Kicking the can

Congress and the Fed are on a spending spree.

By Jim Reber

If you ultra-busy community bankers have been able to catch some of our policymakers commenting on the waves of fiscal and monetary stimulus rushing toward the U.S. consumer, what you heard essentially translated into an elaborate game of Kick the Can. Please note that I said "elaborate" and not "elegant."

Here are some popular sound bites from these commentaries: "The amount of debt that we're adding up is a matter of genuine concern." "We are deploying these lending powers to an unprecedented extent, enabled in large part by the financial backing from Congress and the Treasury." "Our country's highest priority must be to address this public health crisis." All of which sound good, and each of which are undoubtedly true. As is this: We're going to have one large bill to pay sometime in the future.

It came from Foggy Bottom

In barely a six-week period in March and April, we saw three different bills enacted, each providing assistance to individuals and the domestic economy. The three have an aggregate price tag of about $2.8 trillion. Congress and the administration have not yet advanced any bright ideas about how this spending is actually going to be repaid.

For context, here is some color on what $2.8 trillion entails:

*It's equal to the annual gross domestic product of France.
*It's greater than any annual U.S. budget up until 2008.
*It's twice the amount of all the individual income tax payments in the U.S. in 2017.

And more may be in store as the government tries to keep our economy from completely shutting down. Still, to summarize, we've just taken a big jump in deficit spending to finance our way of life until we can go back to our normal routines.

Fed's bag of tricks

Not to be outdone, the Federal Reserve has supplied a set of monetary responses and more to come. Some of these moves have not only rebuilt its colossal balance sheet but have far surpassed its previous buying binges. As of the end of April, its total assets were up to around $6.6 trillion. That number never exceeded $4.5 trillion even during the succession of quantitative easings (QE) in the past decade.

Of course, we learned last time that the counterweight to the buying spree is the increase in reserves in the banking system. The finance textbooks will tell you that an increase in the money supply will cause prices to rise, as inflation is the residue of "too much money chasing too few goods."

But since inflation never really picked up during the prior rounds of QE, and since it sure looks like monetary stimulus is currently needed to keep the economy from collapsing, deficit hawks have completely thrown in the towel at the present. Thirty-year Treasury bonds with yields below 1.50% have further empowered lawmakers to borrow-and-spend, and we'll figure out how to finance it later.

What's of value
The list of Fed activities is too lengthy to go into much detail, but let's just say it is taking its role as Lender of Last Resort quite seriously. It has invested in, or provided financing to, several investment sectors that it had never done so in the past. This includes corporate bonds and municipal loans.

More fundamental to community banks is that it has again cut overnight rates to just about zero and has invested in a lot of mortgage-backed securities (MBS). This includes more generic MBS like the 30-year fixed rate pass-throughs, but it has also increased its holdings of 15-year pools and, for the first time, bought multifamily MBSs. The Fed's objective is to enhance liquidity in that space, and it appears to be effective. Between mid-March and mid-April, prices on many of these pools rose by almost three points (3%), while Treasury notes with comparable durations were essentially flat.

Not that anything in this market is going to have nominally attractive yields, but there are some pockets of relative value. MBSs that the Fed are not buying, such as jumbo pools and collateralized mortgage obligations (CMOs), have not yet followed the prices on the Fed's pools. The aforementioned liquidity facility to support municipalities is concentrated on short (two years and less) duration credits. Therefore, longer (e.g., more than 10 years) munis should remain the highest yielding sector that's of interest to community banks.

I think we'd agree that we're not having an especially fun time at the present, but it surely appears to your correspondent that our policymakers are using all the toys in their sandbox. Some of these will hopefully prove to be popular (and effective) at maintaining sufficient activity in the financial sector until normalcy returns. Then we can all look forward to dealing with the extended-play game of Kick the Can 2020.

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[Sidebar]
Funding options
ICBA Securities and its exclusive broker-dealer Vining Sparks can assist your community bank in building an efficient collection of funds. A recent Strategic Insight "Defending Your Bottom Line" explains some strategies to maintain reasonable interest margins. For your copy, visit *icbasecurities.com* or contact your Vining Sparks sales rep.