Tuesday, August 26th, 2019

Dear Chris,

For all his bluster and braggadocio it cannot be denied that President Trump, the NYC real estate impresario, has an intuitive grasp of the financial plumbing of interest rates; he has, after all, gone bankrupt a number of times. Whether it's this memory or telephone calls from his nervous New York network something has caused Donald to declare the Fed Chairman an enemy of the US economy. But looking at the economic data this is hard to understand. Why should interest rates need to decrease? Isn't unemployment at an all time low? Isn't the US economy still growing, maybe at a slower pace? What is all the fuss about? What is the plumbing 'back up' that is irking the Developer in Chief?

Perhaps the problem is staring us in the face:

The 30-year US Treasury is paying 2.0% per annum whilst the overnight rate for money left at the Fed is 2.1%.

The US Treasury is the world's highest form of collateral. It is the ultimate 'safe haven' asset and, until the financial crisis of 2008, it stood alone. After that point the US Federal Reserve offered financial institutions a Fed rate of interest for leaving their money with it. These were known as the 'Interest on Excess Reserves' (IOER) and the 'Overnight Reverse Repo Price' (RRP). Given that the Fed and the US Government are supposedly fungible, they represent the same credit. But today it is more profitable and flexible to keep rolling overnight money at the Fed rather than buying the long-term US Treasury.

We cannot have two prices of money for exactly the same risk, therefore, in layman's terms, there is indeed a pesky plumbing problem. Trump senses this, he knows the economy is backing up and the 'plumbers' he hired are not fixing it. They are either deliberately or are institutionally incapable, hence the recent twitter moniker of 'enemy' for his chief financial plumber - Jerome H. Powell, the Fed Chair.

Trade flare ups, Brexit outcomes, Hong Kong riots, and presidential twitter-bursts pile political debris on to the current plumbing problem, creating the stench of volatility. But the key issue remains - how to fix the plumbing?

It is rather simple, the Fed rate cannot be higher than US Treasury rate. The Fed is a subordinate institution to the US Govt and being the Government's banker it cannot be in competition with it in rates or sizes of trades. But the Fed suffers from an institutional inertia that hinders it in this new world of low interest rates and massive balance sheets. Plumbers are hard to change, but can also then be fired.

See you on your return from Karachi next week - Mustafa.

Christopher Andrew
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