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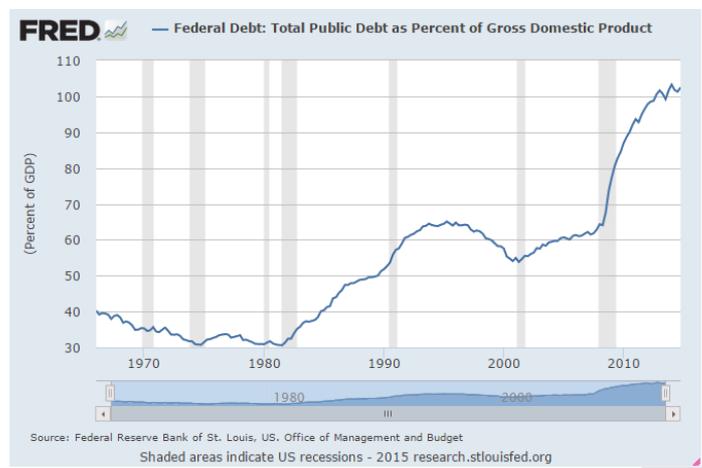
The Costs

One of the significant advantages I enjoy to other economic and market pundits is my direct contact with clients. I speak to very smart business people across the country who are clients and friends of Mariner Wealth Advisors. These folks (many of you are reading this piece) are smart, engaged and success-oriented. My role with most of these relationships is to act as Mariner’s economic and capital market spokesperson – an effort which I drive.

Recently, I spent time in Fort Worth, Chicago, St. Louis and Los Angeles. I was also asked to guest lecture a few business classes at Washburn University in Topeka, Kansas. One question, which seemed to be on many peoples’ minds, is the current state of the Federal Reserve. People aren’t questioning if the Fed is going to start raising interest rates, (they will, it is just a matter of when), but they are questioning the Fed’s balance sheet and government debt levels. When will the Fed lower leverage on their balance sheet? ***How much has the leverage on the Fed’s balance sheet and quantitative easing (QE) actions “cost” the economy?***

Background

I first formally addressed the federal debt problem in 2007 in my “Long, Hard Slog” thematic pieces. It has been my stance that the severity of the economic contraction in 2008-2009 was exacerbated by the levels of debt – or leverage – in the developed world’s economy. Government, financial system, consumer and industrial debt levels were all at unhealthy levels. As a percent of gross domestic product (GDP), debt levels have declined since



2009 in most areas of the U.S. economy. The Federal Government didn’t join this parade, as deficit spending has hit a new crescendo from 2009 – current. Please see the chart above, (Source: Federal Reserve Bank of St. Louis). Below is data comparing different leverage levels for different segments of the U.S. economy between 2010 and current:

	2010	Current	% Change
Nonfinancial Corporate Debt – as % of GDP	40%	43%	+7.5%
U.S. Federal Government Debt – as % of GDP	63%	102%	+61.9%
Household Debt – as % of GDP	95%	80%	-15.8%

Total debt outstanding in the United States (as a percent of GDP) has fallen by 10 percent since 2010. The consumer has led this contraction in outstanding debt – a process called deleveraging by reducing debt – through pay-downs or by default. On the other hand, ***the Federal Government has seemingly done all they can to offset this improvement in the nation’s economic “balance sheet” by expanding their liabilities at the fastest rate in 70 years.***

But federal government debt expansion is only part of the story. The Federal Reserve, through QE actions, has increased the size of their balance sheet. The Federal Reserve now has \$4.45 trillion of assets on their balance sheet as compared to less than \$1.0 trillion in 2007. These assets are primarily debts of the Federal Government. During QE actions (three so far) the Fed purchased massive amounts of U.S. Treasury and other bonds from the open market, driving interest rates downward and infusing fresh cash into the banking system, in an attempt to kick-start economic activity.

The Fed’s actions, in fact, helped facilitate the massive expansion of debt issuance by the government. The Fed became a major purchaser of Treasury Bonds/Notes while QE actions were ongoing. Effectively, the government was purchasing their own debt issuance, thus keeping the cost of that debt low.

Now, where did the Fed get the money to buy these trillions of dollars of bonds? They basically printed the money. According to monetary economic theory, more dollars in the economy chasing the same amount of goods should lead to higher inflationary pressure. This hasn’t happened yet because much of the cash the Fed used to purchase these bonds has been stuck in the banking system, and hasn’t been released into the overall economy.

Enter Swiss Re

Recently, I read a report released by Swiss Re, a highly regarded Swiss based reinsurance company. In this report, they make an honest effort to analyze the costs QE actions have released on the U.S. economy. Why do I term this an “honest” effort? Swiss Re, being a foreign based organization, has no real political ax to grind with their analysis. Additionally, the company is one of the more highly thought-of organizations in the financial world today. ***They have titled the costs of QE “financial repression.”***

The Report and Findings

Findings of the Swiss Re report are as follows:

- Due to systemically low interest rates, the cost of “financial repression” has cost U.S. savers \$470 billion in interest income, ***net of lower debt costs. These findings are not just due to central bank actions, but also increased regulatory (Dodd Frank) rules which favor the use of Treasury bonds on bank’s balance sheets. According to the authors, 10-year U.S. Treasury bond yields have averaged 1.2 percent below “fair value” on average since 2008.* This “distortion” has helped drive asset values upwards on a global scale.***

- \$470 billion in lost income – even to the U.S. economy - is real money. That amount, spread out since 2008, equates to an **annual 0.4 percent “hit” to overall annual economic growth.**
- Significant **unintended financial and socioeconomic consequences have occurred due to increased levels of “financial repression” including:**
 - Asset price bubbles: Driven by systemically low interest rates, investors across the risk-spectrum increased their risk profile, seeking reasonable returns. Is the average investor taking too much risk?
 - Impact on private households: Private households are being “taxed” as their income has been lower than otherwise. In the case of inflation, savers are experiencing a devaluation of savings due to low interest rates – rates which are lower than inflation.
 - Wealth inequality: Stock market values have expanded dramatically since the lows in 2009, with the S&P 500 Index up more than 200 percent over that period. The top 1 percent of income earners have 50 percent of their financial assets invested in stocks while the lowest 90 percent have 9 percent of their financial assets invested in stocks. As a percent of total financial wealth, the top 1 percent have recorded an increase in wealth of 50 percent while the lower 90 percent of households have recorded an increase of only 12 percent.

In summary, financial repression has led to the following numerical results:

1. U.S. Federal government debt has increased by \$8 trillion, to \$17 trillion. Government debt has **doubled since 2008.**
2. The Federal Reserve’s **balance sheet has risen four-fold to \$3 trillion in an effort to kick-start the overall economy and facilitate massive levels of federal government borrowings.**
3. U.S. households have **earned \$470 billion less** in interest income since 2008, net of lower debt costs, **directly hurting consumption patterns by an average of .4 percent of GDP annually.**
4. Foreign and domestic **insurance companies have earned \$400 billion less in income** since 2008 due to extremely low interest rates (as compared to “fair value”^{**} analytics).

The U.S. financial sector (insurance companies, banks) now hold **\$2 trillion more in government bonds than was the case in 2008**, lowering profitability of this segment of the economy.

Answering the Question – Has It Worked?

So has this expansion in outstanding liabilities by the Federal Government worked? What has our country’s economy gained by this leveraging? Additionally, the Federal Reserve’s balance sheet has expanded over the last five years as quantitative easing actions have mounted. Since 2008, the Fed has increased the size of their balance sheet from \$850 billion to \$4.44 trillion, or a growth rate of 422 percent over the last eight years.

Has all of this increased governmental “management” of our economy been worthwhile? The true cost the global economy is going to face due to increased governmental leverage isn’t yet known. What we do know is as follows:

1. Since the major expansion in federal government debt issuance, GDP growth has averaged 2.1 percent per year (2010-2014), whereas the average post-World War II growth rate has been 3.2 percent. So, to the degree the massive infusion of cash into the economy was supposed to kick start growth – that has failed.
2. To the degree the country has been concerned about wealth inequality, QE actions have apparently added to that very inequality, as asset values have risen dramatically, benefiting those who own the assets – the wealthy. By this goal, QE has failed.
3. The global financial system was in absolute turmoil in 2008-2009. The banking system was on the verge of freezing. Now, while the financial system hasn’t returned to normal, the financial crisis of 2008 – 2009 is over. Is QE to receive credit for this rescue? Perhaps. Some argue the counterfactual view that the financial system would have collapsed if not for QE. Maybe. But then again, while **counterfactual arguments are not irrefutable, they are not provable. That is the weakness of these arguments. Those who say QE saved the world’s financial system are speculating.**
4. What we now know, according to the Swiss Re report is QE actions have cost U.S. households and the global insurance industry a **combined \$900 billion in foregone net interest income.**

Answering the Question – What Costs Have Been Incurred?

When will (if ever) the Federal Reserve de-lever their balance sheet? When will the Federal Reserve “put back” the \$3 trillion in debt, they are now carrying, to the Federal Government? We don’t know the answer to either of these questions. If they do “put back” the bonds to the government, I suggest interest rates may indeed rise due to this action. The Fed knows this to be the case – consequently my best guess is the **Federal Reserve will not actively sell bonds from their portfolio back into the capital market, but rather will allow the bonds to mature slowly over a period of years to lessen the shock oriented impact which may happen if they actively enter the open markets and unload upward of \$3 trillion of debt on the capital markets.**

If my thoughts hold water, the impact of QE actions on the economy have the chance of being spread out over a long period of time, lessening the overall impact on economic activity. However, if the Swiss Re report is accurate, it is reasonable to assume that \$900 billion of foregone net interest income has been withheld from investors world-wide due specifically to QE actions.

Now, Europe and Japan have entered the QE parade. Their central banks have launched their own version of QE actions. The costs of QE? They continue to mount.

**Application of the “Taylor Rule” as to fair value for U.S. Treasury bond yields.*

We will be back next week.



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