October 2018

Dear Investor,

October has historically been a volatile month for the markets, and this past month witnessed some of the most volatile market action in years. Most major U.S. stock market indexes fell between 5% and 10%, and some of the most volatile declines were in the stocks that have been in the very center of this market bubble, such as the FANG stocks. Equity markets outside the U.S. fell as well.

The most interesting aspect of the market action over the past month was that the volatility appeared to be triggered by a sudden concern about rising interest rates. Short-term interest rates have been rising all year, and longer-term rates, such as the 10-Year Treasury yield, have trended higher this year as well: from 2.41% at the end of 2017, to 3.06% at the end of September. However, the yield on the 10-Year Treasury began a spirited move up above 3.1% at the beginning of October, and it was that same week that stocks began to fall. At the end of this month, the yield on the 10-Year Treasury remained higher, at 3.14%.

We mentioned in last month's letter, and we'll highlight it again toward the end of this letter, that if the 10-Year yield rose much more than it had already, it could usher in a new era for long-term interest rates. Since the early 1980s, investors have known only one long-term interest rate trend, that of falling short-term and long-term rates. More than any other market trend, this supported the expansion in the stock market's valuation. Yet the Fed has been increasing short-term interest rates for two years now, and in fact the 13-Week T-Bill yield peeked above the year-over-year percent change in the Consumer Price Index in October. This was the first time since 2007 that the real, inflation-adjusted 13-Week rate was positive with interest rates not pinned to zero, and it's no coincidence that market volatility increased with the first sign of positive real rates.

The economy, the financial markets and the housing market have all been living with negative real interest rates for a decade now, and while those rates helped prevent a deflationary debt spiral in the wake of the financial crisis, they also inflated a broad-based bubble in the financial markets. A return to positive real interest rates would have far-reaching consequences, and it's clear by the reaction this month how vulnerable risk assets are to any positive real interest rate. With the U.S. stock market still near twice its long-term median valuation, there is little, if any, margin of safety built in to today's stock prices in the absence of extraordinary monetary support from the Fed.

In this month's letter:

- The History of Fed Independence Is Less Independent Than Commonly Believed
- The Line That Was Crossed in October

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The History of Fed Independence Is Less Independent Than Commonly Believed

> *Institutions both shape the society of which they are part and adapt to the dominant views in that society. Although the Federal Reserve was independent of the day-to-day political process, the public, acting through its representatives, could insist on structural changes or, without formally changing structures, demand that the Federal Reserve undertake new responsibilities or give up old ones. No institution can be independent from this pressure to change.*
>
> \- From *A History of the Federal Reserve, Volume I*, by Allan Meltzer

We have read and written a lot about the Federal Reserve over the years, and this has not been without reason. Fed policy has had an increasingly strong influence on financial market trends since the time of the Asian financial crisis in 1998, and the Y2K problem in 1999, and it's difficult to think how one could have understood the bubble/bust nature of the markets since the 1990s without an understanding of how overbearing monetary policy can drive markets to extremes. Yet despite being aware of what the Fed has been doing over the last two decades to influence markets, not long ago it seemed it was time for a deeper dive into the Fed's history. In light of our deleveraging economy and the rapidly mounting national debt, it was time to learn how the Federal Reserve had managed through some of the more difficult economic times in our country's history on a more granular level.

Part of this effort has been reading Allan Meltzer's three-part series, *A History of the Federal Reserve*, which offers a meeting-by-meeting account of the Fed's deliberations and decisions from its earliest days through the 1980s. The first book in the series covers the years from the Fed's founding in 1913 through 1951, and it is one of those books that serves as a detailed summary of the early years of one of the most powerful institutions of our government — but one which almost no one will read, because, to say it plainly, the subject matter does not exactly lend itself to page-turning drama. Yet be that as it may, the overall effort is an important study on how a powerful government institution can play a role in transforming society, for better and worse.

There are many take-home lessons from the first book, as it covers the years of the 1920s bubble, the Great Depression, and the years during and just after World War II. However, one of the most relevant lessons for us today is how the Fed began those years as a more or less independent institution within the government, and ended those years as a subservient arm of the U.S. Treasury.

First, some needed context. The Great Depression and World War II saw an astronomical rise in government debt, and as the national debt rose, Fed independence correspondingly declined. In 1929, federal government debt was $17 billion (just 16% of GDP), but by 1946 the it had climbed to $271 billion (119% of GDP), a nearly 15-fold increase. More than any other financial trend during the time, this increase in debt fueled a transformation of the American economy from top to bottom, but in the process, it more or less transformed the Fed into a debt nanny. In effect, the rise of federal debt in the 1930s and 1940s converted the Fed from an independent agency of monetary policy, which had sought to keep the nation on a sound monetary footing over the long term, into an institution whose policy goals by the end of the 1940s had been whittled down to managing the economic consequences and potential market impacts of all the various bond maturities that made up the national debt.

The overall arc of that transformation is a fascinating study of mission creep and the evolution of policy inside a government institution as it is painted into a corner, largely by forces outside of its control. The reason this is relevant today is that a similar process may have begun unfolding right before our eyes, though the early signs of that process are often subtle and hard to notice without an understanding of how the transformation in the 1930s and 1940s began. Yet if projections for the national debt over the next decade prove to be anything remotely close to forecasts, U.S. monetary policy may already be on a trajectory toward a much less independent future.

This past month, President Trump publicly made his feelings clear about the Fed's campaign to increase interest rates. As headlines appeared that the federal government's deficit had increased 17% to $779 billion during Trump's first full fiscal year in office, and is set to hit $973 billion in 2019, the President lashed out with criticism of the Fed's interest rate increases, and voiced his displeasure with the man he had nominated to lead the Fed — Jerome Powell. After decades of public reverence for the leaders of the Fed by political leaders, especially during the latter years of the Greenspan era, the criticism by the President over the past month marked a moment of sharp contrast that sent a mild shock through the Fed-watching community.

However, although public criticism of the Fed has been a rarity, especially in recent decades, political pressure on the Fed from the executive branch has been far more a part of its history than is commonly known. In the post-war era, presidents of both political parties have at times tried to exert pressure on monetary policy to serve political ends, and many times that pressure has had the desired effect. Sometimes that pressure came in the form of a president personally requesting the Fed to alter its plans. Although examples of this are too numerous to list here, Nixon's pressure on Arthur Burns for an expansive monetary policy ahead of the 1972 election stands out as a particularly well-documented episode. And sometimes, that pressure came in different, softer forms. In the 1950s and 1960s, "working groups" of White House and Fed officials were common, and although these groups were ostensibly formed to "facilitate communication" between government branches, they were really forums in which administration officials would often pressure the Fed on monetary policy.

The attempts to nudge monetary policy in politically expedient directions in the post-war era have been real and they have had a deleterious effect on the dollar over time, but the roots of modern-era political influence on monetary policy date back much further, to two events prior to World War II: the establishment of the Federal Reserve system itself in 1913, and the Banking Act of 1935. The former event created a network of regional reserve banks that asserted control over monetary policy in their respective regions, and the latter event centralized control of that entire network in Washington, D.C.

Political considerations had been part of decision making at the Fed since its founding. It was only a few years after the first Fed meetings in 1913 that World War I began to impact thinking at the New York Fed, which was by far the most powerful regional Fed bank, and when the U.S. entered the war the Fed agreed to help the federal government finance the war effort. During the 1920s, politics again played a strong role in decision making, as the New York Fed felt compelled to aid European countries to regain their footing after the war. These international political considerations had a significant impact on monetary policy in the 1920s, and that political influence grew exponentially when the Great Depression began. As one reads through the policy debates and decisions through the 1930s with the benefit of hindsight, there is an unmistakable trend toward political control of monetary policy as economic conditions worsened and government indebtedness grew.

When President Franklin Roosevelt devalued the dollar against gold in 1934, it symbolized the first major intervention of the executive branch into the realm of monetary policy, and it was not the last. After the devaluation, the Treasury had a large "profit" on its gold reserves, because those reserves were now worth $35/oz instead of $20.67/oz, and it used this profit to create what was called the Exchange Stabilization Fund. Throughout the rest of the 1930s, the Treasury threatened to engage in open market operations of its own using the Exchange Stabilization Fund and other vehicles when the Fed proposed changes in monetary policy the Treasury didn't agree with, and this had the effect of corralling decision making at the Fed into line with what the Treasury wanted. This corralling was made easier after the Banking Act of 1935 was passed, as it consolidated decision-making authority at the Fed into the Washington, D.C.-based Federal Reserve Open Market Committee (FOMC).

With authority over monetary policy concentrated in Washington, D.C., instead of dispersed among all the regional reserve banks, the Treasury was able to effectively get the monetary policy it wanted — which, at that time, was centered around selling Treasury debt at low interest rates. There are many episodes of the Treasury exerting its influence on the Fed's decision making during this era, but we'll highlight this one episode as an example of many other similar interactions.

* * *

In early 1937, the yield on government bonds fluctuated in a tight range between 2.46% and 2.48%. This tight range was being partially maintained by the Treasury department, which was headed by the Secretary of the Treasury, Henry Morgenthau. With the government borrowing billions of dollars a year from the bond market, Secretary Morgenthau considered it critical to maintain market rates on Treasury debt near all-time lows, so as to minimize the government's interest expense in selling new notes and bonds. However, despite the Treasury's efforts to keep yields in that range, on March 12 the bond market sold off somewhat, and the yield on Treasury notes rose to 2.52%. This was a relatively minor market move, just 0.04% above the prior range, but it was large enough to alarm Secretary Morgenthau. In response, he called on Mariner Eccles, the Fed's chairman, to begin purchasing bonds from the open market to keep the yields on government bonds at 2.5% or lower.

On March 13, the day after the rise in yields and Secretary Morgenthau's meeting with Fed Chairman Eccles, an emergency meeting of the Open Market Committee's Executive Committee was held. The Fed governors considered the recent rise in Treasury yields, but concluded 1) it was not a very large market move, 2) Treasury yields remained near all-time lows, and 3) it was not a market move that was caused by any of the Fed's current policies. After their meeting, they then informed Secretary Morgenthau that the Fed did not consider the move higher in Treasury yields to be something that merited a response by the Fed.

Not satisfied with this response, Secretary Morgenthau responded with a threat: if the Fed would not agree to act to lower Treasury yields, the Treasury would end its sterilization of gold inflows. Since this would have the effect of allowing the base money supply to rise, and thereby fueling inflation, which the Fed was at that time seeking to curb, the members of the FOMC hastily agreed to a compromise: they would authorize the purchase of $250 million of Treasuries to support the market, *if* an emergency arose. Secretary Morgenthau agreed with this policy, and, for the moment anyway, tension between the Treasury and Fed eased.

But the relative peace between the Treasury and the Fed did not last long. Over the next week the yields on Treasuries continued to rise, hitting 2.62% on March 18, and rising further to 2.72% the week of March 27. Secretary Morgenthau now considered the 0.3% rise from the prior range of yields to be a full emergency. Yields continued to rise the following week, to 2.78%, and on April 3, a Saturday, the full FOMC met to consider monetary policy. Despite the rise, the committee members still considered the market to be orderly, and did not think market conditions represented any kind of emergency. However, committee members were split on whether to begin market purchases, with some concerned that if they did not act, the Treasury would act on its own — and the Fed would lose control of monetary policy in the process.

Later that afternoon, Secretary Morgenthau and Fed Chairman Eccles met with President Roosevelt, and the three attempted to find a solution that would end the standoff between the Treasury and the Fed. The President proposed a compromise: Secretary Morgenthau would inform the FOMC that if the Fed did not fulfill the responsibilities that had been given to it by Congress, the Treasury would act alone. By this time, Secretary Morgenthau was incensed at the Fed's inaction, and apparently intended to act regardless of what the Fed decided to do. At another meeting at his home later that evening with the New York Fed President William Harrison, he snapped: "You people just don't want to admit that . . . you monkeyed with the carburetor and you got the mixture too thin. . . . You give us this policy now!"

When all the members of the FOMC met again the next day, and were informed of the Treasury's intention to desterilize gold inflows if the Fed did not start buying notes and bonds to lower Treasury yields, the FOMC voted to begin purchases immediately, and to purchase the full $250 million by the end of the month. Even the members of the FOMC who were against the purchases on the basis of the action in the bond market thought it more important to maintain the Fed's authority on monetary policy than to cede practical control to the Treasury. In other words, the Fed's decision support the Treasury market in early 1937 was not a decision based on market conditions, but one that was made purely from political pressure. In the months that followed, yields on Treasuries declined, while the Fed's balance sheet expansion from the purchases remained.

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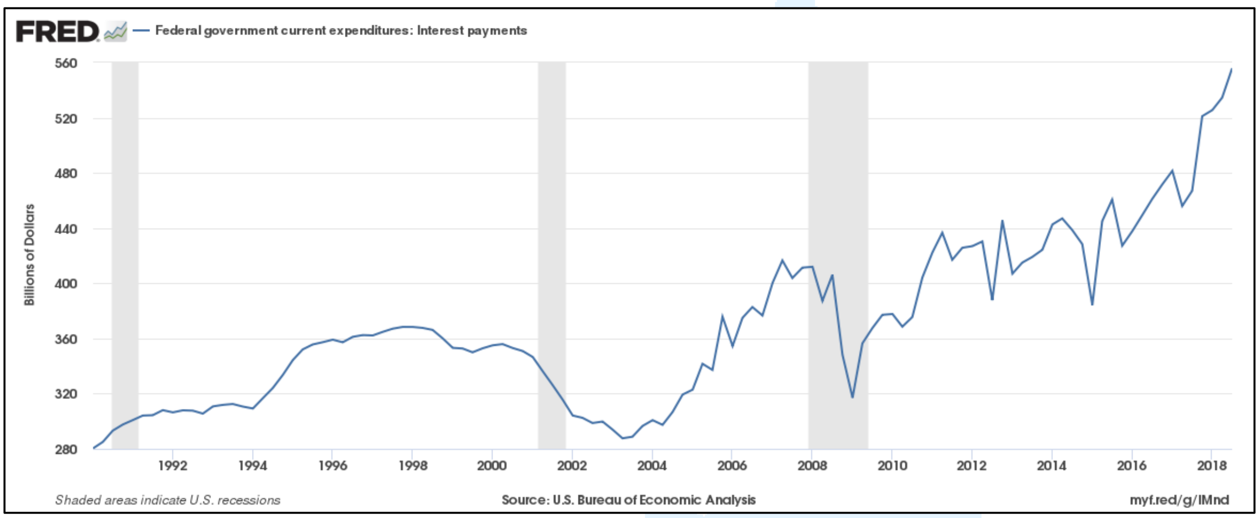
In the years that followed this episode in 1937, the Fed would find itself increasingly hemmed in by political pressure from the Treasury, and by 1942 the Fed had agreed to maintain a policy of fixed low rates on all Treasury debt — including new issues. On a practical level, this meant that the Fed was committed by buying all the Treasury notes and bonds from the open market that were necessary to maintain 90-Day T-bill interest rates at 0.375%, 1-Year rates at 0.875%, and long-term rates at 2.5%, or below. This allowed the Treasury to finance the war effort with new notes and bonds at favorable and dependable interest rates. The Fed was also committed to buying bills, notes or bonds offered by the Treasury that were not bought by the public in war bond drives.

What had begun in the mid-1930s as Treasury pressure to support the bond market when yields rose, ended up as a policy of pegged rates on a soaring national debt that remained in place until the 1950s, all facilitated by monetary expansion. Although the years during WWII were a unique time in the history of this country, and the history of the world, this is a progression that appears to be embedded in any system in which there is central control of monetary policy — because we have seen the same progression again and again throughout history, all the way up to the present day. As we have discussed, the Bank of Japan is currently keeping rates on its government notes and bonds pegged near zero, so the government can afford its enormous debt, and as in the U.S. in the 1930s and 1940s, it is all made possible by a dramatic monetary expansion.



Although Fed officials are not elected by the public, they have not been immune to political pressure from those who are elected by the public. This past month, the Treasury quietly announced that it anticipated needing to borrow $1.34 trillion over the course of the 2018 fiscal year. It was also reported recently that interest on the existing national debt, shown in the chart above, is set to become the largest single expense item in the Federal budget in the current fiscal year, rising above the military's official budget. These trends place the Fed in a situation that should sound familiar to anyone familiar with the battles between the Treasury and the Fed in the late 1930s, and it is in this context that we heard the President's recent public criticisms of the Fed. Unfortunately, we have no way to know whether there is political pressure currently being applied to the Fed behind the scenes, but circumstances certainly seem ripe for such pressure to begin. In the years ahead, as the national debt soars toward $30 trillion and beyond, the Fed may well find, as it did in the 1930s, a growing gap between the monetary policy it would ideally like to implement, based solely on economic and market conditions, and the monetary policy that is politically and fiscally achievable.

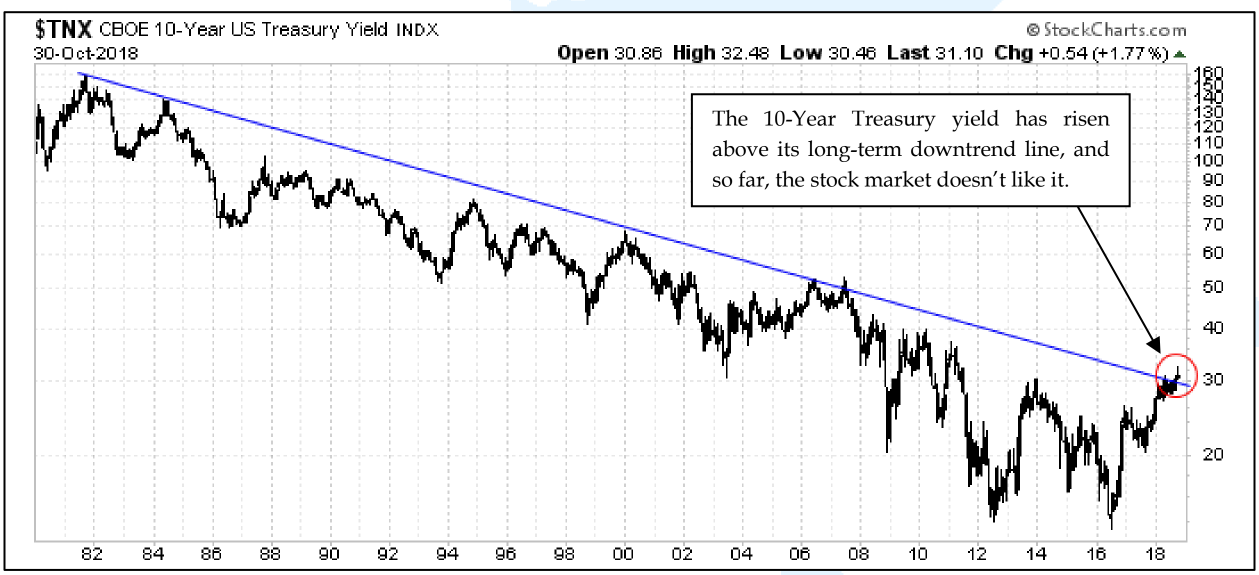
The Line That Was Crossed in October

When interest rates rise and monetary conditions tighten in an extremely overindebted environment, something eventually breaks and triggers a cascading market response. What's unknowable is just what that trigger will be, and when.

- September Client Letter

Only a few days after we sent out last month's letter, the yield on the 10-Year Treasury note rose above its long-term downtrend line, which we highlighted last month with the chart below. It appears this was a significant moment, not just because the 10-Year Treasury yield moved through a line on a chart, but because the very same week, the stock market began to decline in a meaningful way. All of a sudden, the markets started caring about higher interest rates.

A similar market dynamic took place in 1965 and early 1966, at the beginning of the long-term bear market that lasted until 1982. Although yields on long-term Treasury bonds had been rising very modestly from the start of the decade, in 1965 the market dynamic suddenly changed, and Treasury yields began moving higher in a much more volatile way. Within months of that shift in the bond market, the stock market hit its highest valuation for that cycle, and also began to trade in a much more volatile way. Although it was impossible to imagine at the time, these little market tremors were the beginning of a very different market environment than had been in place since the late 1940s. Over the subsequent 17 years, the yield on the 10-Year Treasury note would rise from the 4.2% yield seen in the summer of 1965, all the way up to 15.9% in 1981. Over the same period, the stock market's valuation would fall 73%, and the real price of the S&P 500 would fall 62%. These dramatic long-term trends didn't start out dramatic, however — they began with a modest, but notable uptick in volatility, and a coincident decline in stocks and bonds, not unlike the market environment this year.



With long-term interest rates having reached all-time lows in 2016, and with the stock market rising into valuations that have in the past only occurred within a market bubble, we have been suggesting for some time now that the years ahead may feature a market dynamic that is completely hostile to the standard diversified portfolio of stocks and bonds. This year we have perhaps seen a preview of such a market dynamic, as both stocks (e.g. the NYSE Composite) and bonds (of many stripes) have fallen modestly from their levels at the end of last year.

However, none of what has transpired in the markets this past month, or this year for that matter, should be construed as anything resembling a long-term market bottom, or a “buying opportunity,” any more than the shift in 1965 and 1966 did. Once valuations in stocks reach as high as they have over the past few years, it takes many more years for valuations to fall to levels that give investors a reasonable chance of a positive long-term return. During that reversion, investors swim at their own peril against a very strong ebb tide. After the 1965/1966 shift in the markets, it took eight years for the stock market to reach a nominal price low, and twice that long before valuations stopped falling and gave way to another long-term bull market. Throughout such long, extremely volatile periods, it can be difficult to earn a positive return without a willingness to be independent, nimble and strategic when deciding which assets trade in and out of through the volatility, and which asset classes to invest in for the long term.

In the period following the current bubble, we continue to believe precious metals and other select real assets will be one of the few asset classes to invest in for the long term, because they will benefit from the monetary response which will likely accompany the soaring national debt. As the Fed finds itself increasingly hemmed in by the political and fiscal realities created by the increasing national debt, monetary policy will likely veer ever further away from the path the Fed would follow otherwise, just as it did in the 1930s and 1940s. In the widening policy gulf between the monetary policy the Fed would pursue based solely on economic and market conditions, and the one that proves politically palatable and fiscally realistic in light of a rapidly growing national debt, bull markets in precious metals have in the past filled the vacuum, and they will likely do so again over the next decade.

As always, if you would like to discuss investments in your account, or topics discussed in this letter, feel free to contact us — we would be happy to talk with you.

Sincerely,

Brian McAuley
Chief Investment Officer
Sitka Pacific Capital Management, LLC