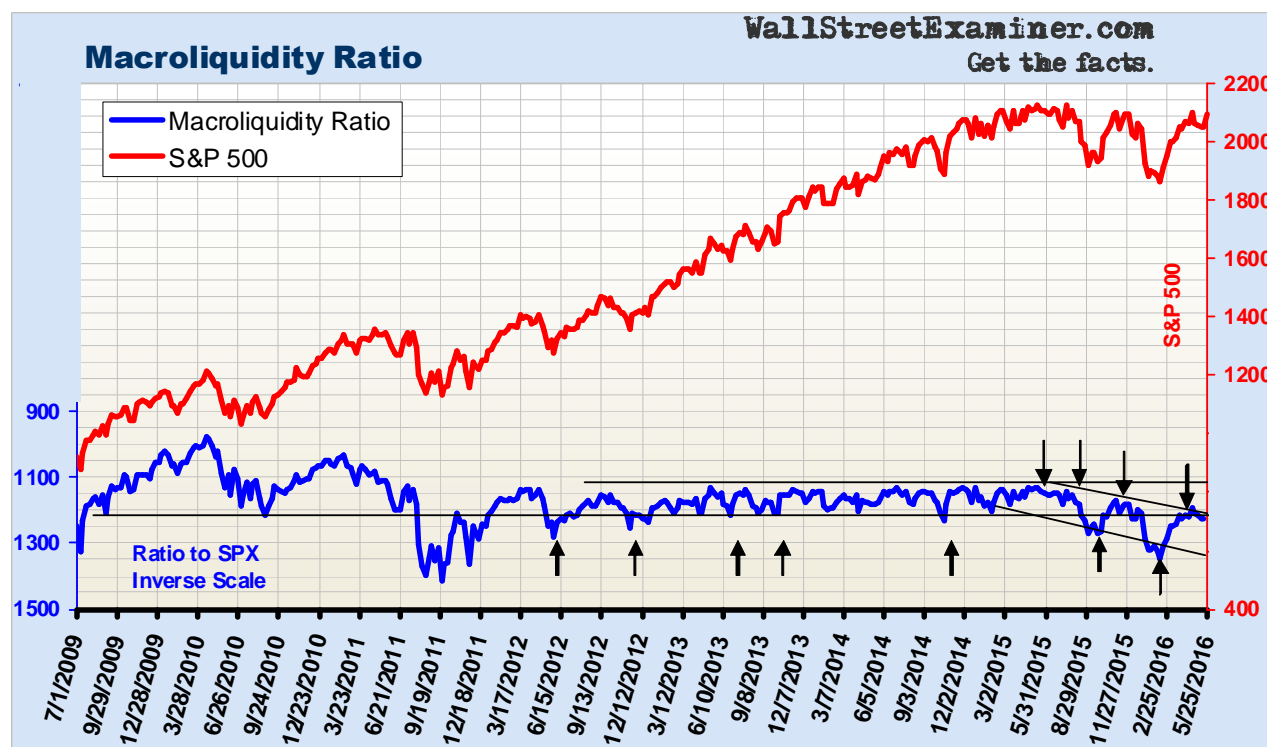
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The Composite Liquidity Indicator (CLI) US market liquidity has grown faster this year after being nearly stalled in 2015. This increase has buoyed US stock prices. This index is now up 4.6% over the past 12 months. The growth rate has been fluctuating around 4% since February. The SPX is now down just 0.8% from one year before after falling by more than 10% in February.



4/3/16 Last year the growth rate in the CLI was around zero from January to August, which helped to cause the August stock market plunge. Aggressive money printing in Europe and Japan and negative rates in Europe helped to spur an increased rate of capital flight into the US from the rest of the world, pushing the growth rate gradually up to 2% by the beginning of this year. From there it has increased to around 4.5% as foreign central banks became increasingly aggressive in both printing money and penalizing it for staying home in Europe and Japan. That results in increased flows of capital into the US. The Fed hasn't had to do a thing to keep the US markets afloat and, lately, levitating again on the tidal flow of increased liquidity.

9/2/15 Stock prices mimicked the rangebound pattern of the indicator this year until the past 2 weeks when they parted ways and headed south. The drop in the market has dropped the SPX below the level of the 78 week moving average of the liquidity line for the first time since late 2012. While this relationship is an artifact of the scaling of the chart, the fact is that this correlation has lasted for 6 years. We need to pay heed to it. When the Fed was expanding its balance sheet under QE, a stock market break below the 78 week MA of liquidity on this chart was a buy signal. However, "this time is different" because the Fed apparently has no intention of returning to QE.



12/15/15 The potential downshift of the ratio channel indicates a sea change in market sentiment toward holding more cash versus equities.

4/18/16 The macroliquidity ratio is now at the upper trendline which has delineated the last 2 intermediate market tops. A reversal from this area would be another intermediate sell signal, whereas breaking the downtrend would signal a shift back toward a more positive sentiment trend. It would mean that the sentiment shift over the past year was cyclical, not secular. If the line reverses here, then it might still be the early stages of a secular downtrend—the “rally that fools the majority.”

1/14/16 If this line now decisively breaks the descending channel through which it has already edged, the crash in equities is likely to accelerate. If the line rebounds here, we should see a rally lasting several weeks until the line approaches the top of the descending channel.

9/29/15 I now believe that the tight linkages of the past 3 years between this indicator and US stock prices are poised to break. We have yet to see how this relationship will behave in real time in a bear market. The closest proxy we have is the 2011 break, where we saw that this indicator can reach much greater extremes of divergence than it has in the past 3½ years. In a bear market, not only would those extremes be likely to be reached again, but they would persist far longer than they did in 2011. My guess is that as long as the indicator is below the black line the market trend is likely to remain bearish.

We must be flexible in our view of how liquidity drives the market. In any era, different forces may emerge to drive the trend. Risk aversion, forced liquidation, and deleveraging could be new, long lasting forces that we must account for. Those forces may to some extent be reflected in these indicators, but ultimately technical analysis of the price trends themselves may be the most revealing indicators.

9/2/15 This Macro Liquidity Ratio indicator chart shows the relationship of the two measures on a ratio scale. It has finally reached the buy signal line following the sell signals of March and May. Over the past few months, the composite liquidity index components have been mixed. The Fed adding cash to dealer accounts every month at mid month via its MBS purchase settlements is still a minor plus. Inflows to the US banking system from elsewhere around the world, as the ECB and BoJ continue to print money also add liquidity. In the past couple of weeks foreign central bank and US commercial bank buying of Treasuries and other securities have been weak. That has kept a lid on total liquidity.

6/5/15 So far the QE programs of the BoJ and ECB in the absence of the Fed have not resulted in growing US macro liquidity. It is surprising that they have not had greater impact. It suggests that there are negative undercurrents, aka selling, driven by a change in the level of confidence among the world's major investment and trading firms.

The macro liquidity line and stock prices remain highly correlated. A flat liquidity trend would not preclude a breakout of up to a couple hundred points, nor would it prevent a similarly sized correction. Persistent low liquidity growth would tend to favor a correction. But beyond that, in this era of central bank driven markets, we simply do not know whether the central banks would attempt to stop a bear market, and if they tried, if their moves would be successful. They have created a new game with new rules, and so far the most players have moved in only one direction pursuant to the new game rules. Nobody knows what will happen if the players should ultimately decide to run the other way.

I think that it will eventually happen, and that the mass of spectators would be likely to riot trying to escape the stadium when and if the players start to run the other way.

The Fed has made certain that everything they say gets beaten to death in the media. The interpretations are usually simplistic and often absurd, but after the Fedheads have said the same thing, and their media repeaters have done their job of regurgitating the message over and over for a number of months, everybody settles in with the official propaganda and hunkers down for the script to play out.

When we spot the false assumption, or false interpretation of reality inherent in the propaganda, we note it and wait for the consequences. Months ago I began to note in these pages and on the free side of the Wall Street Examiner that I think that the false assumption here is that the Fed can control interest rates by simply commanding, "Make it so."

The Fed is still making its rate increase decision contingent on continuing labor market improvement coupled with the "expectation" that inflation will return to the Fed's 2% target. That gives them an out if it doesn't because they only need to "expect" that it will. If the labor market continues on its current pace then they will have a basis for "expecting" inflation. Withholding tax data shows no sign of the labor market slowing. Furthermore, the official inflation stats have been understating price increases. It's only a matter of time until the lagging, suppressed official stats catch up with and possibly zoom past the reality of inflation on the ground.

However, some of this hinges on the commodity markets, which are beginning to look very shaky again. If they break down, then CPI and PCE could again ratchet lower, which would complicate the case for the Fed attempting to raise rates.

When the time comes for the Fed to attempt to raise rates, my opinion has not changed that the only way that interest rates will rise on a sustained and material basis will be for the Fed to start shrinking its balance sheet. That would be almost certain to destabilize the markets. So the Fed may try to raise rates in the second half of the year, and all kinds of chaos could ensue when they fail to do so and the talk and speculation grow about shrinking the balance sheet. The market may at some point learn that the Fed does not have control of rates. That could lead to a loss of confidence and even greater instability, which would then force the Fed to reverse course.

Given that we are heading into uncharted waters, I am not tied to any particular scenario. However, I feel reasonably certain that those waters will be stormy, with lots of chop, big waves, and no view of the horizon. The Fed probably will no longer be able to keep the financial market ship on a steady course. It will be a dangerous time.

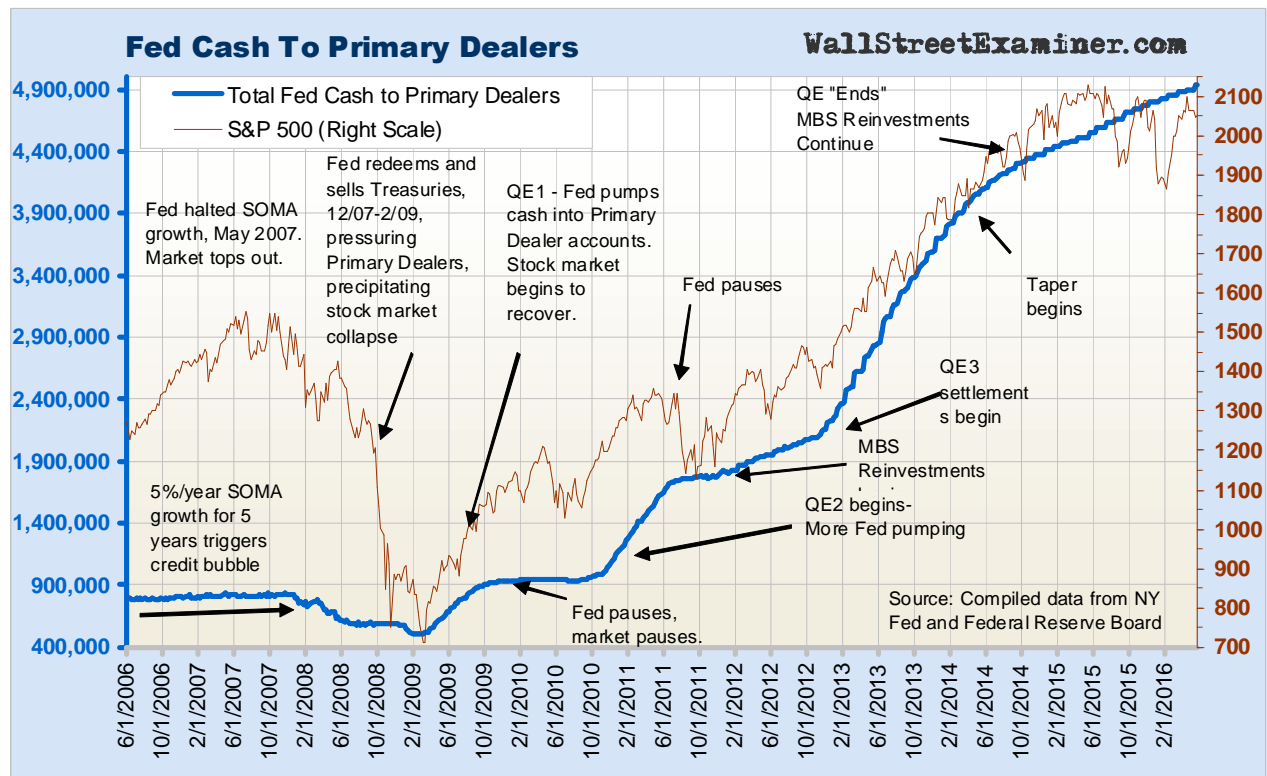
9/17/14 I have held the view that the quantity of funds that the Fed pumps into dealer accounts is far more significant in boosting asset prices than is the price of funds. With QE virtually ended by year end and a low level of MBS purchases going forward, especially if bond yields increase, the markets will be getting insignificant assistance from the Fed.

However, that will not be the case with the world's other major central banks all of whom pump funds into the same worldwide liquidity pool, largely through the same network of mega banks and bank owned securities dealers. The BoJ continues to print money helter-skelter and that will continue to prop prices. The ECB's new programs also threaten to add liquidity, although I suspect that its new programs will fail in that regard. This bears close watching in the weeks and months ahead.

Fed Cash to Primary Dealers This indicator rose last week as the Fed was doing its regular mid month MBS purchase settlements. This cash helps to put a bid under stock and bond prices during these periods which typically occupy the third week of the month.

10/26/15 This remains the most important of all indicators as it measures the direct flow of cash into Primary Dealer accounts. It had appeared that the historic linkage between this and the direction of stock prices had broken but the recent market rebound suggests that when other liquidity factors are bullish, the Fed's purchases of MBS can still be a contributory factor. The correlation between the trend of this indicator and stock prices may be looser but stock prices still show a propensity to regress toward the trend of this indicator.

The real test will come if and when the Fed stops reinvesting principal as its MBS and GSE holdings are paid off. The Fed's balance sheet would begin to shrink and this line would turn flat as the Fed stops pumping cash into dealer accounts via the purchases of replacements for the MBS and GSE paper paid off. We know all too well what happens to the market when the Fed completely stops pumping cash into dealer accounts. That's what ended the bull market in 2007.

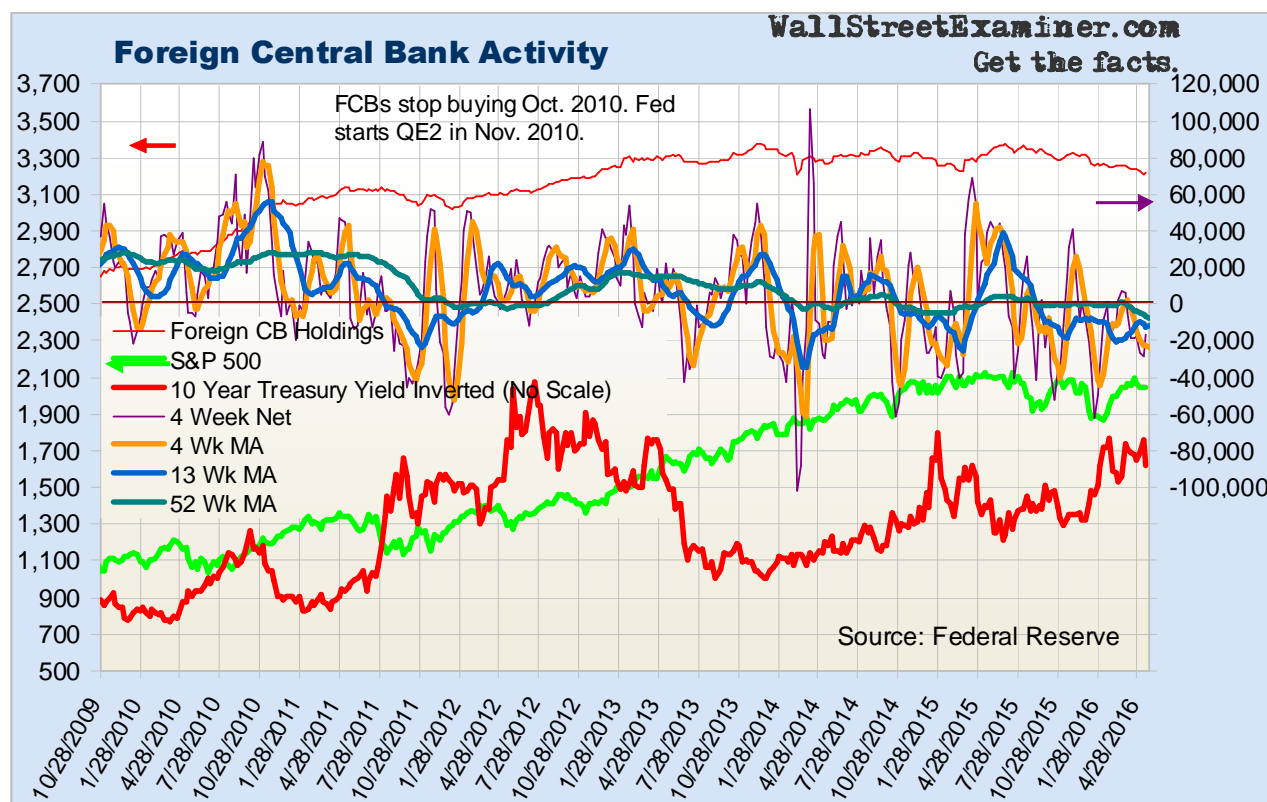


1/7/15 The slope has turned flatter since the Fed reduced its purchases to just the MBS reinvestments beginning in November. Because this indicator reflects the Fed's cash infusions to Primary Dealers, even though the Fed's balance sheet is now flat and will stay that way until the Fed changes course, this graph will continue to have a slight upslope for as long as the Fed continues the MBS replacement purchases. Those purchases settle each month at mid month when they will help to absorb new Treasury note and bond issuance which occurs simultaneously each month.

Rick Santelli featured this chart on his segment on Monday August 5, 2013. Overall, he did a good job in spite of some minor misstatements. <http://wallstreetexaminer.com/2013/08/05/rick-santelli-features-my-cash-to-primary-dealer-chart-on-cnbc-video/>

It is a proprietary indicator composed of the cumulative value of operations which the Fed conducts directly with Primary Dealers. It measures the flow of cash into Primary Dealer accounts from Fed securities purchases. This indicator has the heaviest weighting in the composite. The current growth under QE3/4 is the fastest in history. It will be bullish until the Fed ends QE. Stocks will stall or pull back from time to time, occasionally hemmed in by trend resistance and buffeted by news flow, but the Fed's cash will find its way into equities sooner or later.

Foreign central bank (FCB) purchases The Fed's custodial holdings of Treasuries and Agencies for FCBs fell by \$16.5 billion over the past month. FCB buying stalled and has turned into sales and redemptions after a weak upswing in the first quarter. The intermediate trend has been heading down in recent weeks after being neutral from October of last year to April this year. The longer term trend continues to be down.



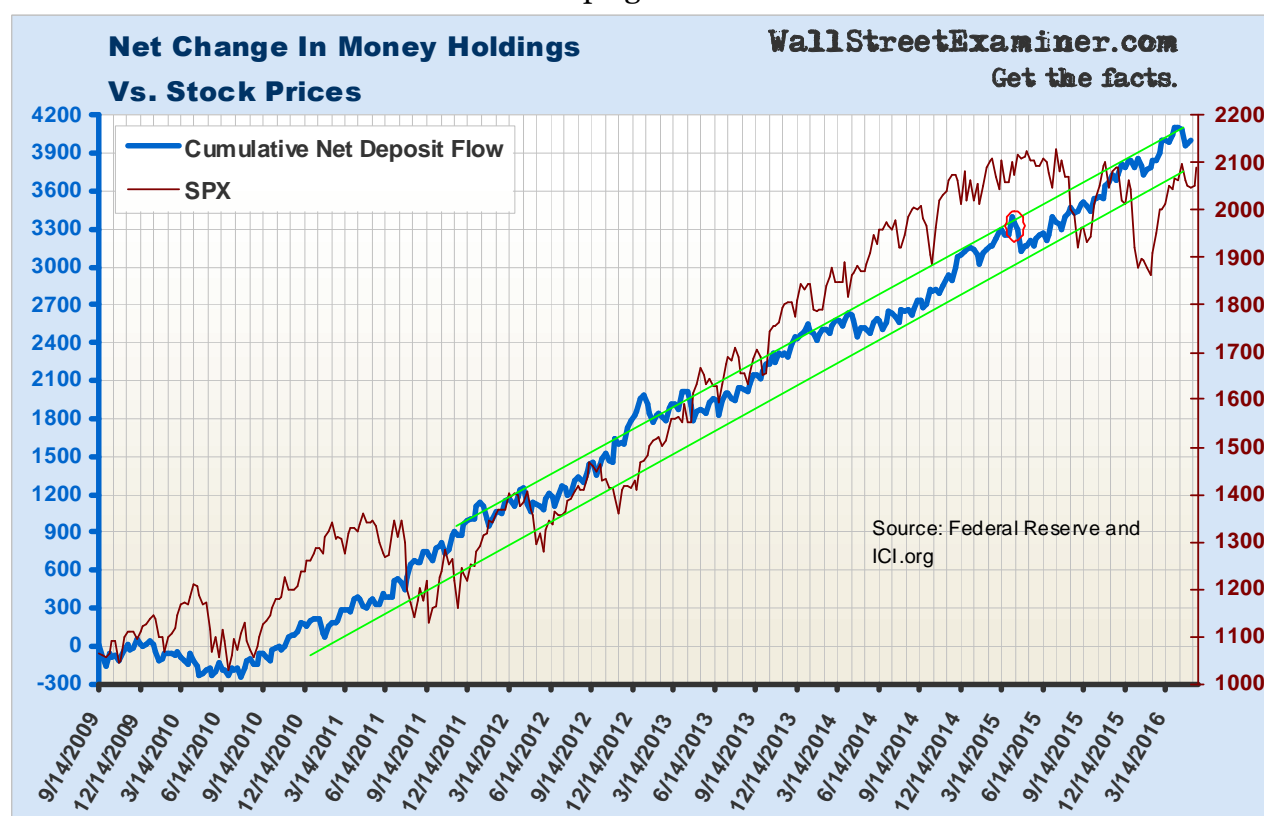
We do not know whether this represents an outright reduction in holdings, or some holders shifting holdings from the Fed to other repositories. We do know that from time to time correlations exist between the direction of these holdings and both the stock and bond markets. There's some basis for recognizing a degree of cause and effect in this relationship.

The Treasury was paying down debt over that 4 week period, pumping \$41 billion in cash into dealer and investor accounts. The simultaneous decline in FCB holdings was probably a result of that rather than evidence of them selling into the market, as some of their holdings were redeemed. The Treasury market is slightly stronger than it was 4 weeks ago as a result of the Treasury paydowns. But stocks are slightly weaker. Without FCB buying pumping cash into the US system there simply is not enough juice to push the markets materially higher.

It's remarkable that stock prices have held up as well as they have under these conditions. By deduction and observation of other data we know that ECB and BoJ money printing combined with negative interest rates drives capital out of Europe and Japan into the US where it still finds higher yields. I call this NIRPitrag. NIRPitrag flight capital continues to boost US markets, in what otherwise would be a hostile environment. Instead of buying Treasuries outright, the two big FCBs are printing money which banks then use to purchase US assets.

1/9/16 If the recent brief uptick in their buying was the up phase of their buying cycle, what happens in the down phase? If the FCBs start liquidating on a regular basis because they need to repatriate cash, this could have devastating impacts on US markets.

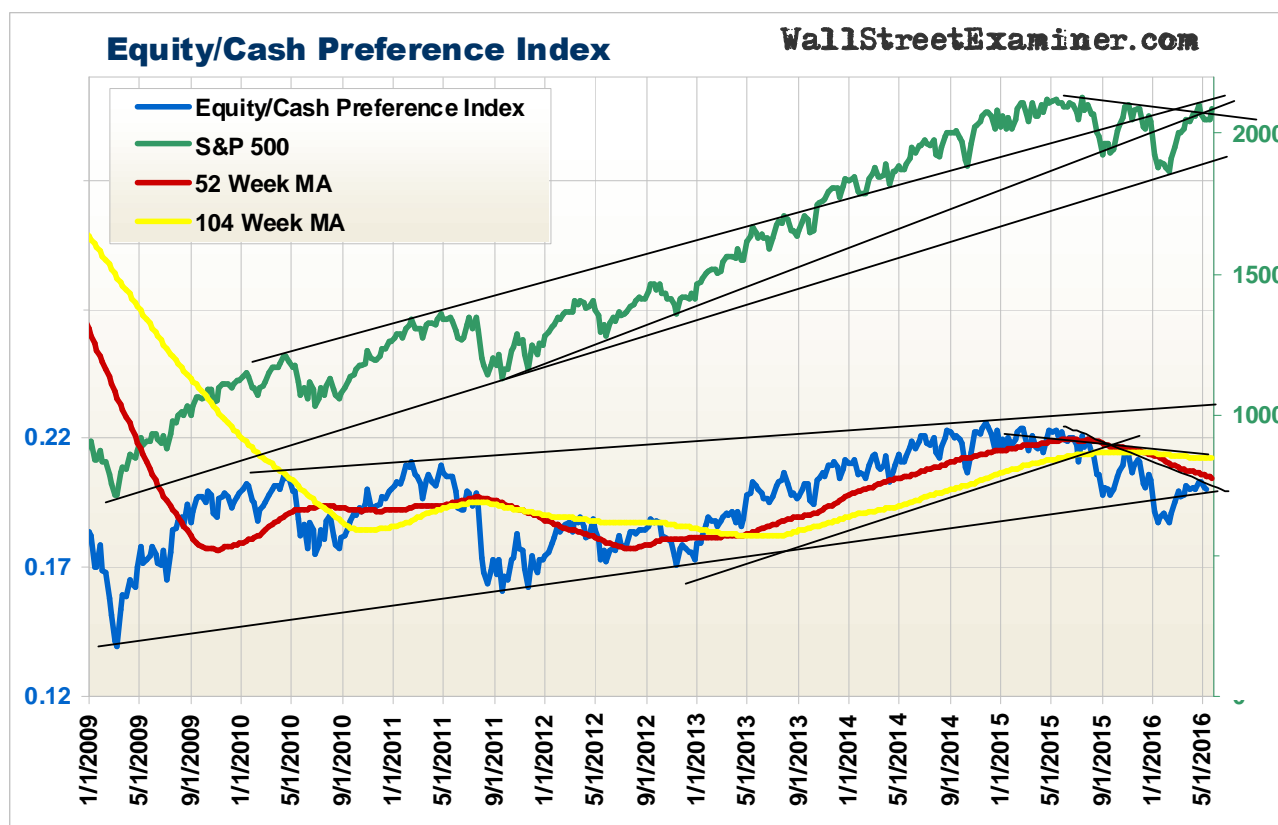
US commercial bank deposit flows, not to and from money market funds, rose by \$27.6 billion in the week ended May 9. This comes 2 weeks after the normal seasonal plunge that occurs every year at tax time as payments go from bank accounts to the US Treasury account at the Fed. Deposits then gradually rebuild and deposits go on to new highs as the Treasury spends the cash. This year looks no different. It continues to represent a bullish influence, but not one which results in an extended upleg.



4/3/16 Liquidity is still being created and deposited into the banks at a very rapid clip. However, the fact that the markets have not kept pace is a sign of the sea change in sentiment that has been under way for the past year. In recent weeks the stock market has shown renewed froth, but it has not been enough to break the negative trend in sentiment until just now. The Equities/Cash Preference index (chart below) shows the trend on the cusp of potential change.

10/7/15 The recent correlation between banking system liquidity and stock prices has broken. It remains to be seen whether this condition is temporary, as in 2011, or long term. Given the very different conditions today versus 2011 when the Fed was between QE 2 and 3 versus today when it seems determined to "normalize" its balance sheet, it's possible that this will be a more lasting change. On the other hand, if the divergence becomes wide enough, will it be, "QE5, anyone?"

10/26/15 In tracking these numbers, some years ago I developed an Equities/Cash Preference Index (ECPI). It is a ratio of the S&P 500 to total cash-like (both demand and time) deposits in the US banking system. As I have watched this index over time, it became clear that it trends with stock prices, and since 2009 it has helped to identify when trader sentiment is overextended with or against the trend as shown on the chart below.



4/3/16 The tremendous amounts of cash generated by ECB and BoJ printing results in capital inflows to the US causing deposits in US banks to grow. Astronomical loan growth in the US also adds deposits. The surging growth in deposits has not resulted in commensurate moves in stock prices.

The downtrend in this ratio has shown the sentiment shift away from holding equities. This shift is only cyclical so far. A downturn in the market here would keep the trend intact, and the year long downtrend could turn from cyclical to secular. Excess cash would have diminishing returns in terms of rising stock prices over the long haul if that happens.

This intermediate up-move is currently on the cusp of breaking the downtrend if it continues. If the index breaks out through the 52 and 104 week moving averages, then little has changed in the past year. The players will have returned to the camp of true believers in central bank market rigging.

1/20/16 This ratio has broken the major trendline as deposits surged but the stock market did not respond in kind. The breakdown through the trendline suggests that a sea change in investment sentiment is under way which could affect the market for years. For the bull market to resume, the line would need to cross both the 52 week and 104 week moving averages.

11/24/15 The August selloff and retest resulted in both the S&P 500 and this ratio reaching long term trendlines (Technical analysis really is pretty simple). The furious rally in stock prices in October was far less impressive on the ECPI, which remained below its 52 week moving average. Depending on whether the indicator rises back above its 52 week moving average it should give us some indication of whether the long term trend of rising equities preference is shifting.

The picture here indicates that the big rally in October was built on the rising tide of liquidity rather than a sharp increase in enthusiasm for stocks. That cuts both ways. It leaves a lot of room for an additional rise in prices if sentiment does begin to become more bullish and traders decide to commit more of their cash to buying stocks.

But if the indicator rolls over below the 52 week and 104 week moving averages, it would support the thesis that the long term trend of sentiment is turning less positive toward stocks. In that case, rising banking system liquidity would have less and less impact on stock prices. Ultimately, stock prices might decouple completely from the liquidity trend, just as oil and other commodity prices have done in the past year.

11/5/15 Investor attitudes can and do change over time. Sentiment and liquidity go hand in hand. Rising liquidity tends to drive increasingly bullish attitudes and behavior. That can cause liquidity to increase even faster as speculators and business increase the leverage ratio of their collateral. In other words they borrow more. That's what credit bubbles are about.

But the process can also work in reverse. When some speculators and businesses become suspicious of current conditions they begin to delever. They sell assets and pay off loans. That extinguishes deposits and liquidity growth begins to slow. As that trend gains a foothold, systemic liquidity may stop growing completely, and on rare occasions turn negative. But the process of falling liquidity actually begins with a subtle shift in the attitudes and behavior of a few market actors.

Under the current circumstances, we could see overall macroliquidity levels begin to decline as economic actors and leveraged speculators opt to pay down debt and delever if they grow increasingly suspicious of the current level of stock prices relative to the underlying conditions, including how they view the ability of central banks to keep stock prices levitated.

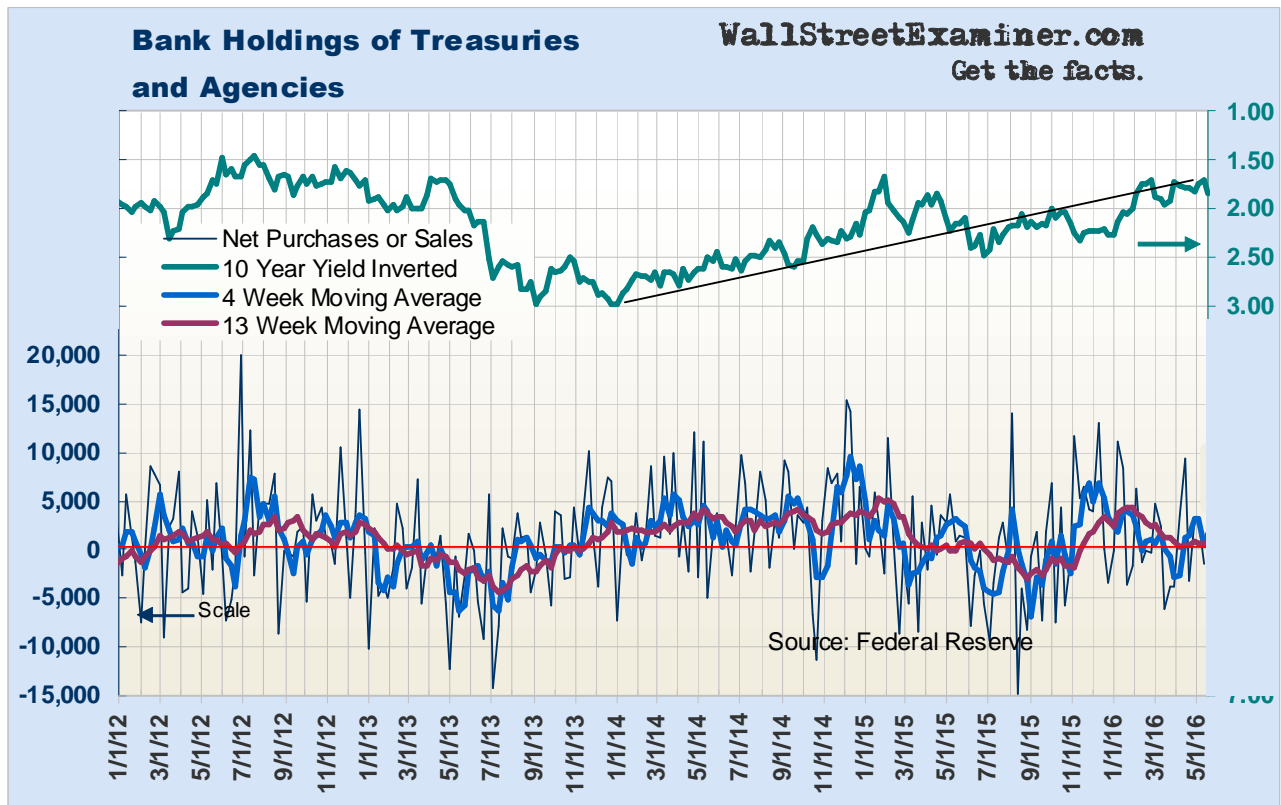
Eventually, shifting attitudes lead to changes in market behavior, which ultimately may evolve into forced liquidation. As prices fall, collateral values fall, and the margin calls go out. That actively destroys money and liquidity as deposits are used to pay down outstanding debt. Whether central banks would deploy enough monetary armament to offset that would depend on whether enough traders believe that it will work.

We're seeing hints that some traders are starting to jump off that bandwagon, the bandwagon that we first recognized 6 1/2 years ago. In the weeks ahead we should learn just how far the old bandwagon can take us before the wheels fall off.

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Bank Treasury purchases

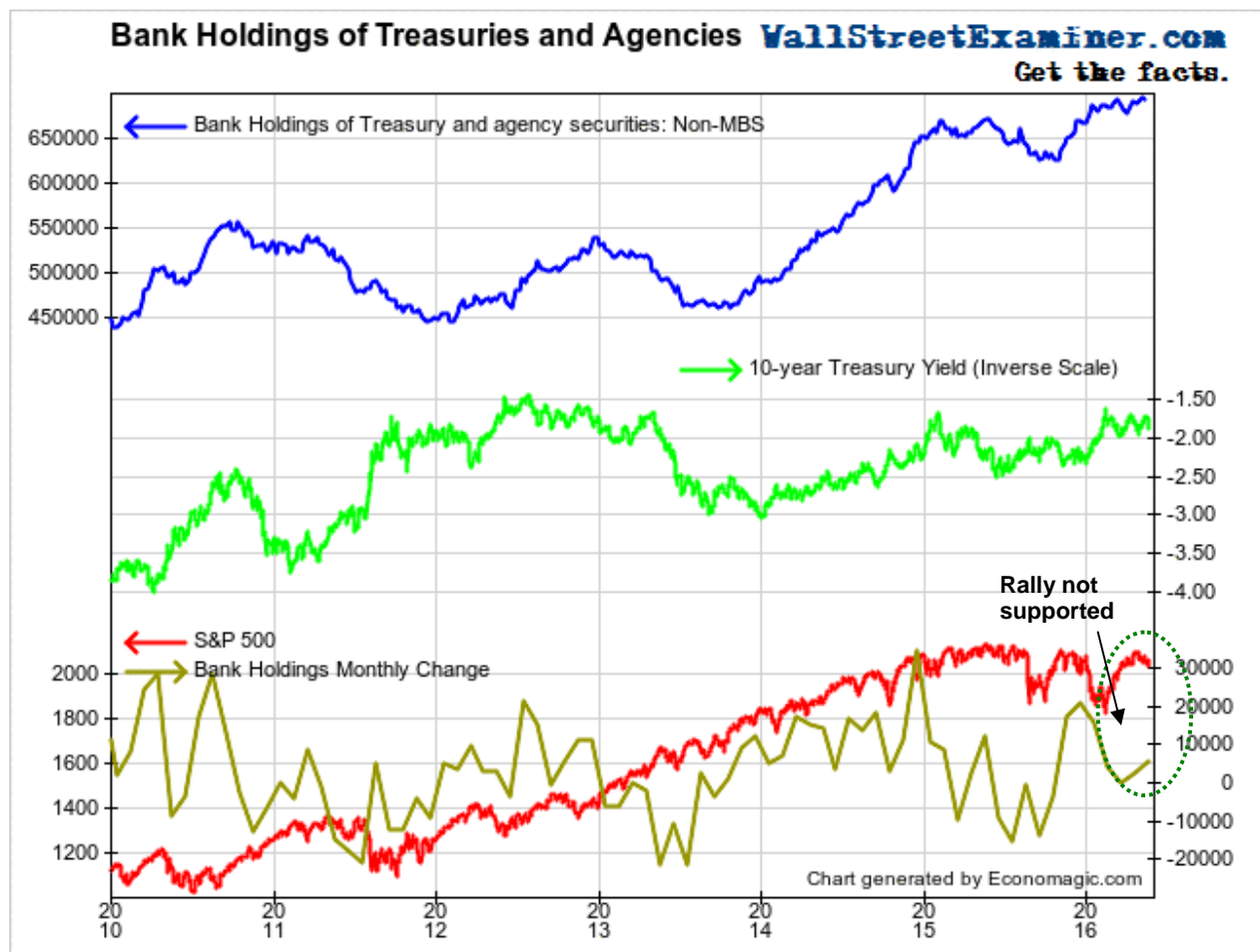
US Commercial bank holdings of Treasuries and Agencies rose by a minuscule \$1.9 billion over the 4 weeks ended May 11. That compares with an increase of \$5.4 billion a month earlier.



The weak buying by banks did not hurt the markets during that time window because the US Treasury was in the midst of its usual April-May debt paydowns. As tax collections come in and are processed in the last two weeks of April, the Treasury uses that cash to temporarily pay down debt. That 4 week period from mid April to mid May saw paydowns totaling \$104.5 billion. This cash went back into the accounts of the erstwhile holders of the paper that was paid off. That includes dealers and other investors who may redeploy the cash into other short term paper, bonds, or stocks. This annual process tends to give stock and bond prices a lift in late April and early May.

The process then reverses as the Treasury comes back to the market to raise new money in May. The inflow of estimated taxes in mid June provides another brief period where paydowns can boost the market, but the effect is far smaller than in April. The summer is the weakest period, and the Treasury tends to raise the most cash via debt offering during those months. If banks don't step up to take a significant share of that, it usually spells trouble for stocks and bonds.

The trend of bank buying has been flat this year. Unless there's an uptick in that pattern, the lack of bank buying as the Treasury begins its seasonal increase in supply would be a negative factor for prices.



2/19/16 However, here again, the negative interest rate (NIRP) factor in Europe and Japan is a wild card that continues to foment intermittent rallies in stocks, and more or less constant buying of Treasuries. In theory that is only sustainable for as long as foreign deposit holders do not decide on balance to use deposits to liquidate debt, a rational decision which more and more holders will reach the longer NIRP is in force. At some point as US yields sink and perceived risks increase, rather than transferring capital out of Europe and Japan into the US, they'll just liquidate and the worldwide liquidity flows into The Last Ponzi Game Standing (US markets) will shrink.

The Fed probably recognizes the benefit that NIRP arbitrage holds for the US and therefore would never go to negative interest rates. As long as US rates are slightly positive, the more this arbitrage works to the benefit of US markets. In the UK, Mark Carney said last week that the UK will never go to NIRP, because he said that the evidence shows it's counterproductive. In reality, he knows that as long as the UK has positive rates, NIRP in the Eurozone will work to the UK's benefit.

2/8/16 Applying a little technical analysis we see a negative divergence in the 4 week average, and the 13 week average near the peak levels of 2012 and 2014 where bond prices peaked and yields bottomed. This could be a similar setup to those major turning points.

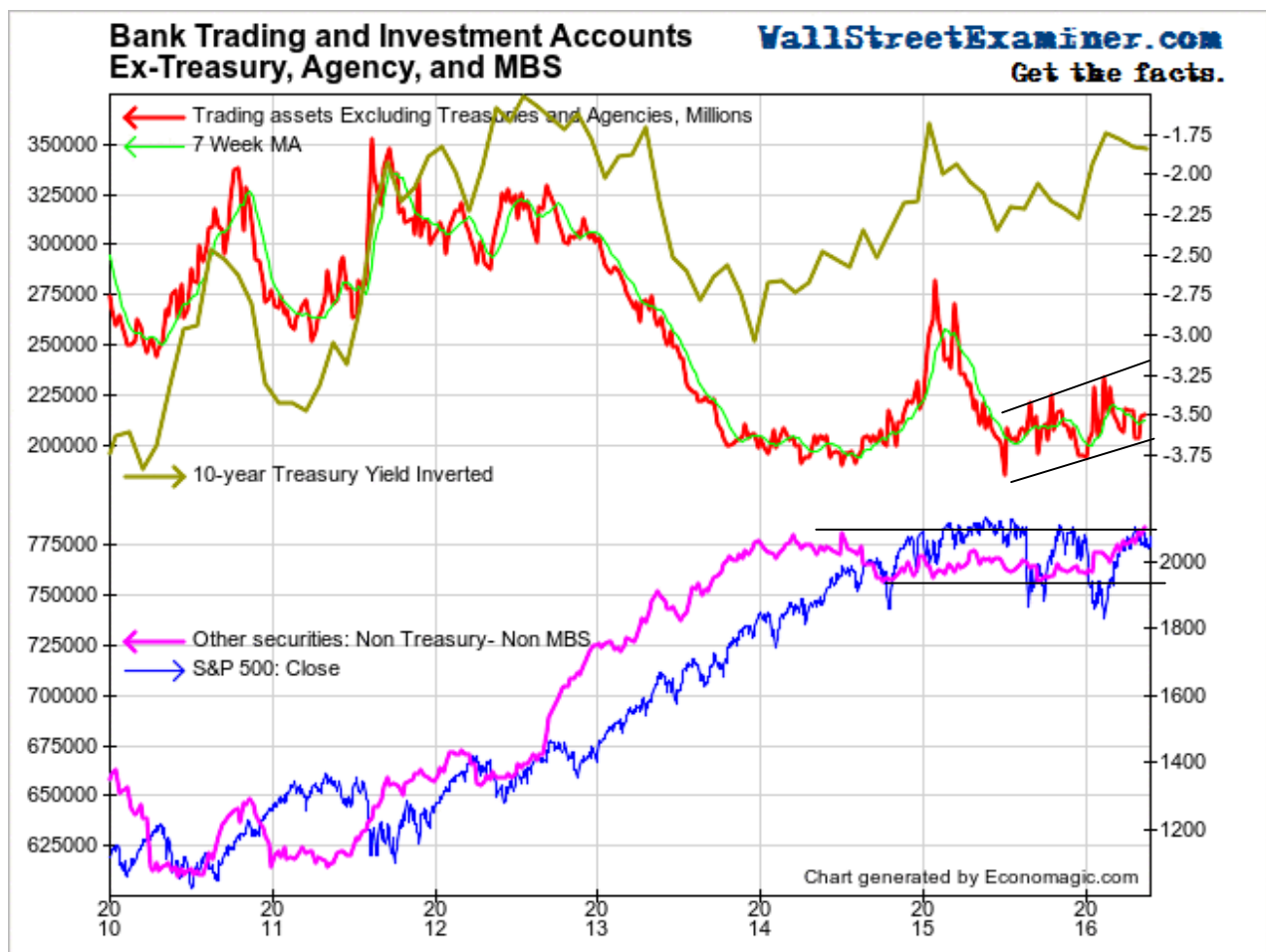
7/27/15 Treasury market performance has tended to correlate well with this indicator since 2010 (chart next page). Trends in the monthly rate of change in bank holdings of Treasuries have tended to reverse either just ahead of, or concurrent with, trend changes in the bond market. The monthly rate of change is now near the level where it bottomed in 2011 and 2013, but it is not yet near a break of the downtrend in effect since December.

The stock market in recent years has rallied regardless of what this measure was doing. However, that could change if banks began to refrain from injecting liquidity into the markets by stopping their fixed income purchases altogether. They may do so if the bond market begins to move against them consistently. Even though the Fed might want to play the game of pretending to raise short term rates, The Fed and its cohort central banks would want to keep bond yields from rising materially, at all costs. If yields were to break out, I think it would mark the beginning of the endgame.

Bank Non Treasury Trading and Investment Accounts

2/30/25 The Fed has stopped reporting Non-Treasury Trading Accounts, so I have substituted a line item called Trading Assets which currently is around \$250 billion. The Fed says that this does not include most securities but does include the fair value of derivative contracts interest rate, foreign exchange rate, other commodity and equity contracts, which I read to mean futures, options, and swaps. It correlates nicely with bond prices, but not with equities. It tends to lag changes in bond prices, so it's probably a good measure of trading profits but not a good leading market indicator. However, in 2011-12 it led the market, foreshadowing the decline in bond prices in 2013.

Trading assets rose in the week ended May 11, keeping them within the rising trend channel of the past 10 months. A breakdown from this channel could be a bearish intermediate signal.



The long term Non-Treasury, non MBS investments have edged above their range of the past year. Because these accounts are carried at cost it means that the banks have been adding long term assets since early January, both leading and mirroring the rally in stocks. This is not a significant move yet. It would be if the line materially exceeds the 2014 highs. That would be a bullish sign.

Effects of Other Central Banks on US Markets

10/13/15 The Fed's cohorts continue to pump money into the world financial pool. In recent months, that pumping has apparently not been having the desired effect until the last 2 weeks. The October rally was more about the massive paydowns in the US Treasury market than it is about dealers deploying cash from the ECB and BoJ.

The ECB reported that in the week ended May 20, "The holdings by the Eurosystem of securities held for monetary policy purposes (asset item 7.1) increased by EUR 17.8 billion to EUR 1,113.8 billion." Weekly MRO (Main Refinancing Operations) outstanding fell by €1.5 billion to €49.9 billion. Banks continue to pay down existing debt with the new cash from the increased QE purchases.

4/18/16 In the week ended April 1 the ECB did a new TLTRO or Targeted Long Term Lending Operation of 910 days. The banks took down all of €7.3 billion. Thud!

After that weekly statement closed, the next MRO was €60.2 billion which increased loans outstanding by €10.3 billion. An LTRO of €6.3 billion was issued. This appears to result in a paydown of \$7.3 billion against an expiring LTRO of €13.5 billion. Next week's statement should reflect that.

3/24/16 The ECB is starting a new TLTRO (Targeted Long Term Lending Operation) at a negative rate, paying institutions to make loans. The TLTRO will only be available if the bank makes loans. The problem is that the rate the ECB will pay the banks is still less than the negative deposit rate. That means that the banks will still be paying net interest on any funds it takes from the program since they will remain on deposit in reserve accounts at the ECB unless the bank withdraws them as cash or sells the loan to another bank who would then be the mark holding the deposit at the ECB.

12/1/15 Negative deposit rates continue to give banks an incentive to use deposits to pay down outstanding ECB credit to reduce net interest costs. ECB loans have been declining as the banks use some of the cash proceeds of the ECB's bond purchases to pay them down. However, the loan paydowns have usually been much less than the total weekly security purchases, so the ECB's balance sheet has still trended upward, pumping cash into the world's financial markets. This cash is the likely fuel for the buying that has helped US stock and bond prices stay levitated.

10/26/15 Meanwhile, Mario Draghi's threat to do more QE in December is meaningless. If they do it, the results are likely to be muted, with more loan paydowns a likely result. If and when they actually pull the trigger, we'll watch for a couple of weeks to see where the cash goes and how the markets react and make a judgment then.

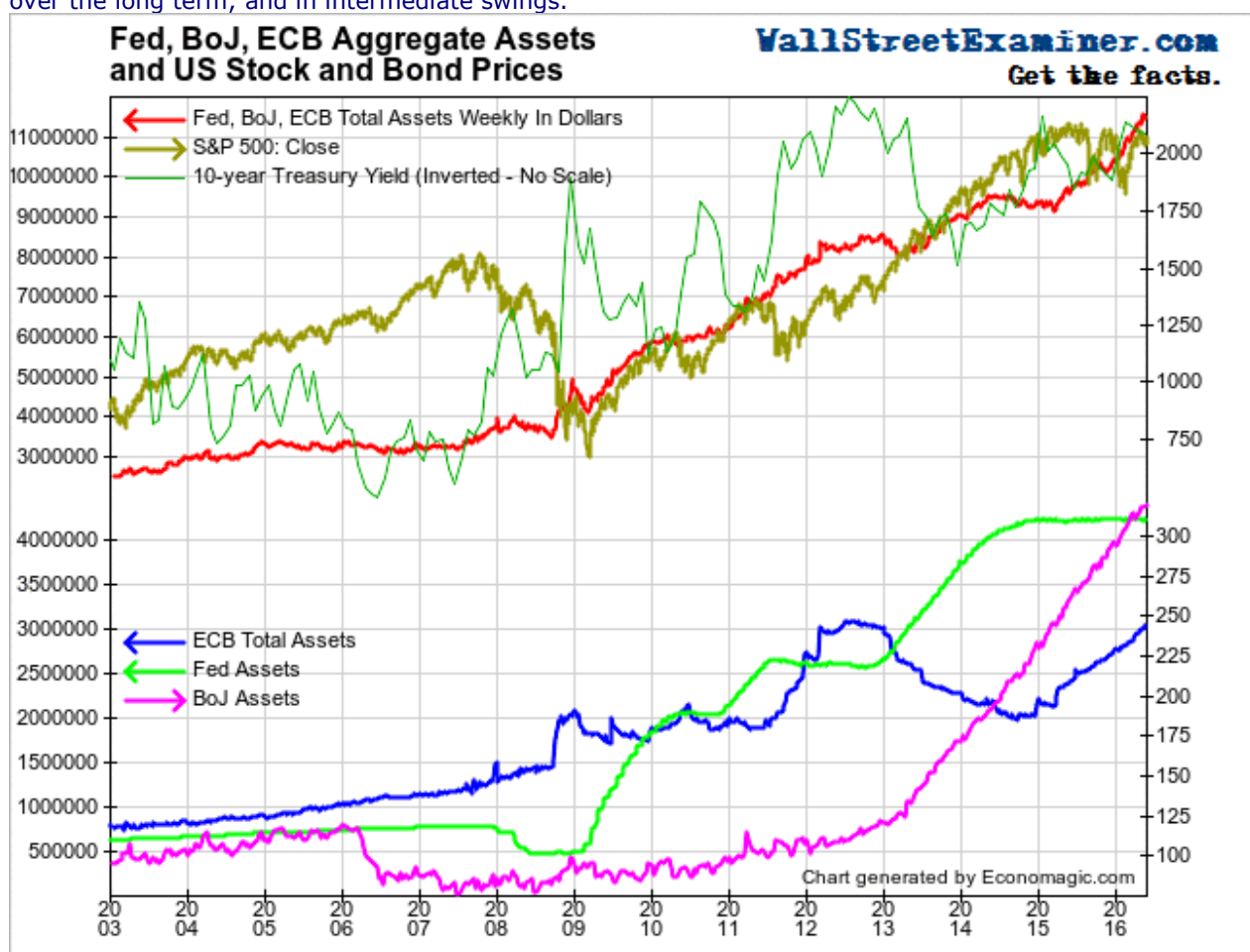
2/19/16 While we do not track the BoJ balance sheet actively, the institution of negative rates there should have the same impact as in Europe. It will suppress lending and deposit growth and mute any positive impact of QE on stock prices in Europe. However, because US paper still carries a positive yield, we should continue to see positive flows into the US, boosting US market liquidity. That could keep the burners on under Treasuries indefinitely, and cause the bear market in US stocks to be a herky-jerky, stop-start affair as waves of foreign cash seeking a haven in the US alternate with waves of liquidation and capital destruction around the world.

The US market has benefitted and will continue to benefit from the arbitrage caused by negative rates elsewhere in the world. It hasn't been enough to prevent the onset of a bear market in stocks because the destruction in other markets around the world causes waves of offsetting pressure on worldwide liquidity. But the cash flight from Europe and Asia to the US have been sufficient to prevent a complete collapse of the US markets. Negative rates haven't helped Europe and they won't help Japan, but could have the perverse, unintended effect of creating an intermittent bid for US securities, still the Last Ponzi Game Standing.

2/10/15 There's been no change in BOJ policy. Its balance sheet will continue to grow.

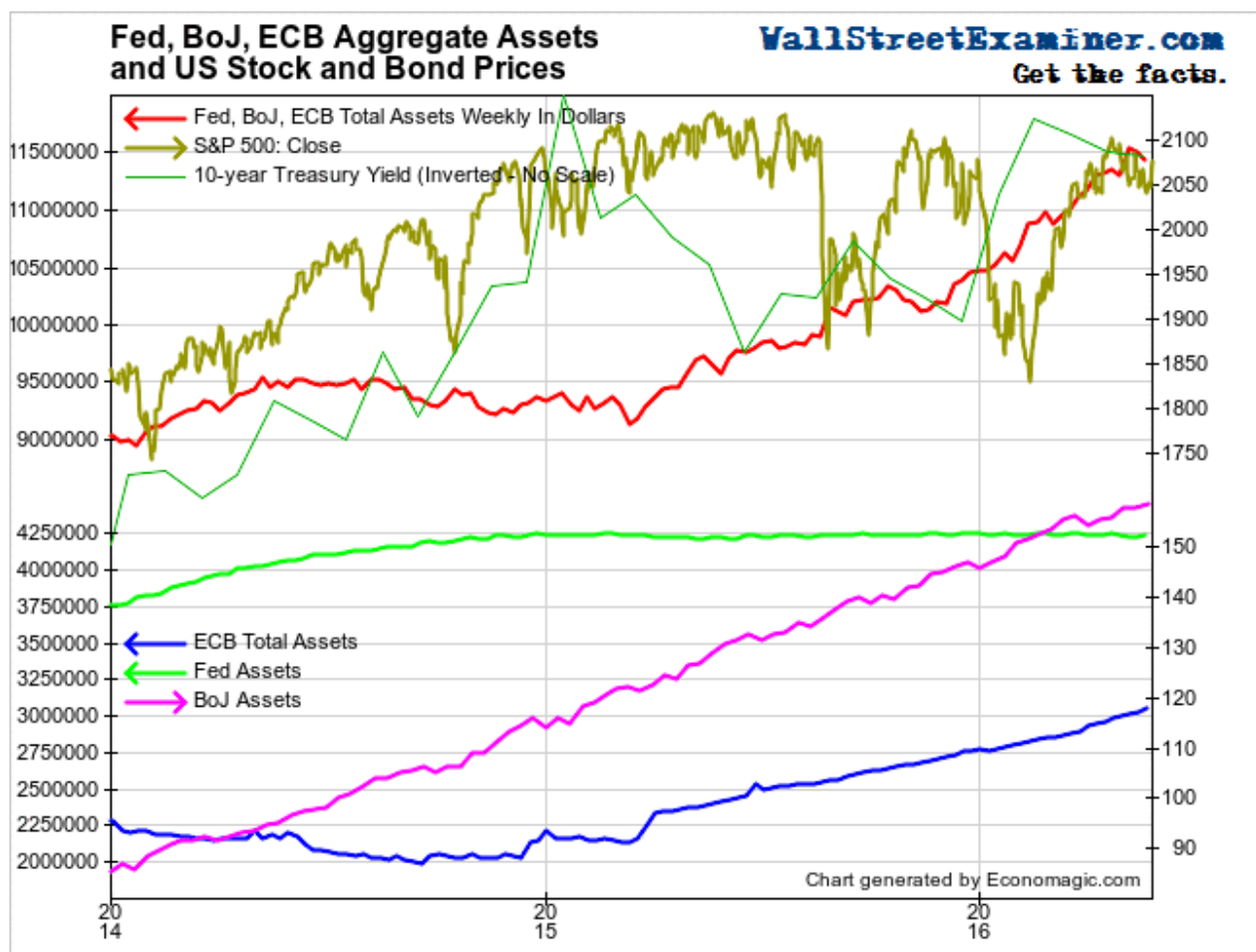
5/8/13 The correlation between the size of the ECB, Fed and BoJ balance sheets and the direction of financial asset prices is no accident. Treasury prices have mostly correlated with the ECB's balance sheet, while stock prices have marched almost in lockstep with the Fed's and BoJ's.

4/30/13 The 3 big central banks deal with the same banks. Some of the money that the BoJ prints not only can but does move into US paper, whether Treasuries or stocks. It will show up in the FCB measure and in banking measures. There's a strong correlation between the BoJ balance sheet and US stock prices, both over the long term, and in intermediate swings.



The weaker dollar and the boost in the amount of ECB QE over the past couple of months has caused the value of ECB and BoJ money printing to increase in dollar terms. These flows contributed to rallies in US stocks and bonds, but headwinds from other factors have prevented sustained uplegs.

4/3/16 Yet they have not prevented stocks from making lower highs and lower lows since May of 2015. This was a sign of the secular decline in confidence in the Fed that we have been expecting since 2014. That trend is now in the process of being tested. Stock prices have reached the point of breaking that downtrend. If they do so, then we're back to the same old "You gotta believe" markets where the players buy into the central bank con game.



12/23/15 Why haven't stocks responded to the money printing as they have in the past? Because the markets are destroying cash as fast, or faster than the BoJ and ECB are printing it. Secular sentiment has turned negative on emerging markets, commodities, and junk bonds over the past year. That has resulted in forced deleveraging and destruction of money that has offset the growth in central bank money injected into the system. The best that the central bank money printing has been able to do is to keep prices of US equities and bonds from collapsing. Without the participation of the Fed, the markets have not been able to forge new highs. There's no reason to expect that to change.

2/17/15 The PBOC's lack of real transparency in its money operations renders the data somewhat suspect. Reuters does a good job of reporting what PBoC watchers are seeing.

1/14/16 It's difficult to know if any information out of China bears any semblance to reality. With Western financial news providers only reporting sporadically it's even more difficult, which leads me to question how useful this information is at all. Is no information worse than disinformation? I'll keep an eye on the China news, but will devote less time in these pages to its coverage unless there's something major and apparently well verified.

7/28/15 I suspect that the limitations placed on major investors against selling in China will cause bear markets by proxy in the rest of the world. Chinese players will raise cash wherever they can, in whatever they can, whenever they can. I believe that it is this selling that has caused the resumption of the bear markets in oil, gold and other commodities, as well as the worsening bear markets in emerging markets, softness in Europe and Japan, and the first signs of cracks in The Last Ponzi Game Standing, the US markets. The more restrictive China becomes toward selling, the deeper and more drawn out the effects will be in the rest of the world.

7/17/15 Without the active support of the PBoC, their stock market bubble began to implode in June (chart below). That in turn triggered the Chinese government's draconian actions to stop the selling. There's no longer any semblance of a real market in China. I suspect that this will ultimately pressure US markets as Chinese wealth funds seek to liquidate assets anywhere in the world where they can. This may already be impacting the US Treasury market. I would speculate that it is also muting the rise in US stocks, and that this effect will increase over time, the longer the Chinese authorities disallow selling.



12/10/14 China's financial system is now integrated sufficiently into the world liquidity pool that when China tightens, the world frightens. The tightening of collateral requirements means that Chinese players must raise cash where they can. That means the rest of the world, including especially the Last Ponzi Game Standing—the US stock market. The June 2013 selloff was about just that, not a "Taper Tantrum" on the words of Ben Bernanke. It happened because the PBoC tightened credit on the Chinese wealth funds, who were then forced to sell in the rest of the world. The PBoC relented soon after and markets recovered.

4/3/16 For now, the rally there has taken the pressure off the rest of the world. With capital levels stabilized in China, the US rally could continue until the Dow Jones Shanghai index makes a run at the 480 level. The recent short term uptrend line on that chart may hold the key to the US rally. When the DJ Shanghai breaks that uptrend line, it could mark the end of the US rally. Another wave of liquidation there would destroy more capital, affecting all world markets. But as long as the ultra sensitive Chinese market remains in an uptrend, it might be a good idea to hold our fire in shorting the US markets.

4/18/16 In the past week we saw the first sign that the authorities in China may be losing control of the situation there when the market slipped below the short term uptrend line. If it breaks the 13 week moving average, the rebound is probably dead, in which case the only way it would see the 52 week moving average in the next few months would be by holding sideways. A resumption of the decline in China should result in another wave of selling rolling out of China to the rest of the world.

Open Market Operations (OMO) and Monetary Policy Actions

1/20/15 The Fed ended outright purchases of Treasuries at the end of October but it continues to purchase MBS in amounts sufficient to replace its MBS holdings that are paid down each month. MBS paydowns settle at the turn of the month, reducing the size of the Fed's balance sheet. These are then replaced with the Fed's MBS purchases settling at mid month.

2/5/13 The Fed settles all of its MBS purchases around mid month and then leaves the markets to fend for themselves at the turn of the month. In view of that pattern, the markets should tend to be rockier at the turn of the month than at mid month. Markets should strengthen at mid month during the period when the Fed settles its prior MBS purchases.

The Fed just completed its regular monthly MBS settlements, which took place this month May 12-23. These are settlements of the Fed's forward MBS purchases from Primary Dealers to replace Fed holdings of MBS and GSE paper which were paid down or matured. This month, these settlements totaled \$32.5 billion. While this merely returns the Fed's balance sheet to its previous level, on the dealer side it's a net cash injection to their accounts as they sell the paper to the Fed.

These funds immediately become available to the dealers to use to absorb new Treasury supply, or to deploy in whatever manner they see fit. The availability of this surge of cash tends to put a bid under financial asset prices for a few days when the funds are injected and just after. Once again this month the markets played true to form, with stocks rallying, and bonds remaining stable as the Fed cash piled on top of the steady cash pumping from the BoJ and ECB.

During interim periods where the Fed is not buying, the market is a little more vulnerable, especially when the Treasury is settling a significant amount of new supply as it did at the turn of this month April 29-May 2 and will do again at the end of this month.

4/18/16 At current levels these cash infusions have only modest effect given that they are only a fraction of new Treasury supply each month. There's not enough cash left over from paying for the new Treasuries to juice the stock market. That juice is coming from elsewhere. That elsewhere is the US Treasury, and the Fed's cohort central banks.

The current infusion from the Fed is coupled with the massive Treasury debt paydowns that happen every year in April as a result of the big tax collections in April. These funds are temporarily used to pay down existing debt. The cash flows into the accounts of erstwhile holders of the maturing paper. These accounts include dealers and other investors. Treasury supply increases in May, causing that cash to be reabsorbed by the Treasury. But in the interim, those whose paper is paid off often redeploy the cash. Even if only some of that goes toward stock purchases, the incremental buying is usually enough to push stock prices higher for a few weeks in April and May every year. That can lead to piling on to a rally that has already been under way, like this year. The result is a blowoff.

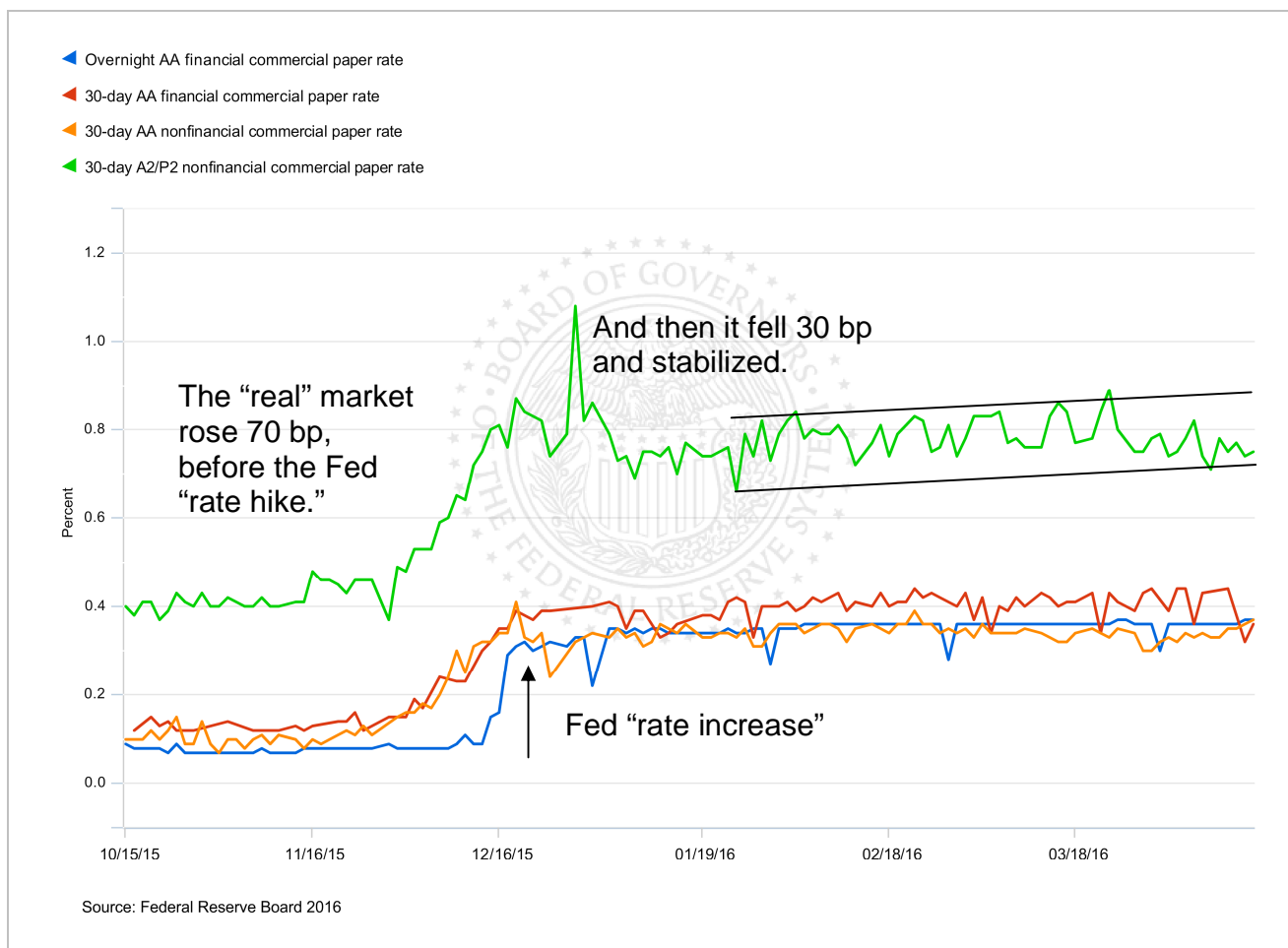
3/25/14 The MBS purchase schedule and results can be found at http://www.ny.frb.org/markets/ambbs/ambbs_schedule.html

Interest Rates



4/18/16 Interest rates in the market for Treasury bills continue to have a life of their own, virtually unaffected by the Fed's ham-handed effort to rig the money markets. This market tightened on its own well before the Fed moved. Then it stabilized for a while making it look like the Fed's con was working. The real reason for the rise in February and March was that the Treasury increased the weekly supply of 4 week bills from \$40 billion to \$60 billion. That extra supply put upward pressure on short term rates.

4/3/16 While the Fed does not have the ability to control rates, it seems to have hypnotic power where the market responds to the Fed's suggestion of where it wants rates to go. So commercial paper rates haven't moved much after first preempting the Fed by a month or two (chart below).



The 1 day AA financial company rate represents the "make believe the Fed controls rates" segment of the market. It has been almost perfectly flat around 30-35 bp since the Fed rate increase. 30 day AA paper, both financial and non financial has also been relatively stable. These markets are still being rigged. That's not a conspiracy theory. We know that traders of short term paper rig markets. There have been and continue to be prosecutions for rigging libor and Fed Funds. The difference is that now the Fed is likely to support that rigging directly, not tacitly as before.

The real market is more visible in the lower quality 30 day non financial paper. It crept higher by about 10 bp from January to March as liquidity tightened, but it has fallen below the bottom of the recent range in the past 2 weeks as the Treasury cut back the supply of 4 week bills. The level of Treasury bill issuance has a much greater influence on the real market than anything the Fed says or does. The more important fact is that these tiny fluctuations in rates will have no influence whatsoever on the level of bank lending, or on inflation, or on the US economy.

4/18/16 A month ago the Fed quietly began reporting Fed Funds trading volume. Trading volume has been between \$60 billion and \$80 billion per day. Since Fed Funds are overnight money, the amounts outstanding reported weekly in the Fed's H8 statement of the US commercial banking system's assets and liabilities shows that as the "Fed funds and reverse RPs with banks" line item.

The only historical data available on daily Fed Funds trading volume was published in Fed research papers. That data is consistent with what the Fed H8 shows us. Fed Fund trading collapsed as the Fed printed and pumped ever more excess cash into the system, obviating the need for banks to borrow from one another. Today, Fed Funds trading is down 90% from the peak levels of 2008. Only distressed banks need to borrow. A few may also be arbitraging Fed funds when they can borrow them a little more cheaply than the rate they receive on IOER or can lend them back to the Fed in the overnight RRP program.



In fact, there probably would be even less fed funds traded if it weren't for the fact that the Fed has created a phony market by paying interest on excess reserves (IOER) at the lately declared level of 25-50 BP. The daily reports from the Fed now show most Fed Funds are going at a rate of 37 basis points. Banks that want to juice their subsidy can borrow at that rate and hold the reserve deposit at 50 basis points. It can do this with no risk. Pretty cool game, but it's not a real market, and the rates in the rest of the market are also "pretend" rates. Out in the real world these pretend rates have no influence on lending rates in the real world. They depend mostly on the actions of the US Treasury and international capital flows driven by the policies of the Fed's major cohorts.

1/5/16 I was keeping my eye on the intraday levels on the 4 week T-bill and it dropped back below 10 basis points for a couple of days last week after being at 26 basis points in anticipation of the Fed "hike." However, in the past 2 days, the 4 week bill did jump back to around 25 bp. Something more than appearances may be going on in the market that may be causing it to actually tighten. The prices of financial assets, commodities, and emerging markets fall, margin calls go out, and capital and cash is vaporized. One measure of this process is the strength of the dollar. Keep an eye on that in the weeks and months ahead. A dollar breakout above 100 on the US Dollar Index basket of currencies would probably be a death knell for US stock and bond prices.

Regardless of whether this is a real market or not, the interest rates that are reported to the public are rising, and that has an impact in the real world. While it may be an illusion, it encourages the belief that interest rates are in fact rising and will continue to rise. As a result, carry trades have been, are being, and will continue to be unwound, and the prices of financial assets of all kinds will come under pressure, sometimes gradually and sometimes violently. The Fed, in its gamesmanship, has set in motion a process whose consequences are as yet to be known, but they won't be positive.

12/23/15 The Fed has "raised interest rates" (wink-wink). Its primary tools in this make believe policy are interest on excess reserves (IOER) and the interest paid on reverse repos (RRP). The new Fed Funds target rate is now 25-50 bp. Fed Funds were reported to be trading at a weighted average rate of 36 bp on December 22.

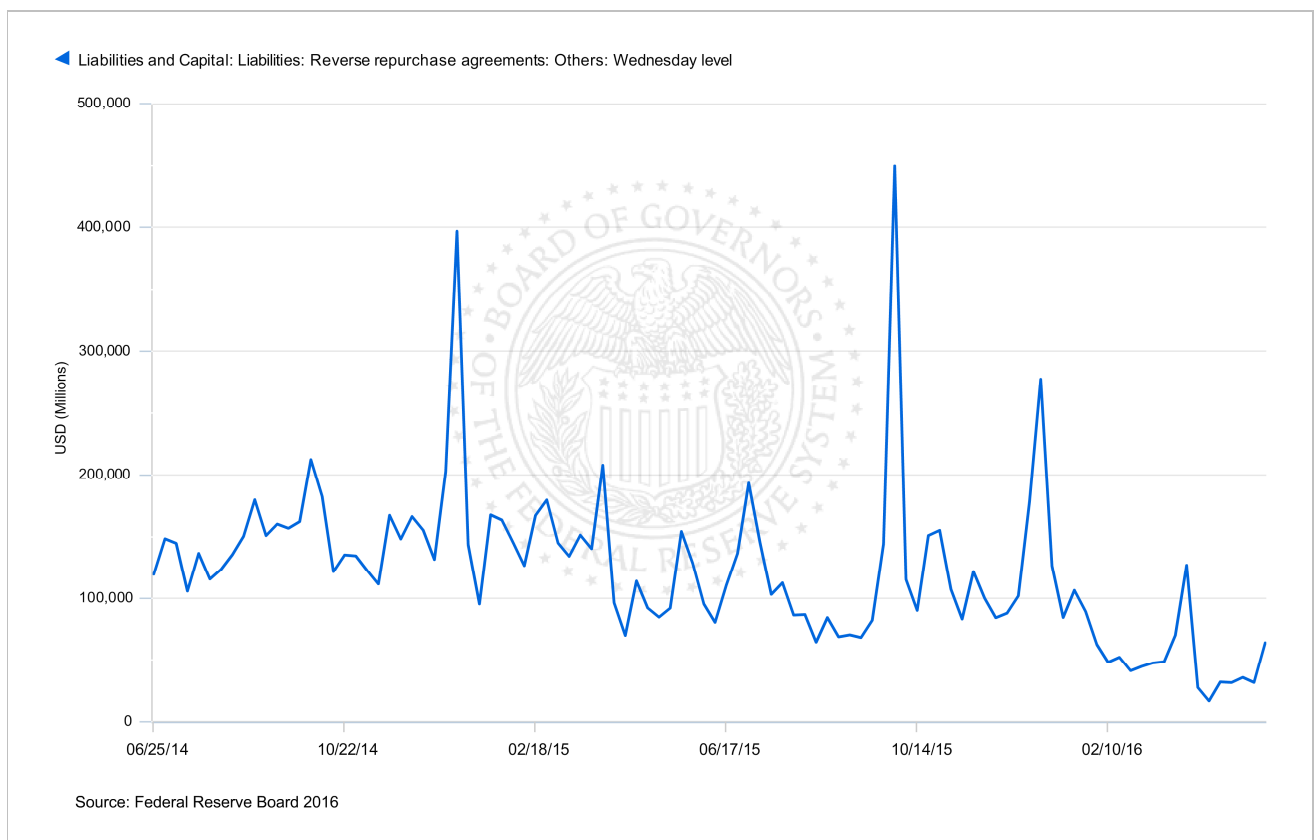
Of course, there is no actual Fed Funds market. Fed Funds are the money that banks who were short of reserves borrowed from banks which had excess reserves, so that they could meet the minimum reserve requirement. In 2008, the amount of Fed Funds outstanding rose as high as \$450 billion. Over the past 7 years, as the Fed pumped \$2.6 trillion of excess reserves into the system, virtually no banks have been short of reserves, so the amount of Fed Funds outstanding shrank to \$50 billion.

Today there are very few banks which need to borrow reserves to meet their requirement, and those that do are certainly not representative of the market as a whole. These would be banks in distress, or banks who are acting at the behest of the Fed to make it appear that a real market exists. But in reality, banks that need to borrow Fed Funds today are more like people who are so short of cash that they are forced to resort to payday lenders to pay their bills. The Fed Funds rate is therefore the equivalent of the payday lender loan shark rate for banks who are so short of cash, they can't pay their bills.

In order to make it appear that the it actually has control over short term rates, the Fed has increased IOER by 25 basis points. This increases the subsidy the US taxpayers are paying the big banks from \$6.5 billion per year to \$13 billion per year. But hey. We don't mind. It's for a good cause. And it's only \$40 per American. We're happy to help out.

Somehow, the Fed expects that by having us pay the banks more income the banks will raise the interest rates that they charge their customers and that this will gradually cause the money markets to tighten. Or to put it differently, that by lowering the banks' cost of funds, that will somehow make them want to charge even more to lend money to their customers.

Think about it. You are a bank and your costs go down. What are you going to do to put more loans on the street and maintain or grow your market share? Raise the price to borrowers? I think not.



Another tool the Fed is pretending will have an effect is the daily overnight reverse repo operations. While the typical daily operations of \$100-150 billion are small relative to excess reserves, the Fed also expects that by paying the banks more to switch their deposits at the Fed from regular reserve deposit accounts to overnight RRP accounts that this will somehow reduce the amount of cash and lendable funds in the system. The Fed is attempting to compound the illusion by augmenting the overnight operations with quarter end window dressing term operations lasting a week or two. At the end of the third quarter outstanding term repos briefly soared to \$440 billion as the banks and money market funds opted to show that they were holding repos from the Fed on their books at the end of the quarter.

That isn't merely tantamount to fraud, it is fraud. Those term RRP's existed purely for the purpose of window dressing. They come for a few days at the end of the quarter and then they're gone. The question is, "Who's kidding whom?" The Fed isn't fooling anyone except itself.

The banks don't need reserves to make loans, so these games the Fed is playing will have no effect whatsoever on bank lending.

You can watch the daily operations here

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

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Lee Adler

The Wall Street Examiner

<http://wallstreetexaminer.com>

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