Front-Running the Fed in the Treasury Market

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Introduction

For some nine years I have been predicting that the economy is going to a recession morphing into a depression, using a purely theoretical argument. The essence of my argument is that the open market operations of the Fed cause a protracted decline in interest rates which is responsible for the hard-to-detect capital destruction affecting the financial sector no less than the productive sector. The immediate cause of the depression is the destruction of capital. The ultimate cause is the monetary policy of open market operations. The chain of causation is as follows.

(1) Open market operations (in effect, net purchases of T-bills) by the Fed are predictable. They invite bond speculators to take risk-free profits offered by this fact of predictability.

(2) Bond speculators buy the long-dated Treasurys and sell the short-dated ones, to pocket the difference in yields. These straddles represent borrowing short and lending long. As such, they are inherently risky. However, Quantitative Easing takes the risk out by making the odds, that the normal yield curve will invert, negligible.

(3) The bond speculator faces the problem of having to roll forward the fast-expiring short leg of his straddle by selling T-bills. The extraordinary funding and refunding requirements the Treasury is facing, and the extraordinary pressure on the Fed to increase the money supply combine to make it ultra-easy for the bond speculator to move both the short and the long leg of his straddles as he sees fit.

(4) The upshot is that interest rates keep falling along the entire yield curve. Regardless how many long-dated issues the Treasury offers, bond speculators snap them up even before the ink is dry on them.

Here we have the solution to the Greenspan-conundrum: the sky is the limit to the bond speculators' appetite for Treasury paper. They are all right as long as they can sell T-bills against them. But as the sky is the limit to the Fed's appetite for T-bills, both flanks of the speculators are secure.

In my other writings I have explained how a prolonged fall in interest rates along the yield curve brings about depression through the indiscriminate destruction of capital in the productive as well as financial sector.

There is a vicious spiral: the more currency the Fed creates, the more risk-free profits bond speculators will reap, contributing to a further fall of interest rates.

This outcome is the exact opposite of the one predicted by monetarism. The latter predicts that the new money created by the Fed will flow to the commodity market bidding up prices there, to nip depression in the bud. Bernanke & Co. fully expects this to happen. This is not what is happening, however. The new money refuses to flow uphill to the commodity market. It flows downhill to the bond market where the fun is. Why take risks in the commodity market, the speculators ask, when you can gamble risk free in the bond market? So grab the money, buy more bonds and sell an equal amount of bills. As a consequence of bullish bond speculation interest rates fall, prices fall, employment falls, firms fall. The squeeze is on, bankrupting the entire economy.

Official check-kiting

Some might object that the Fed could short-circuit the process and undercut the bond speculators' lucrative business. All it has to do is to buy the short-dated paper directly from the Treasury. Inverting the yield curve will shake off the parasites. My answer is that there is no danger of this happening. The Treasury and the Fed know that bond-vigilantes watch what they are doing like a hawk. Any hanky-panky of direct sales of T-bills by the Treasury to the Fed would make them cry "foul play!" As indeed it would be: direct sale of Treasury paper to the Fed would degrade the dollar from irredeemable currency to fiat currency. There is a subtle difference, realized only by the few.

Fiat currency is worse. Its arbitrary augmenting is decided behind closed doors. It does not need the endorsement of the open market. Fiat currencies have a short life-span as they readily succumb to the sudden-death syndrome. Irredeemable currencies are different from fiat in that they are created openly, using collateral purchased in the open market. They have a more respectable life-span. As long as the official check-kiting conspiracy between the Treasury and the Fed remains hidden from the general public, irredeemable currency may even prosper. Direct sale of T-bills by the Treasury to the Fed would tear down the curtain that hides the fact of check-kiting.

The mechanism of check-kiting is as follows. The Treasury issues debt which it has neither the intention nor the means ever to repay. This debt is used as "backing" for Federal Reserve notes and deposits, which the Fed has neither the intention nor the means ever to redeem. When the Treasury debt matures, it is paid in Federal Reserve credit issued on the collateral security of new Treasury debt. When Federal Reserve credit is presented for redemption, the Fed offers interest-bearing Treasury debt in exchange. This is a shell game and it exhausts the definition of check-kiting. Neither the Treasury debt, nor the Federal Reserve credit is issued in good faith. Neither is redeemable any more than Charles Ponzi's tickets were. They are both issued in order to mesmerize a gullible public, much the same way as Ponzi did.

Treasury and Fed officials know their history. They are familiar with the fate of the assignat, the mandat, the Reichsmark, not to mention the Continental. They know that no fiat money ever survived "the slings and arrows of an outrageous fortune". Their only hope is that the fate of the irredeemable dollar, as predicted by Friedman, would be different. They would not embark upon an adventure in monetary policy involving direct sales of T-bills by the Treasury to the Fed. If they did, surely this would be the end of their experiment. Foreigners as well as Americans would start dumping the dollar unceremoniously, and buy anything they can lay their hands on. This is variously known as flight into real goods, *Flucht in die Sachwerte*, crack-up boom, Katastrophenhausse. I purposely avoid using the term hyperinflation as it connotes with the Quantity Theory of Money, which is not really a theory. It is a linear model trying to explain non-linear phenomena.

Falsecarding by the Fed

There is also a second method by means of which bond speculators are making risk-free profits. They "front-run" the Fed in the bill market. This means that, through inside information or otherwise, they divine when the Fed has to answer "nature's call" and must make the next trip to the open market in order to buy the collateral without which it cannot issue more money.

Bond speculators forestall the Fed by purchasing the bills beforehand, thus driving up the price. Then they turn around and dump the paper into the lap of the Fed at the enhanced price, making a risk-free profit. This process is called "scalping", after the kindred activities of small-time speculators in tickets for the World Series and other popular sporting events.

The objection that the Fed knows how to throw bond speculators off scent by various stratagems — for example, through falsecarding, say, by selling when speculators would expect it to buy — can be safely dismissed. There is no question that every year the Fed is a big buyer of bills on a net basis. If it sells, it has to buy that much more later on. Fiddling means that the Fed may miss its target. Falsecarding may backfire.

The speculators are a smart lot, thanks to "natural selection" culling the rank and file. They risk their own capital, which they stand to lose if they place the wrong bet. Once their capital is gone they are out, and smarter guys will take over. Hired hands at the Fed are no match for them as far as brightness and adroitness is concerned. The latter work for salaries. If they make the wrong bet, losses will be replenished by dipping into the public purse. Think of the losses the Bank of England suffered at the hand of a lonely bond speculator, one George Soros. The British public was forced to swallow the loss, and Soros was allowed to run with the loot and boast in his book that he has busted the Bank of England *single-handedly*. Recently Soros said in Davos that he is bearish on gold. In his opinion gold is in a bubble. Of course. He knows that he couldn't bust the Bank of England again, once it is back on the gold standard!

Cheating in Las Vegas

My voice has remained a cry in the wilderness. Nobody paid attention to the mumblings of this armchair economist.

My idle theorizing got an unexpected boost from the website *Jesse's Café Américain* (http://jessescrossroadscafe.blogspot.com). On January 22, 2010, Jesse posted a story with the title *Front-Running the Fed in the Treasury Market* from which the following quotation is taken.

Attached is some information from a reader. I cannot assess its validity, not being in the bond trading business. But it does sound like someone has tapped into the Fed's buying plans to monetize the public debt and is front-running those purchases, essentially 'stealing' money from the public. It's what they call a 'sure thing'. To try and figure out who might be doing it, I would look for some big player who is showing extraordinary returns on their trading, with consistent profit that is not statistically 'normal', but is consistently 'too good'. The problem with cheaters is that they sometimes get greedy and call attention to themselves. In Las Vegas the bigger cheats at the casino were often taken to the desert for further questioning and final disposal. On Wall Street they are more arrogant and persistent, defying resolution *with that ultimate defiance, "We'll just have to figure out other ways to cheat, and come back again".*

Time for a trip to the desert?
Here are my reader's observations from the bond market.

"I used to work for a BB on a prop desk until the financial crisis took hold and they fired the less senior guys. I now trade US Treasurys for a small prop firm in xxxxx, to scalp basis trades in most on-the-run securities. Occasionally, I will also take position in the repo markets for off-the-runs if I see something 'mispriced'. Your recent article piqued my interest because we, too, have noticed 'shenanigans' of a sort in the Quantitative Easing program involving US Treasurys.

"What we have noticed, especially in smaller issues like the 7 Year Cash, is that before a Fed buy-back would be announced, the price would pop significantly as if buyers would run through all the offers on the two major electronic exchanges (BGC Espeed and ICAP Broker Tec). This has occurred more than several times as the 7 Year Cash would be overvalued both by its BNOC, by as much as 20-30 ticks, as well as by its value relative to similar off-the-runs. These buyers would lift every offer they could, driving the price substantially above its 'value', sometimes for as long as a week at a time. After this buying occurred, the Fed would announce the purchase of that security, sometimes a handle above its approximate value. This 'luck' has occurred not just in the on-the-run 7 Year sector, but also in the 30 Year Cash, 3 Year Cash, and in several other off-the-runs. Again, it was especially prevalent in the less liquid Treasury products. Often the 'appetite' for these securities would begin two weeks before the official Fed announcement. The buying was well-orchestrated and done in such a way as to throw it out of kilter with the like cash Treasurys and the CME Ten Year Contract. If you examine the charts of some of the selected buy-backs before the official announcement, you will see a similar occurrence.

"While I haven't broken this down into a paper to prove it (and I see nothing positive coming out of contacting the ESS-EEE-SFE about this issue), I can assure you that it was occurring on a consistent basis across the entire curve. A certain issue would be bid up substantially above market value (as determined by several metrics), only to be gobbled up later by the Fed at an unreasonably high price. These players must have substantial pockets as we, the small guys (but with a decent capital base) would take the other side of what seemed to be an obvious fade. While this did not occur in every issue of the Quantitative Easing program, it occurred often enough to be obvious to any knowledgeable observer.

While I am not sure that this can be attributed to a purposeful Fed policy or someone at the Fed talking to his pals, I am certain that it transpired."

Congenital disease of the monetary system

The anonymous correspondent of Jesse is looking for an answer in the wrong direction. Cheating is not necessarily involved. What he has observed need not be a purposeful, if veiled, Fed policy, nor is it necessarily someone at the Fed tipping off his brother-in-law at a brokerage house (however valuable the tip may be).

What we face here is a congenital disease of the irredeemable dollar. Open-market operations is the tool for the purpose of increasing the money supply through monetizing government debt as needed. It should be recalled that open-market operations by the Fed were illegal according to the Federal Reserve Act of 1913. The original Act looked at the monetization of government debt as an *anathema*. Illegal open-market operations started in the early 1920's. They were legalized *ex post facto* in 1935 by an amendment to the Act, after the gold standard was destroyed by the proclamation of president Roosevelt in 1933. Those who sponsored the amendment were ignorant of what effect open market operations would have on bond speculation. Economists in and out of government and academia were equally ignorant. The financial press also failed to criticize the hare-brained scheme of open market operations making, as it did, profits from bond speculation risk free.

There is no need to look for a conspiracy in the bond market. It is quite possible that a large number of smart speculators, acting spontaneously and independently of one another, have come to realize that there is a bonanza, perfectly legal, in ripping off the public purse. Of course, they kept their own counsel.

If anybody is responsible for this colossal blunder of economics releasing the genie of risk-free speculation out of the bottle, the names that come to mind are those of Keynes and Friedman, resp. They invented, resp., 'improved', the system of floating exchange rates assuming a goldless currency that has to be arbitrarily augmented from time-to-time through the monetization of government debt (that, incidentally, proliferated profusely after the politicians deliberately unbalanced the budget upon the explicit advice of Keynes). The rest, as they say, is history.

As long as budget deficits were 'modest', the activity of speculators making risk-free profits in the bond market escaped public attention. With the advent of 'Quantitative Easing' and mega-deficits, everybody sitting at a bond-trading desk can see it. The figures literally jump off the screen, as explained by Jesse's blog.

Recruiting a corps of shills

To be fair to Jesse's anonymous correspondent I must admit that his conjecture, that in risk-free bond speculation we may be looking at deliberate Fed policy, is plausible. It is not impossible that the rot in the U.S. monetary system has already spread so far that in a truly free and unrigged bond market no bidders would turn up. Time is long since past when Treasurys were eagerly sought after by the most conservative segment of the investing public, such as guardians of widows and orphans, trust funds, eleemosynary institutions. Typically, they held the bonds to maturity. Treasurys, second only to gold, were the most trusted instruments of wealth-preservation.

Under the regime of the irredeemable dollar no investor in his right mind would buy a Treasury bond and hold it till maturity. Treasurys lose value as ice melts in the sunshine. They have become a plaything in the hands of speculators for their value in turning a fast buck. Under the gold standard there was no bond speculation, just as there was no foreign exchange speculation. Interest rates were stable and so were bond prices. Speculators would shun bonds. Of course, all this changed when president Nixon defaulted on the short-term gold obligation of the Treasury to foreigners in 1971, and gold was finally removed from the international monetary system at the behest of the U.S. government.

For a decade speculators were happy with the trading profits they could make in the bond market. But as the monetary system kept deteriorating, they started abandoning bonds, transferring their activities to the commodity market. By 1981 demand for bonds practically evaporated. As this spelled the end of the regime of the irredeemable dollar, the Fed had to do something to prop up the bond market by enticing bond speculators back.

Thus, then, it is quite possible that a decision was made at the highest level to offer the enticement of risk-free profits to bond speculators. It certainly cannot be denied that bond speculators have been making obscene profits in the course of the 30-year bull market in bonds that is still ongoing. These profits are unprecedented in the history of speculation, both on account of their magnitude and their regularity. They were made at the expense of productive enterprise, the capital of which has been surreptitiously siphoned off by the falling interest-rate structure.

Another way of describing this scenario (assuming it is correct) is that in 1981 the Fed, unknown to the public, decided to recruit a corps of shills to prop up a moribund bond market. The shills hired by the casinos of Las Vegas bet big and win big at the gaming tables in full view of the gamblers who are unaware that they are being treated to a show. The sight of these big payoffs will then perk up the gambling spirit of a lethargic clientele.

The shills recruited by the Fed are the bond speculators, and their remuneration is in the form of risk-free profits they are allowed to make (and keep). The scheme was a roaring success. Not only did it save the bond market from extinction; it also saved the dollar from ignominy, and was instrumental in making possible a whole string of bubbles, each bigger than the previous one.

The Road to Hell Is Paved with Good Intentions

The problem is far more serious than it may at first appear. Risk-free speculation is like a computer-virus that has no antidote and threatens to wipe out the Internet. It short-circuits normal economic processes and gobbles up the world economy.

I would welcome a public debate of my thesis that risk-free bond speculation suppresses the rate of interest and destroys capital in the process. I have challenged neo-classical economists who still consider the open-market operations of the Fed as a ‘refined tool to manage the national economy’. I want them, instead, to see in open-market operations the cancer of the economy responsible for the withering of the world's prosperity. So far my challenge has fallen upon deaf ears.

Here is the problem. The prevailing orthodoxy is the unholy alliance between Keynesianism and monetarism inspired by Friedman (defying the pretence that these two are antagonistic theories). The idea that an artificial increase in the money supply must raise commodity prices dies hard. But as my theory suggests, and as events have repeatedly shown (first during the Great Depression of the 1930's, and again, during the present crisis), the presence of risk-free speculation renders the increase in the money supply counter-productive. It causes prices to *fall* rather than *rise*.

Giving them the toy of risk-free profits makes speculators vacate the commodity market where risks are too high. They will then congregate in the bond market where risks are non-existent. The speculator who in the absence of risk-free profits might resist falling prices in the commodity market, will decline the honor of pushing the Keynesian agenda if given the choice of risk-free profits in bonds. This is basic human reaction that cannot be criticized, still less rectified, by official brow-beating. Keynesians should have thought about the consequences of their master-plan more thoroughly before they put open-market operations into effect.

The intentions of policy-makers at the Fed are praiseworthy. They want to prevent prices and employment from collapsing. But they are prisoners of their orthodoxy, and their good intentions make them steer the economy to the road to hell. A catastrophe is confronting the Titanic, but the captain, just confirmed in his position in spite of a most serious public challenge, will not change his course.

A head-on collision with the iceberg straight ahead, otherwise known as the debt-tower, now appears inevitable.

Calendar of Events

Seminar at the Martineum Academy, Szombathely, Hungary, March 25-29, 2010

Is the Global Financial Crisis Over?

Sponsored by the Gold Standard Institute, with the participation of Sandeep Jaitly, Peter van Coppenolle, Rudy Fritsch, Darryl Schoon, Nathan Narusis, Professor Fekete, and others. Among other topics, there will be a presentation of the latest research on the gold basis, the world's pension woes, and an exclusive business idea **turning the ridiculously undervalued "legal tender gold coins" to your advantage**. For further details, see: www.professorfekete.com