Strategic International Securities Inc.

A Registered Investment Advisory

Economic & Stocks Weekly*

Economic & Stocks

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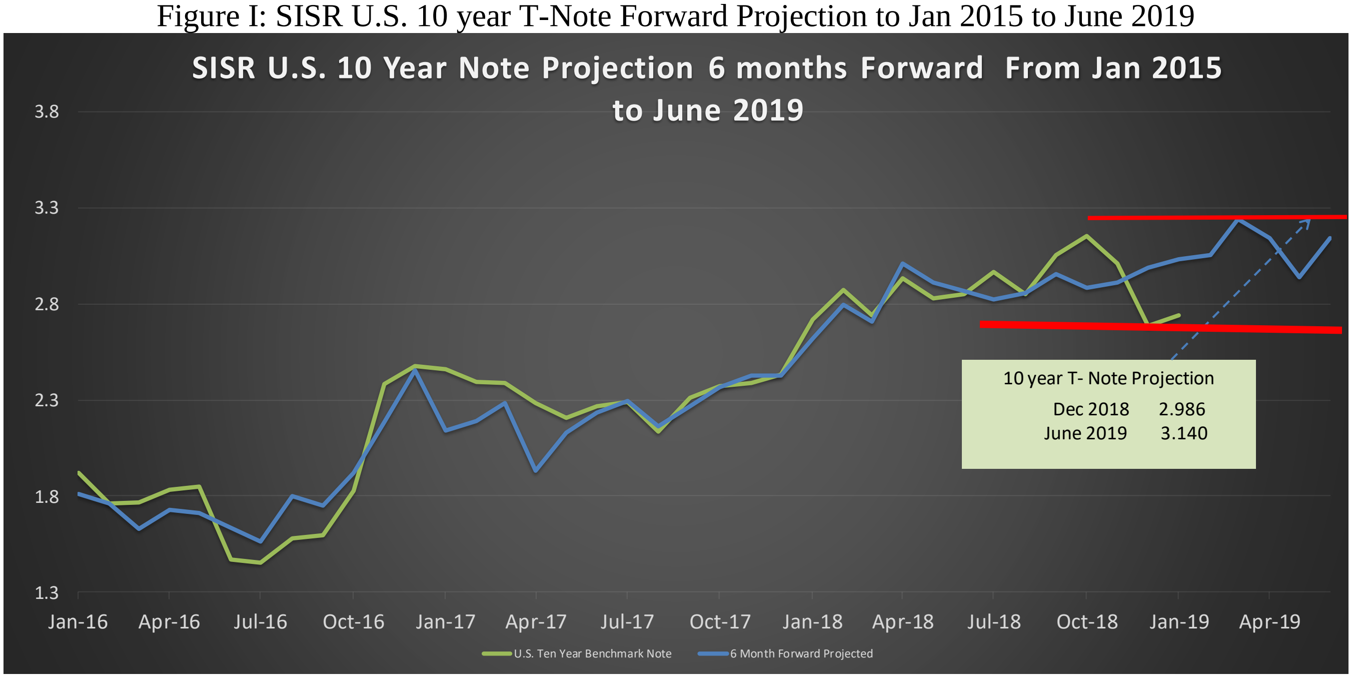
U.S. 10 year T-Note Yield likely have hit bottom and may break out to new highs by Spring 2019 caused by higher inflation expectations

Figure I: SISR U.S. 10 year T-Note Forward Projection to Jan 2015 to June 2019



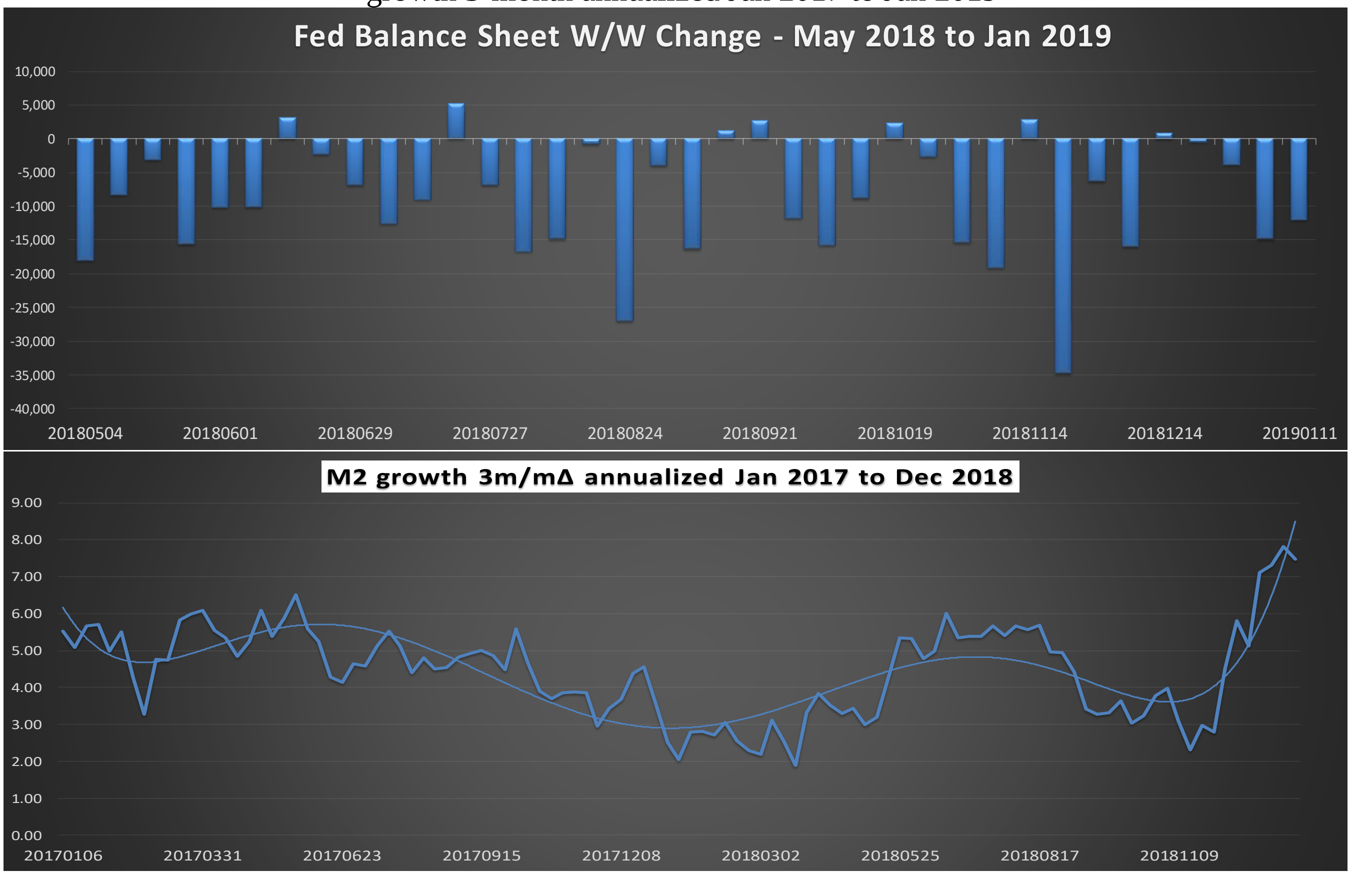
Source, SISR proprietary Model

Introduction

The equity markets are coming off a 19% correction on fears of a possible recession. While there likely will be a global & U.S. slowdown in 201. For the U.S. barring another extended government shutdown, and or WTI falling off a cliff, causing major damage to the energy sector and emerging market countries, or the U.S. international trade policies throwing the world into mayhem, resulting in a major global recession, it is highly UN-likely that the U.S. will fall into a recession.

As we have been pointing out it appears that the Fed in fact did get the memo and has probably changes their policy direction to fewer rate hikes going forward, and a slowdown in QT.

Figure II: Fed Balance Sheet Changes Excess Reserves held by U.S. Banks Jan 1975 to Jan 2019 & M2 growth 3-month annualized Jan 2017 to Jan 2019



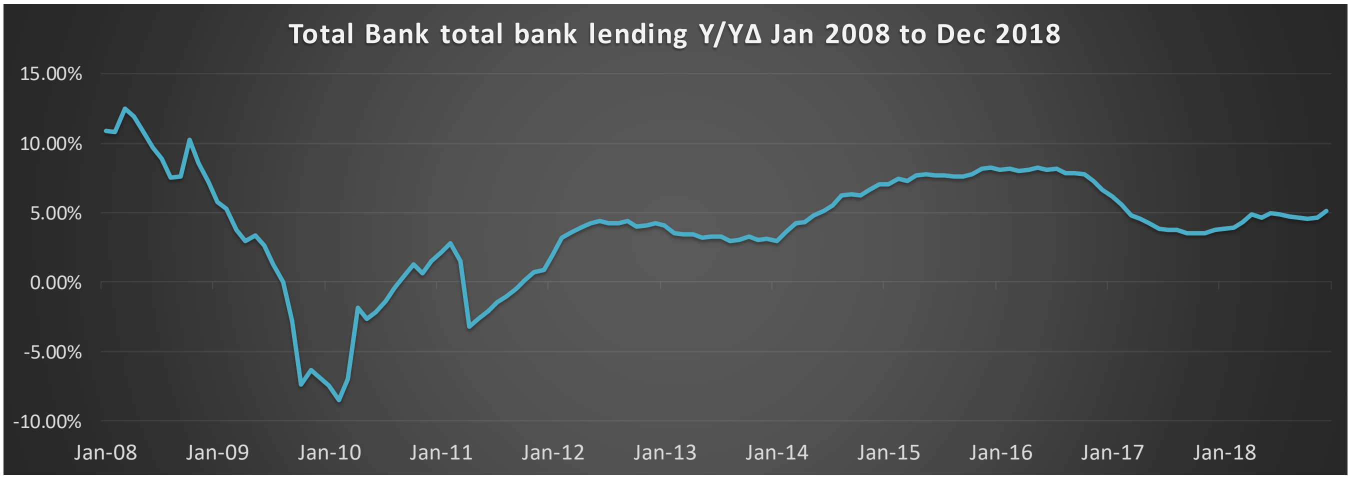
Source: Fed, SISR

Over the past couple of months, we at SISR had anticipated the recent correction when we observed that the Fed had increased their balance sheet drawdown from 25B to 50B in one month, noting that M2 growth was grinding to a halt, and observing that with M2 growth at 2% annually or less, the economy would be in recession within the year. This narrative of an expectant recession gained currency within the markets, although with different arguments, and a 19%-year end correction wiped out all the 2018 market gains.

Then in very late December of 2018 after the anticipated December Fed rate hike, the Fed talking points signaled to the markets that the market expectations of further rates hike and rapid drawdowns may have been overdone. We quickly noted last month that one should not focus on what is said but to focus on what the Fed is actually doing. Over the past month or so money supply has spiked to over 7.8% on a 3-month annualized basis (Figure IA), and the balance sheet drawdown have slowed significantly back to the 25B to 30B per month range down from a recent high of 75B per month, prior to the Fed receiving "its memo" (Figure IB).

With bank lending accelerating especially C&I loans (Figure III) if the Fed were to keep their balance sheet drawdown in the 30B per month range the growth in bank lending would compensate for the drawdowns and not cause any problems for the economy, while letting M2 growth expand in the optimal 5% to 6% desired range helping to generate a high 2% GDP growth rate with slight inflation under 2.5%.

Figure III: Total Bank lending Y/Y Change Jan 2008 to Dec 2018 with table breakdown by lending sector



Total Bank Lending by Subgroup Y/YΔ

Date	Total Bank Lending	Total Real Estate loans	Residential Real Estate Loans	Commercial Real estate Loans	Commercial & Industrial Loans
Jun-17	3.85%	4.75%	3.92%	8.27%	1.80%
Jul-17	3.75%	4.59%	3.87%	7.96%	1.53%
Aug-17	3.73%	4.26%	3.56%	7.55%	1.98%
Sep-17	3.54%	3.90%	3.57%	6.71%	1.62%
Oct-17	3.52%	3.90%	3.82%	6.42%	1.06%
Nov-17	3.55%	3.98%	4.09%	6.34%	0.63%
Dec-17	3.80%	4.13%	4.40%	6.24%	0.98%
Jan-18	3.84%	4.05%	4.60%	5.81%	1.20%
Feb-18	3.94%	4.16%	5.04%	5.63%	1.35%
Mar-18	4.30%	4.23%	5.47%	5.44%	2.86%
Apr-18	4.85%	4.15%	5.63%	5.17%	4.67%
May-18	4.63%	3.68%	4.67%	5.13%	4.64%
Jun-18	4.95%	3.69%	4.63%	5.23%	5.38%
Jul-18	4.84%	3.49%	4.50%	4.92%	6.03%
Aug-18	4.73%	3.39%	4.47%	4.74%	5.81%
Sep-18	4.67%	3.72%	4.60%	5.29%	5.49%
Oct-18	4.57%	3.39%	3.86%	5.22%	6.36%
Nov-18	4.64%	3.03%	3.33%	4.90%	7.96%
Dec-18	5.13%	2.88%	3.12%	4.76%	9.68%

Source: Fed, SISR

For several years now, we have been discussing the most thought out QE exist strategy as developed by Bernanke when he was Fed Chairman and the architect of QE.

Bernanke and the exit strategy:

The rise of excess reserves:

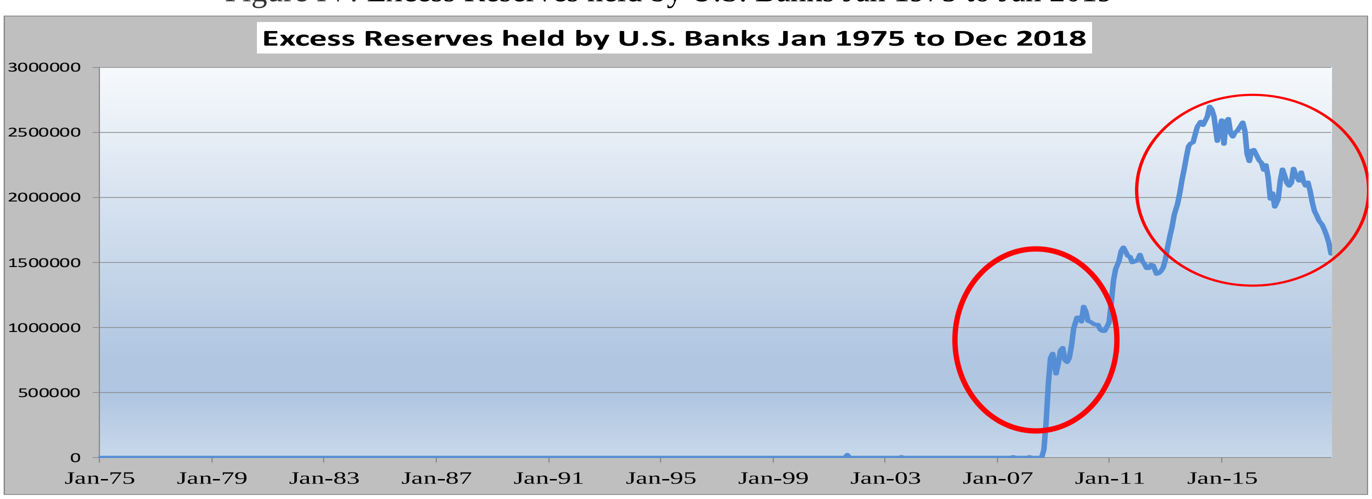
Bernanke on February 10th, 2010 in testimony to the Committee on Financial Services of the U.S. House of Representatives presented testimony on the exit strategy. Bernanke stated:

> *I appreciate the opportunity to discuss **the Federal Reserve's strategy for exiting from the extraordinary lending and monetary policies** that it implemented to combat the financial crisis and support economic activity.*
>
> *Broadly speaking, the Federal Reserve's response to the crisis and the recession can be divided into two parts. First, our financial system during the past 2-1/2 years has experienced periods of intense panic and dysfunction, during which private short-term funding became difficult or impossible to obtain for many borrowers. The pulling back of private liquidity at times threatened the stability of major financial institutions and markets and severely disrupted normal channels of credit. In its role as liquidity provider of last resort, the Federal Reserve developed a number of programs to provide well-secured, mostly short-term credit to the financial system. These programs, which imposed no cost on the taxpayer, were a critical part of the government's efforts to stabilize the financial system and restart the flow of credit.[1] As financial conditions have improved, the Federal Reserve has substantially phased out these lending programs.*

The problem for present purposes was that the Financial crisis created "*intense panic and dysfunction, during which private short-term funding became difficult or impossible to obtain for many borrowers.*"

1. Translating into our language, *"the impossibility to obtain loans for many borrowers,"* translate to there was a rise in excess reserves (Figure IV).

Figure IV: Excess Reserves held by U.S. Banks Jan 1975 to Jan 2019



Source: Fed, SISR

2. The channel of effect of this radical expansion in excess reserves was its impact on M2 growth (Figure III).

Figure V: M2 growth Y/Y change Jan 2000 to Dec 2018

Source: Fed, SISR

Then Bernanke in an op ed for the Wall Street Journal on July 21, 2009 titled: "*The Fed's Exit Strategy"* filled in the details where he states:

> *"The exit strategy is closely tied to the management of the Federal Reserve balance sheet. When the Fed makes loans or acquires securities, the funds enter the banking system and ultimately appear in the reserve accounts held at the Fed by banks and other depository institutions. These reserve balances now total about $800 billion, much more than normal. And given the current economic conditions, banks have generally held their reserves as balances at the Fed.*
>
> *But as the economy recovers, banks should find more opportunities to lend out their reserves. That would produce faster growth in broad money (for example, M1 or M2) and easier credit conditions, which could ultimately result in inflationary pressures—unless we adopt countervailing policy measures. When the time comes to tighten monetary policy, we must either eliminate these large reserve balances or, if they remain, neutralize any potential undesired effects on the economy."*

Translating further:

3. *"The exit strategy is closely tied to the management of the Federal Reserve balance sheet. When the Fed makes loans or acquires securities, the funds enter the banking system and ultimately appear in the reserve accounts held at the Fed by banks and other depository institutions. These reserve balances now total about $800 billion, much more than normal"* This is fairly straight forward comment, the Fed balance sheet expanded to 800B.

   More importantly, this increase in the Fed balance sheet replenished M2 growth as seen in Figure III which was the main purpose of QE.

4. *"as the economy recovers, banks should find more opportunities to lend out their reserves."* This means as the economy recovers banks should start to lend more which in our language would start to lower excess reserves (Figure III).

5. ***"That would produce faster growth in broad money (for example, M1 or M2) and easier credit conditions, which could ultimately result in inflationary pressures" Translating as banks start to lend that would increase M2 too quickly, possibly causing inflation.***

6. ***"unless we adopt countervailing policy measures. When the time comes to tighten monetary policy, we must either eliminate these large reserve balances or, if they remain, neutralize any potential undesired effects on the economy."*** Translating: When M2 is expanding too quickly cause by higher bank lending the Fed can contract its balance sheet to reduce the rate of M2 growth and slow the risk of inflation.

The transmission mechanism for the exit strategy goes from excess reserves held by the banks to Money supply which leads to economic growth and possible inflation or economic stagnation. The Bernanke exit strategy was for QT to work, there must be a shared relationship between excess reserves declining caused by greater bank lending, in conjunction with the drawdown of the Fed balance sheet.

Today's Possible **Glaring problem**:

As shown above M2 growth is now growing at 7.8% on a 3-month annualized basis. This is a bit too high to prevent inflation, were this rate to continue for several month. Since, we all have slightly diminished confidence in the Fed that are not convinced that the Fed has fully embraced the nuances of the Bernanke exit strategy. It is our expectation that they may cut short, or reduce the Fed balance sheet drawdowns too quickly, to the point that with C&I loan growth, and the massive government deficit, will cause M2 growth to exceed its optimal 4% to 6% growth rate at full employment and possibly cause inflation. This may well be the next big challenge for the markets beginning in the Spring 2019.

However, having recognized that the Fed may have successfully adjusted its policy direction, everything could change on a dime, and again we will may be signing "all is well that ends well." In this respect we strongly recommend paying particular attention to the weekly Fed releases on M2 and on the Fed balance sheet levels and drawdowns.

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A price chart, with changes of ratings and price targets in prior periods, is included above, for all securities covered in this report.

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