QE3 Is Already Underway

Just as the transition from QE to QE2, the purchase of MBS to the purchase of US treasuries was a seamless exercise, so too the transition to QE3, the funding of banks to purchase US treasuries will be seamless and this time if done right, done without fanfare.

The US economy cannot survive higher interest rates, in particular the housing market, now slipping back into recession with a -3.6% shrinkage in the Case Shiller Index, cannot survive higher interest rates. The benchmark 10 year US treasury yield needs to be capped and controlled. The 10 year yield has declined steadily from 3.6% to just a touch over 3% in a little over a month, a remarkable feat given that the Fed’s 600 billion USD purchase program is expected to end sometime this month.

The various recovery acts of the US to deal with the credit crisis of 2008 have required the government to either purchase, underwrite or finance an enormous quantity of mortgage debt. This requires that the government itself finds means and ways to finance itself. With the USD’s role as a reserve currency waning, with the creditworthiness of the US in question (whether or not in jest), new ways were and are required to finance government debt. QE2 was not so much an exercise in reflationary monetary policy as an attempt at monetizing government debt. There is still more debt to be monetized. Calling the new effort QE3 or calling attention to it might suggest that previous efforts were a failure, which is an unacceptable perception. Lending money to private commercial banks to in turn lend it on to the US government is as good a plan as any. For the banks, it is a profitable (the yield curve is still relatively steep) and capital efficient (US treasuries have a risk weighting of zero) trade.

Front run the pirates. Curve flatteners 2 and 10 years. Lever them up.

However, if the above analysis is valid, the supply of US treasuries will soak up significant liquidity and would likely draw liquidity from other asset markets. So the recent rally in US treasuries may not be a result of derisking from equities, high yield and commodities. It might be a mighty displacement trade.