



# 10 Year Treasury Yields at Zero, and Why Fiscal Stimulus and Modern Monetary Theory are Financial Follies

Those of us of a certain age can remember watching Saturday afternoon black and white reruns of Laurel and Hardy films. Invariably, after a series of laughable misunderstandings and comic mistakes Hardy would lament to sidekick Laurel, “Well, here’s another nice mess you’ve gotten me into!” Well, today’s Federal Reserve (Fed) reminds me of the well-meaning, but often bumbling Laurel, while pompous and stubborn Hardy is today’s bond market. Unfortunately, the mistakes are no longer playing out in grainy black and white, but in vivid color for all to see.

## A fine mess indeed...

In late September, we saw the Fed—which had made historic purchases of U.S. Treasury and mortgage obligations across the term structure in an effort to influence yields and engender a more robust economic recovery—step back into capital markets to provide overnight and term financing for leveraged financial institutions and funds.

## So much for free and unfettered markets...

Quantitative easing (QE), the novel “wet index finger in air” attempt of Takahashi Korekiyo to reflate Japan in the 1920s, was refined, appropriately quantified and ultimately academically anaesthetized by economist Ben Bernanke to become accepted monetary policy doctrine—just in case of an emergency. Well, the economic emergency came, and the expected growth and strong recovery have not followed— just ask the average American—or better yet, the Japanese and Europeans who’ve had it much worse, and taken the monetary policy experiment even further.

The attempt to exit QE has been anything but watching paint dry. *As far as I know, there aren’t any historical examples where QE was exited “smoothly.”* Korekiyo was assassinated by a military aligned with imperial ambitions, so he never saw the tragic results of his desperate and unorthodox policies; remember, he had had limited formal schooling.

## Coming to you: negative or near-zero yields on Treasury notes...

The discussion around QE and its very weak, flimsy logical underpinnings matter, because I believe that 10-year U.S. Treasury yields may approach zero in the next period of weak economic growth—the Japanese and some European economies have already beaten us there. How different is the U.S. really than those economic zones? The U.S. also has low birth rates, aging demographics, weakening productivity, and broadly increasing aggregate debt burdens.

The policy of QE has become a proverbial “Hotel California”: you can check out any time you’d like, but you can

never leave. The disruptions in overnight financing have been brought on by a host of factors including a preference for liquid reserves by the major money center banks due to a panoply of regulatory terms only a bank treasurer can appreciate and understand: HQLA<sup>1</sup>, SLR<sup>2</sup>, LCR<sup>3</sup>, etc.

But the undeniable issue is that the Fed has once again been forced to expand its balance sheet, but this time during relatively strong economic times, with wages rising and unemployment plumbing new generational lows. Against this backdrop, to expect 10-year Treasury yields to fall 200 basis points as the U.S. economy approaches the depths of a normal economic recession does not seem unthinkable to me.

So, prepare now for even lower Treasury yields over the next few years...just in case. A fine mess, indeed!

*Part 2 of my blog will examine why fiscal stimulus and modern monetary theory are more financial folly than a pragmatic panacea.*

<sup>1</sup> High-quality liquid assets

<sup>2</sup> Statutory liquidity ratio

<sup>3</sup> Liquidity coverage ratio

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