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Markets in High Resolution

IOER Rant and Weekend Links

Today's essay is a follow up to "There is No QE" (1/6/20), in which I ascribed last Fall's repo market volatility to the Treasury Department's withdrawal of ~250bn in liquidity from the system, and defended the Fed's response.

There's far too much analysis out there that amounts to little more than "the Fed's balance sheet has expanded; stocks have gone up; therefore, the Fed's balance sheet expansion is driving stocks higher." Of course, stocks also rose aggressively over the first nine months of 2019 while the Fed's balance sheet was *shrinking* (and a trade war raging at that), but whatever.

I believe much confusion stems from a simple, seemingly technical, change the Fed made in the heat of the 2008 crisis: the imposition of interest paid on bank reserves (IOR).

Everything about the way the Fed operates changed in 2008 with the introduction of interest-on-reserves.

Prior to the advent of IOR, the Fed's balance sheet machinations were designed solely to peg the funds rate at target. Any issuance of "excess reserves" would push Fed Funds below target and initiate a self-corrective balance sheet contraction to get the Funds rate back to target.

Post-IOR, the linkage between the size of the balance sheet and the Fed Funds rate is broken. The Fed Funds rate is now statutorily pegged via setting of the IOR rate (putting aside technical problems that arise from Fed Funds market participants who are ineligible for IOR).

Here's the thing: **at a Fed Funds Rate target of zero, the two operating regimes are identical.** The old operating system could be thought of having an implicit IOR rate at zero (the rate paid on bank notes).

Perhaps this is why the change to an IOR regime on monetary operations and dynamics in generally underappreciated in its importance: **for most of the post-crisis period we were in a zero rate environment, so it didn't matter.**

It matters now. A lot.

IOR was initiated on October 1, 2008 because the Fed wanted to support asset markets *before they realized the Fed Funds rate was going to have to be dropped to zero*. The Fed Funds target was still 2%. As they began to issue excess reserves to fund purchases of ABS, the Fed Funds rate began to collapse below target. IOR was meant to **sterilize the excess reserves** to keep the funds rate at target.

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> *ster·i·lize : deprive (a person or animal) of the ability to produce offspring, typically by removing or blocking the sex organs.*

The purpose of paying interest on bank reserves is to limit the ability of reserves "multiply" in a monetary sense.

Remember, the Fed doesn't ultimately determine the money supply or financial liquidity conditions – the banks do. The Fed manages "monetary policy" by taking actions to **influence the behavior of the banks.**

Assume the rate on the marginal investment available to Bank ABC (adjusted for duration, liquidity, and credit risk) is 1.5%.

If the Fed supplies Bank ABC with additional reserves at a 1% IOR rate, Bank ABC will use that money to make that marginal investment and generate the risk-adjusted 1.5%. The reserves will then end up in Bank DEF, who now faces an available marginal risk-adjusted ROI of 1.4%. So they make that investment, sending the reserves to bank GHI, and on and on. As you can see, these are very fertile reserves!

Now instead of supplying reserves at 0%, the Fed increases IOR to 1.55%. Bank ABC will now prefer to sit on the reserves, as opposed to investing them at that marginal risk-adjusted return of 1.5%. The reserves are now sterile.

Next, imagine the Fed decided to raise the IOR rate to 3%! Our three banks would then scramble to liquidate investments at risk-adjusted returns of less than 3% to capture that 3% risk-free rate available at the Fed. These reserves are now downright destructive.

Overwrought comparisons of the Fed's recent activities with QEs 1, 2 and 3 obsess over the volume of the Fed's balance sheet expansion, while ignoring the degree to which the complexion of the pool of bank reserves has been altered by increases in the IOR rate.

As a positive IOR rate sterilized reserves, it renders them something other than "money." As long as the IOR rate is above zero, **the Fed actually no longer has the ability to "monetize debt."**

Rather than "money," bank reserves today are more accurately thought of as **overnight CD's yielding 1.55%**.

So here's what the Fed's current balance sheet expansion consists of:

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Bank ABC	Federal Reserve
Sells 1m T-Bill yielding 1.50%	"Sells" o/n CD yielding 1.55%
"Buys" o/n CD yielding 1.55%	Buys 1m T-Bill yielding 1.50%

If anyone can explain to be how that swap alters Bank ABC's behavior in a way that boosts systemic liquidity or somehow gooses equity markets, I am all ears.

On to the links…

As I explained in yesterday's "Phase One Leads to Huawei Crossroads," the balance of U.S.-China relations post-Phase one now swings on events around Huawei. How hard the U.S. presses the issue will provide strong clues as to President Trump's true intentions towards China (although certain aspects of the situation are beyond his political control).

We may soon find out if the U.S. threat to abandon "five eyes" intelligence sharing is credible…

Boris Johnson Hints He Won't Ban Huawei From U.K.'s 5G Networks

> *"The British public deserve to have access to the best possible technology," Johnson said when asked about Huawei in a BBC TV interview on Tuesday. "We want to put in gigabit broadband for everybody. If people oppose one brand or another, then they have to tell us what's the alternative."*
>
> *The U.K. for months has been debating how much, if any, access to grant Huawei to its broadband market in the future amid the suggestion the U.S. may be more wary of sharing intelligence if it uses Chinese equipment. Senior U.S. officials visited London on Monday with a last-ditch plea that the U.K. should bar Huawei from providing the kit, warning again that intelligence-sharing could be at risk*
>
> *The U.S. delegation, led by Deputy National Security Adviser Matthew Pottinger and including officials from the State Department, argued that there was no way the U.K. could mitigate the security risks from such a network, according to a person familiar with the meeting. Johnson showed he's alive to the U.S. concerns.*
>
> *"Let's be clear, I don't want as U.K. prime minister, to put in any infrastructure that is going to prejudice our national security or our ability to cooperate with 'Five Eyes' intelligence partners," he said, a reference to the U.S., Canada, Australia and New Zealand.*

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> *Johnson's spokesman on Monday told reporters that a decision would come "in due course." The U.S. believes that with the general election out of the way, it is imminent.*

Merkel supports Huawei, but is opposed by coalition partners to her left and conservative party members to her right, not to mention the intelligence services. But the #orangemanbad is strong in this one…

In Huawei Battle, China Threatens Germany 'Where It Hurts': Automakers

> *Ms. Merkel is opposed to banning the Chinese company.*
>
> *"It is not about individual companies, but rather security standards," the chancellor said in November. "It is about the certification we will carry out. That should be our guiding benchmark."*
>
> *But a rebellion is brewing in Germany's foreign policy and intelligence community — scared of American threats to limit intelligence sharing — and even among some of the chancellor's own lawmakers, who want to submit a proposal to Parliament with tougher security criteria that would, in effect, keep Huawei out.*
>
> *Ms. Merkel's critics say the current certification process, which merely demands that companies sign a pledge not to spy, is inherently flawed because it relies on trust.*

Taiwan is also caught in the crossfire…

Chipmaker TSMC says ready for potential new US export controls

> *Taiwan Semiconductor Manufacturing, the world's largest contract chipmaker, said it was ready to deal with potential new US export controls, which it predicted would have only a temporary impact on its business.*
>
> *TSMC chairman Mark Liu's comments on Thursday are the first the company has made on plans by the US government to further restrict supplies to Chinese telecom gear maker Huawei and thwart China's rise as a technology power.*
>
> *Mr Liu urged the US to remember that TSMC was a "massive" business. "We are everyone's foundry," he said. He added that the business would comply with the law in every jurisdiction where it operates. "We will deal with every customer equally and fairly," he said.*

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> ***Since the US barred Huawei from buying US supplies last year, TSMC has emerged as the main guarantor for the Chinese company's continued access to the high-end semiconductors*** *Chinese manufacturers cannot produce themselves. This is possible because US export control rules allow shipments of products that contain less than 25% of US-made content to continue.*
>
> *The Trump administration is considering tightening the US content threshold from 25 to 10%. Another proposal that could have more wide-ranging fallout would be including US-made semiconductor manufacturing equipment in the calculation of US components. Since such machinery is very expensive, industry experts believe those* ***changes would spell an end to supplies to Huawei altogether****.*

TSMC denies short term plans for US-based chip production

> *The US government is reportedly applying pressure on TSMC to produce some of its processors within the United States. The urging is in relation to its manufacturing of specific chips that are used by the US military, such as in F-35 fighter jets and satellites, with the US government wanting to bring the production of the sensitive parts within its borders.*
>
> *The TSMC has responded by claiming it has no-such plans in the short term to shift production of the high-security chips and other components to the United States, reports DigiTimes. At the same time, TSMC is still leaving the door open to the idea, with its feasibility for the future under evaluation by the firm.*
>
> *The urging stems from the US government's fear military secrets relating to the chips could leak from the Taiwan-based chip foundry, due to its close proximity to China, as well as its supplies of components to that country's firms and military. A senior Taiwanese government official brief on the affair told Nikkei Asian Review "****The US government wants chips that go into military projects to be built on American soil****. That's for national security concerns, and they don't plan to back off on that."*

U.S. – China Trade

No denying it – this was a bad week for the China hawks…

Trump's Supporters See U.S. Victory in China Trade Deal

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> *Michael Pillsbury, a China scholar at the Hudson Institute who advises Mr. Trump, said that Mr. Trump's campaign advisers have realized that the president's supporters are less concerned about China's record of human rights abuses or fears that it is an existential threat and more interested in having greater access to its market. He said that* ***Mr. Trump appears to be shifting his tone on China away from the caustic rhetoric used by Stephen K. Bannon****, his former chief strategist, in favor of an argument that shows how the president succeeded in "opening up" China.*

This WTO trilateral agreement is awesome except for one minor detail: if China actually eliminated these types of subsidies, its economy and credit markets would implode in supernova fashion...

China Faces Stepped-Up Calls to Slash Trade-Distorting Subsidies

> *Under the agreement among the U.S., the EU and Japan, the list of subsidies unconditionally outlawed by the Geneva-based WTO would be broadened to cover:*

- *unlimited guarantees*
- *aid to ailing businesses that have no credible restructuring plan*
- *support for companies unable to obtain long-term financing or investment from independent commercial sources operating in industries in overcapacity*
- *some direct forgiveness of debt*

No, China won't be making those changes to its system. So what's the proper response on our part? I really hate the direction in which things are going. $200bn in forced purchases in Phase One and now a subsidy program for 5G. If dealing with China requires the complete abandonment of market principles, it would far better to absorb the cost of decoupling and retain our capitalist standards…

Senators Urge $1 Billion Plan to Loosen China's Grip on 5G

> *A bipartisan group of U.S. senators, alarmed by the rise of Chinese electronics supplier Huawei Technologies Co., wants Washington to subsidize firms that could counter China's 5G advances.*
>
> *The proposed Utilizing Strategic Allied Telecommunications Act would steer at least $750 million toward companies developing fifth-generation, or 5G, wireless technology and create a separate $500 million fund for companies that deploy "trusted and secure" equipment around the world.*

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Phase One Reactions

Sensible from China's perspective – see how the Huawei decisions play out and get a better sense for Trump's political standing and the likely Dem nominee before undertaking Phase Two talks…

China's Liu warns against 'impatiently launching' into phase two trade talks

> *Chinese Vice-Premier Liu He has said Beijing has little interest in immediately starting negotiations on phase two of a trade deal with the United States, in a polite rejection of US President Donald Trump's suggestion the next stage of talks would start soon.*
>
> *If China and the US hurry ahead with phase two talks after only just signing a phase one deal, the two countries would be acting like "a bear losing itself in a corn field", said Liu, referring to a Chinese proverb.*
>
> *"We might get nothing if we rush to a second job before the first one is properly done. I don't think it is a wise choice to impatiently launch new stages of talks,"*

These are fair criticisms, and I'm disappointed we're not hearing them more from the U.S. From the Republican perspective, I guess the timing is just not good for criticisms of Trump on any issue…

China's trade deal with US 'rewriting globalisation', Europeans complain

> *After the deal was signed in Washington on Wednesday, Vice-Premier Liu He sought to reassure other countries that they would not suffer as a result of the agreement, but the message was not convincing for some.*
>
> *Joerg Wuttke, president of the European Union Chamber of Commerce in China, said the purchasing commitment was "managed trade – meaning the US tells China what it should buy from America", and it would lead firms from Europe to "wonder where our place is".*
>
> *China faced "less choice or possibilities of sourcing, say, soybeans from Brazil, or gas from Australia and Qatar, or coal from India, or aeroplanes from Europe, and this is distortion of the market", Wuttke told reporters in Beijing on Thursday.*

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There will be no complaints about the deal emanating from China either, per order of the Supreme Leader…

China says trade deal good for all, media discourages 'nitpicking'

> *Chinese state media on Thursday warned against any "nitpicking" as Beijing portrayed the Phase 1 trade deal with United States and its new commitments to massive purchases of American goods as a boon for China's economy.*
>
> *A person who works in censorship at Chinese social media giant ByteDance and a senior official at a state-backed media outlet told Reuters they had been instructed only to use official reports on the deal - guidance that is not unusual for sensitive political news.*
>
> *Official media and government statements were upbeat with the People's Daily saying that boosting agricultural imports will "enrich the common people's dining tables."*

A Taiwan Invasion?!?

A shocking piece from the Global Times…

'Reunification by force' sentiment provoked by DPP: spokesperson

> *The Democratic Progressive Party (DPP) and Taiwan secessionist forces have provoked a **growing sentiment in the Chinese mainland of reunifying with the island of Taiwan by military force**, a spokesperson for the Taiwan Affairs Office of the State Council said on Wednesday.*
>
> *The DPP and Taiwan secessionist forces should reflect on why voices are increasing for military force among mainland residents in recent years, Ma Xiaoguang said at a press conference on Wednesday.*
>
> *Chinese mainland analysts said more people in the mainland are losing faith in peaceful reunification because they believed previous mainland policies of delivering economic benefits to Taiwan went unappreciated.*
>
> *With the fast-growing strength of the mainland, especially its overwhelming military power, **more and more mainlanders hope the government considers a non-peaceful option**, experts said.*

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> *They believe reunification by force could resolve the Taiwan question in a more effective and efficient way, the experts said.*

But by all means, U.S. banks shouldn't let that kind of thing deter them. After all, if the properly follow the direction of the Communist Party, there is some good dough to be made…

Goldman Readies a Hiring Spree and Capital to Meet Its China Ambitions

> *"We're increasingly optimistic that we're going to have the opportunity to actually move more in the right direction, maybe even faster than we thought," Waldron said in an interview last week.* ***"If you're going to have a successful business in China, you need to have an appropriate relationship with the government because so much happening in China relates to the government****."*

Caveat Emptor…

Chinese bonds held by foreign investors exceeds 2 trillion yuan - People's Daily Online

Michael Pettis on why Chinese equity market are the ultimate "Keynesian beauty contest"

Fundamentals simply do not matter in China's stock markets

> *It should not come as a surprise that mainland markets are so detached from economic fundamentals. A well-functioning stock market is one in which buying and selling is driven by an appropriate mix of at least three different types of investment strategies: fundamental or value investing, relative value investing, and speculation.*
>
> *It is the first two that really align prices with growth expectations and that enforce consistency of pricing across assets. Speculative decisions to buy or sell, on the other hand, are driven by market technicals, investment fads, momentum trading, margin lending, and other factors that are irrelevant in aligning share prices with growth expectations or relative pricing consistency. What is more, speculative investing tends to be driven by expected changes in the market consensus, rather than by expected shifts in economic growth prospects.*
>
> *The problem is that* ***in a market in which macroeconomic data is questionable, financial statements are not credible, corporate governance is unclear, government intervention is unpredictable, and interest rates are repressed, it is impossible to be a fundamental investor*** *except at very low prices, driven down by the high discount rates all this*

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uncertainty requires. Investors whose effect is to drive capital according to its most productive use, in other words, are pretty much priced out of the mainland markets. That is why, ***for all the promises by local fund managers of their sophisticated fundamental selection process, mainland markets are wholly speculative****.*

In fact the Chinese stock market is really a Keynesian beauty contest: "winners" are rewarded not for choosing the best-looking contestants, but rather for their ability to figure out the consensus. Successful investors are not those who understand the economy, in other words, but rather those who are good at interpreting government signalling, recognising shifts in liquidity and, above all, quickly discerning or even setting off changes in market consensus.

In speculative markets it is these kinds of "technicals" that matter, not fundamentals. Academic studies have suggested that mainland investors show a strong preference for collectivistic investment behaviour. This is not an anomaly: it is exactly what we would expect from intelligent investors in a speculative market in which government signalling plays so prominent a role.

China Economy & Finance

This sounds worse than negotiating with Donald Trump – Lie He is put in charge of the central authority in charge of organizing and policing the zombie debt-rollover process…

Top trade war negotiator handed more control over China's domestic finances

Vice-Premier Liu He has been given increasing power and control over China's financial industry, with the remit of the finance committee under his purview greatly upgraded to become a de facto full governing institution with local branches.

The Financial Stability and Development Committee, which was launched two years ago as a coordinating body, will set up a ***"regional coordination mechanism"*** *at provincial branches of the People's Bank of China (PBOC), according to a statement released by the central bank.*

Under the new arrangements, the central bank's provincial chiefs will be entitled to convene meetings with banking, insurance, securities and foreign exchange regulators as well as local economic planners, financial service and fiscal departments, to discuss matters concerning regional financial stability.

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> *"It aims to strengthen the coordination between central and local governments in terms of financial regulation, risk disposal, information sharing and consumer protection," said a statement regarding the changes to the committee, which includes members from China's central bank, the banking regulator as well as the securities market watchdog.*

So much for that "currency agreement" in Phase One, at least as far as the Global Times is concerned…

China, US trade ties return to normalcy; yuan's rise worth watching

> *Others say that Japan was once in China's current position. In the 1980s, Japan was forced to accept the Plaza Accord, which saw the value of the Japanese yen skyrocket against the dollar. As a result, Japan's export-driven economy was brought to the ground, and the country has never recovered.*
>
> *Now, China's currency, the yuan, is rapidly rising in value against the dollar and other currencies. Therefore,* ***China's central bank ought to watch the dynamics of the global currency market closely, and intervene when necessary to stop any drastic rise of the yuan in the short term****. Sharp currency appreciation will create heavy headwinds for China's exports and dent its sprawling manufacturing sector - a sector that cannot lose to peers in other countries.*

A classic Chinese love story: LGFV nearly dies trying to save a local textile manufacturer; local government saves the day. Or does it????

Delayed China Bond Rescue Spurs Questions About White Knight

> *Debt-burdened textile manufacturer Shandong Ruyi Technology Group won a lifeline in October when a financing vehicle owned by local authorities agreed to provide a capital injection and guarantee some of its debt. Shandong Ruyi has since then managed to make good on its bond payments, including a coupon due for its 2022 Dollar security this month.*
>
> *Problem is,* ***the white knight -- Jining City Urban Construction Investment Co. -- has yet to follow through on paying*** *for the 3.5 billion yuan ($509 million) stake, its prospectus for a bond sale showed last month.*

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Yang Hao, an analyst at Nanjing Securities Co. doesn't expect Ruyi's rescue to impact the company immediately, but further down the road ***"It's an abyss, which will surely drag down Jining City Urban Construction,"*** *he said.*

Both companies are based in the northeast province of Shandong, one of China's wealthiest areas but one that's seen more than its fair share of the country's record distress in the bond market.

Provincial authorities gave Jining City Urban Construction a helping hand earlier this month, *with an 800 million yuan cash injection, after the local government financing vehicle had said in its bond prospectus last month that it would face pressure if it had to pay in cash for the Shandong Ruyi deal.*

Cross-guarantees have been a notable feature of the province's debt woes, spreading contagion when individual borrowers fall into trouble.

Fringe benefits…

Cash-Stuffed Secret Hideaway Discovered in Chinese Banker's Apartment

The former chief of China Huarong Asset Management Co. has been charged with taking bribes, corruption and bigamy in one of China's biggest-ever financial corruption cases.

On Monday, he confessed in a state TV documentary that he preferred cash when taking bribes and would personally drive to an apartment with trunks of bills, making several rounds to avoid being followed. More than 200 million yuan ($29 million) was uncovered in the hideaway.

Federal Reserve

I'm not sure how Kudlow justifies this optimism. I fear the death of the Phillips curve has been greatly exaggerated. Though, the mere fact that we have it on the run is exceedingly bullish…

Shelton Won't Have Trouble Getting Confirmed to Fed, Kudlow Says

**(Bloomberg) -- Judy Shelton, whom President Trump plans to nominate for the Federal Reserve Board, is "not going to have any trouble" getting confirmed by the Senate, Trump economic adviser Larry Kudlow says.*

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** The Phillips Curve is "dead" and that was a theme in the selection of Shelton and Christopher Waller, Kudlow says*

** Kudlow expects both picks to discuss lack of inflation during their confirmation hearings*

** "If you're looking how to summarize the views of these two nominees, that's the key point -- growth, jobs, low unemployment does not cause high inflation and interest rates"*