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Special Report

April 2011

Systemically Significant Positions

March 31, 2011 Conference Call

(This transcript has been edited)

James A. Bianco, President, Bianco Research: Good morning, everybody, this is Jim Bianco. Welcome to the Conference Call.

Summary/Conclusion

Today's topic is "Systemically Significant Positions." That is a play on the Dodd-Frank Bill about systemically significant firms. It is an outgrowth of what we were talking about with the immediate aftermath of the Japan earthquake and the intervention of the G7.

Are there positions in the Market that are so important that you could almost deem them to be systemically significant? Specifically, the yen is not allowed to rise, equity prices are not allowed to fall, and central banks and governments themselves will pull out any and all stops in order to do what is necessary to ensure that those trends do not happen, that is the yen rising or equity prices falling. I believe that the answer is "yes," and I believe that the answer is "yes" in regard to that fact that that has been a longstanding policy with QE2.

To that end, I wanted to review with QE2 a little bit about how much QE2 is left to be purchased and how QE2 has been affecting the Stock Market because I do think that there is a little bit of confusion about that.

That will launch us into a larger position about systemically significant positions and about the carry trade or the perception of the carry trade in Japan.

We'll then talk a little bit about the systemically significant positions in Europe with what is happening there.

Then we will discuss what upsets this equation because what I want to try to make the case for is that we have been having these markets driven by liquidity, and it is all good right now because we have got the central banks of Japan, which might have actually started QE3, once we look at their balance sheet, and the central bank of the United States – the Federal Reserve – pumping in a lot of liquidity that is helping to push up asset prices. They are on the fast track to the Nobel Prize for Economics except for if this little thing called inflation gets in the way. I want to measure inflation by looking at inflation expectations more so than the debate about core headline. If they should wind up getting high, then that could upset things. And I think that is a possibility that we could see happen before the end of the year.

Is QE2's Purpose to Create a Stock Market Bubble?

So, with that as a little bit of a backdrop, let's start on Page 3 of the handout – "Is QE2's Purpose to Create a Stock Market Bubble?"

There is still a little bit of debate about this. In my mind, there is no debate about this; this is a statement of fact, that, yes, the purpose of QE2 was to create a Stock Market bubble. How do I say that it is a statement of fact? This is because Ben Bernanke made it a statement of fact.

Again, I have used this quote before a number of times – his op-ed from *The Washington Post* of November 4 – "Higher stock prices will boost consumer wealth, help increase consumer confidence, spur spending. Increased spending will lead to higher incomes and profits that, in a virtuous cycle, will support the economic expansion." So that is Bernanke's thought on November 4.

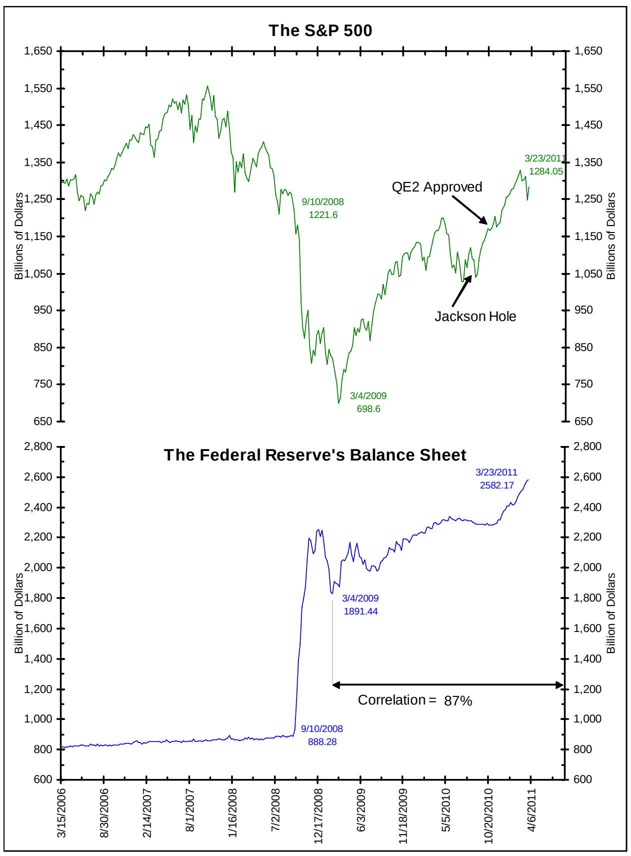
Then, when the Stock Market started moving up, back in January, CNBC had a clip of him in January saying, "The policies have contributed to a strong Stock Market as they did in March of 2009 when we did the last iteration of this" – referring to QE1 – "the S&P is up 20 percent, and the Russell 2000" – which is about small-cap stocks – "is up 30 percent-plus." That is Bernanke speaking. So let's leave no doubt now that the Federal Reserve believes that QE2 has contributed to a higher Stock Market.

I would agree with the Fed that it has contributed to a higher Stock Market. What does that mean? This is a debate that we are having right now. What would happen if QE2 were to stop?

Goldman Sachs's Jan Hatzius has coined a new phrase for this, which is "cliffing." The idea of "cliffing" is, when a Federal Reserve stops with quantitative easing, then do we have a Market that cliffs, that turns and falls lower? The answer to that question is that we don't know. Of course, Goldman Sachs has concluded that they don't think that we will see cliffing. But I like the idea that we are now inventing terms for a lot of these things that we were talking about regarding what happens when QE2 ends, and the nice, neat phrase that Goldman has invented for us to use that is called "cliffing."

Stocks Love QE2

There is some logic to that because, if you go to the chart on Page 4, then you will see that, in the top of the chart, in green, is just a straight line chart of the S&P 500. Highlighted on the chart are the Jackson Hole speech, which is when Bernanke told us that QE2 was coming, and November 3, which is when QE2 was approved.



In the bottom of the chart is the size of the Federal Reserve's Balance Sheet. A number of people have pointed out that, since the Fed added to QE1 by going to $1.25 trillion of mortgages and $300 billion of Treasuries in March of 2009, there has been a very high correlation – 87 percent – between the Stock Market and the size of the Fed's Balance Sheet. The only correction that we have had of any significance in the last two years was between QE1 and QE2.

So there is no doubt in my mind that what QE2 has done is to help to lift the Stock Market. To that end, if we say that it has helped to lift the Stock Market, then that must mean that the Stock Market has gone something extra or somewhere where it wouldn't have without all of the liquidity.

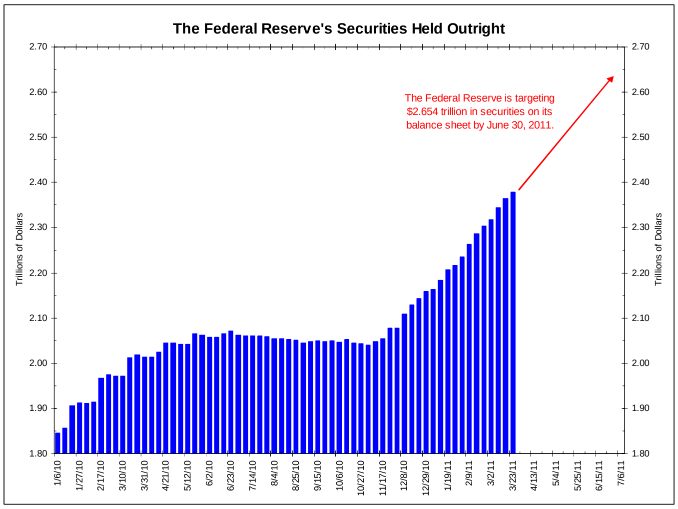
I have heard a number of people say to me, "Yes, I agree with you that QE2 has helped the Stock Market, but if the Fed were to stop with QE2, then valuations justify the current levels of everything, and there would be no correction." Well, then QE2 wasn't necessary, and it didn't help. This is because if it was purely about valuations, then the Market would have been here anyway without QE2, and the Chairman is wrong in saying that QE2 has helped the Stock Market. I don't think that is the case. I think that you must have one or the other. Either QE2 has helped the Stock Market, and it has gone beyond what it would have gone, and so the absence of it would create correction in let's call them risk on markets – because it's not just stocks – or, if the Market is where it should be basis valuation, then Bernanke is delusional and he hasn't helped the Stock Market. You cannot say both – "Well, he's pushed it up, but it is at a proper valuation anyway."

So I think that is an important distinction to be made, that that is the purpose of QE2. This is one of the systemically significant positions in the Market. "Stocks must go up," Bernanke told us in November. He believes that will create wealth, it will create spending, and it will create profits that will support further growth in the Stock Market, which will eventually, in a virtuous cycle, create more economic growth, more jobs, and help Housing. That is what they are trying to do in the Marketplace right now.

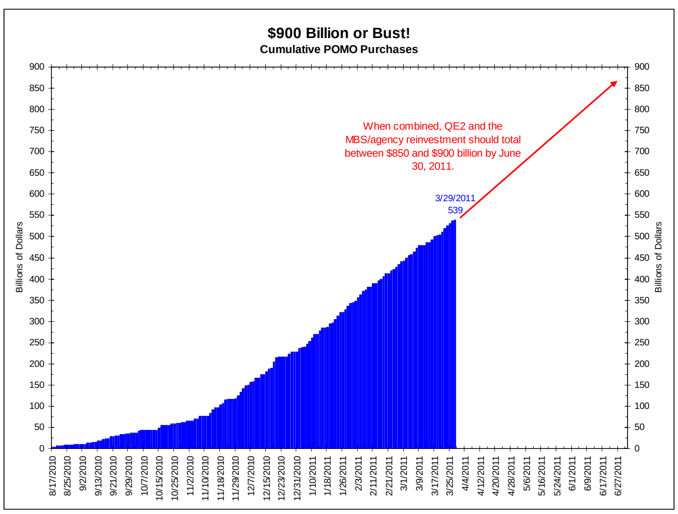
How Much Stimulus Is Left Before June 30th?

If we go to Page 5, I want to make a quick mention about this again. How does it work that the Stock Market is going up? Bernanke is raising his hand and saying, "I made the Stock Market go up," yet the Fed is buying Treasuries, and Treasury yields, largely since QE2 started, having been going down. So they buy Treasuries, Treasuries go down, the Stock Market goes up, and they take credit for the Stock Market. At some level, that also sounds like they are just searing for something pleasurable that is happening and trying to attach themselves to it. But I don't think that is necessarily the case. I do think that what has been happening is that QE2 has been helping the Stock Market, but I think that we need to understand the mechanism by which it has been helping the Stock Market.

First, let's review the charts on Page 5.



The bottom chart on Page Five shows the amount of securities held on the Federal Reserve's Balance Sheet. As the chart says on it, the Fed's target for the amount of securities on their Balance Sheet is $2.654 trillion by the end of June of 2011. You could see that with the red arrow that we drew on the chart, as well. That is what QE2 is eventually going to try to accomplish.



The top chart basically shows us the amount of purchases that it is going to take to get there. Remember that it is $600 billion of additional securities on top of reinvesting the mortgage coupons since last August. So far, roughly about $539- to $540 billion has been bought. They are probably targeting about $850- to $900 billion. So, all told, when you look at what is left to do, it is about $300 billion or so. Let's just round it off and call it about $300 billion left.

So how does this help to raise stock prices? Remember that we have talked about this before. POMO – permanent open market operations – occur everyday at 11 o'clock. Everyday at 11 o'clock, the Federal Reserve purchases Treasuries. Everyday at 11 o'clock, a group of Treasuries – say, $6 billion-worth of Treasuries – is converted to cash.

What happens with that cash? The Fed's Portfolio Channel Theory says that that cash will go where it is treated the best. Right now, that is risk on markets. Right now, as the Fed converts Treasuries to cash by purchasing them, that money tends to leak out into other places and in other ways in the Market. One of the big places that the Fed believes that it goes to – and I agree with them – is equities.

There was a story in *The Wall Street Journal* yesterday and there was a story last week, as well, about what is going to happen to Treasuries when QE2 stops. The assumption in the story is that the Fed is buying Treasuries to push down interest rates, and the Fed is adding to the Treasury Market. No, I think that it is the opposite – that the Fed is engaged in QE2 to get money out of Treasuries and get it into other places. One of the reasons why yields may have been biased at upward is because of QE2. And when it ends, it might have somewhat of a stabilizing force in interest rates.

Let me be clear on my word usage. I said "stabilizing force." I did not say that, when QE2 ends, rates are going to go down. There is not going to be money being pulled out of Treasuries anymore.

Remember that we have talked about this in previous Conference Calls. We have written about this a lot. In QE2, there is some evidence that the Fed might be overpaying for securities to encourage it to get out of Treasuries so that, when they convert those Treasuries to cash, at that moment, Treasuries are overpriced. So you don't definitely do not want to do an about-face and put your money back into the Treasury Market.

A great example of that was on St. Patrick's Day. That was the day that, at five minutes to 11, all of the dealers started submitting their offering prices for that day's permanent open market operation, which was in the five-year sector. At four minutes to 11, there was a story on the wire that the Energy Secretary recommended that all Americans within 80 kilometers get away from the Fukishima Nuclear Power Plant.

The five-year Treasury spiked a point in the next trade in five seconds off of that story. Well, the dealers that had put in their offerings to the Fed for POMO at 11 were then a point below the Market. They were on the hook to take a huge loss in the Market because the Market was trading a point higher. The Fed cancelled POMO. They cancelled it for an hour. They came back an hour later and said that volatilities had calmed down, and they redid it.

The cynic in me could say, "Yes, the purpose of POMO is to let the dealers rip the Fed off so that they can engorge their bonus pool. And the Fed wants to play along, and God forbid that there is a day when their bonus pool won't go up. We've got to stop this for an hour so that we could redo it again." But the economic argument would be that the Fed doesn't want money in Treasuries; they want money to be out of the Treasury Market and pushed into other places. That is why Bernanke said that he has been helping to push stock prices higher. I agree with him.

On the other side, Bernanke believes that it has been stopping at the water's edge of the Equity Market and not going into other places, like in the commodities markets and into the futures markets, per se. The only comment that I would give that – and it is something that we talked about on the last call and something that we have written about numerously over the last couple of weeks – is that the amount of speculation, the raw level of speculation of the net trader positions in futures contracts is, in many markets, at an all-time high. Prices aren't at an all-time high, but these are.

Typically, large traders or momentum traders and, typically, trends in markets will drive them. Yes, we have an uptrend and, yes, Bernanke is correct. And when I had Howard Simons on the call with me last time, when we were talking about inflation, yes, there are a lot of reasons to believe that commodity prices are in an uptrend regardless of the speculation. But we've got record speculation in a number of futures contracts right now. Especially in crude oil, it is off the scales how much speculation there has been in crude oil. Yet, Bernanke wants to say that none of that has been the case. I think that it terms the speculation that the current Fed policy has been a wind at its back.

So are there systemically significant positions? Yes, equity prices are one. The Fed has made it very clear that that is the purpose of QE2. This is the Fed, not even just my opinion. I am just reading Bernanke's words. If you look at the operation of how POMO works, it is actually an operation to get money out of Treasuries and get money into risk markets.

Did The G-7 Panic About The Carry Trade?

Let's go to Page 6. Did the G7 panic about the carry trade?

An interesting that happened right after the Japan earthquake was that, when I say Byron Wien on CNBC, he was saying that there were a number of unusual moves that didn't make any sense in markets. The questions that he posed were relating to why the yen was surging before G7 intervention. This was right after the earthquake on March 10 and before the G7 intervention on March 18.

Isn't the earthquake-nuclear meltdown bad for the Japanese economy and bearish for the yen? The answer is that, yes, it is bad for the U.S. economy and would, all things being equal, be bearish for the yen.

Why are U.S. stocks tanking? How is the Japanese situation bad for the U.S.? You could indeed argue that it is not that bad for the U.S.

Why were commodities tanking? This is in the immediate aftermath of the events in Japan two weeks ago. Doesn't the Japanese disaster create more demand even if it is short-term and artificial for commodities? You could argue that the answer is "yes."

So why did the markets make these positions? I think that a lot of people have been trying to torture the logic, as in, "Oh, it's in anticipation of repatriation" and things like that. I don't think that the first move in a market is necessarily a move based on fundamentals. Rather, the very first move in a market is based on positions, not on a change in the belief in fundamentals. If something happens where you need to de-risk (to use another invented word since that is what we do in this business), then the first thing that you do is look at where the positions are in the Market.

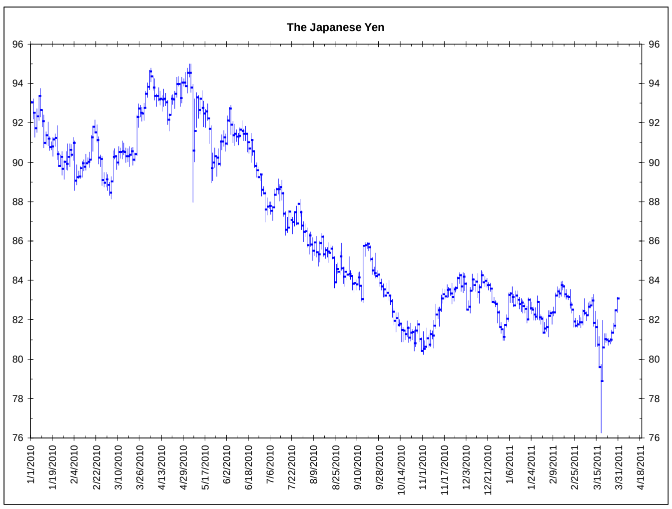
What I think that we learned and where I think that we are back to with the rebound in the Market, is that the Market is very long on commodities and the Market is very long on stocks. So when a black swan event happens, like an earthquake leading to a nuclear meltdown, if we want to reduce risks – I don't care what the fundamentals of the situation are – then reducing risks means selling commodities and selling stocks, and so they are going to go down. Even if the argument is that it shouldn't affect U.S. stocks or that it should be maybe short-term artificial demand because they are going to need a lot of commodities to rebuild Japan, it doesn't matter; the first thing to do to reduce positions is to sell commodities and sell stocks.

The next thing is that maybe there was a belief that the yen carry trade is still a force in the Market. Now, Howard has written in the last couple of days that it really isn't, though it might be coming back, but the G7 might believe that it was. The G7 might believe that, when leverage speculators were very short the yen, once their commodity and stock positions were liquidated, they had to buy the yen in order to close their financing positions in Japan. As a result, the yen surged, it hit stocks, and we went from 80 to 76.

What I thought was curious about that whole move was that, OK, the yen surged, but all things being equal, that is probably not a good thing for the Japanese economy. But the G7 couldn't even wait 24 hours before they stepped in, intervened, and help to push it right back up to above 80. Why not say, "Let's watch this for a week, 10 days, or two weeks, and let's see what happens with it?" Oh, no, it was almost as though there was instant panic from the Marketplace when the yen wound up diving underneath 76, and then the G7 had to step in and come back.

Do We Have Systemically Significant Positions?

So under systemically significant positions – and I'm on Page 7 right now – the answer is that, yes, we have another one. We have another one in the surging yen.



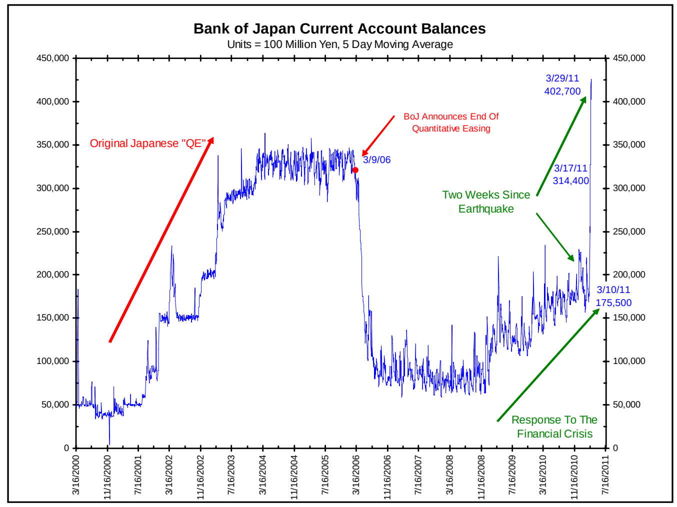
Ironically, while the yen carry trade might not be as big as it used to be, having been supplanted by the dollar carry trade and other things about which we have written a lot in the last several months, this move by the G7 might encourage it to come back because there is a belief that a surging yen is now systemically significant. You could finance in Japan with less currency risk now than you had before because you have the might of the G7, and that might make you want to have your positions stay with you.

Why Is The Market Rallying?

Let's jump now to Page 8 and talk about another type of move that has happened.

The Japanese Stock Market took a horrible tumble in the wake of the earthquake. Then, starting on March 18, it bottomed. It has had a very sharp rally back. It has gotten back most of its losses by now. There are a lot of torturous arguments being made about how this is going to increase GDP and how the Broken Window Fallacy doesn't exist anymore.

I think that that is all wrong. It is just another statement of fact. The Japanese economy combined with the nuclear meltdown is going to decrease the wealth of Japan. It is going to hurt the economy. Full stop, it is. There is no debate. That is what is going to happen. Why the Japanese Stock Market is rallying so tightly – we don't need to torture that statement in order to make it fit with a rising Japanese Stock Market.



Let's look at the Bank of Japan's Balance Sheet. This is the chart on Page 8.

As you will notice here, look at what has happened to the Bank of Japan's Balance Sheet in the almost three weeks now since the earthquake there. It was at 175, and now it is over 400. There has been more than a doubling of their balance sheet. It almost pulled off a doubling in two days back on March 17 and 18.

The Bank of Japan has increased its balance sheet by more in two weeks than it did between 2000 and 2003, which is when the term "quantitative easing" was invented. The Bank of Japan has done more with its balance sheet in this three weeks than it did between 2008 and March of this year in combating the Financial Crisis.

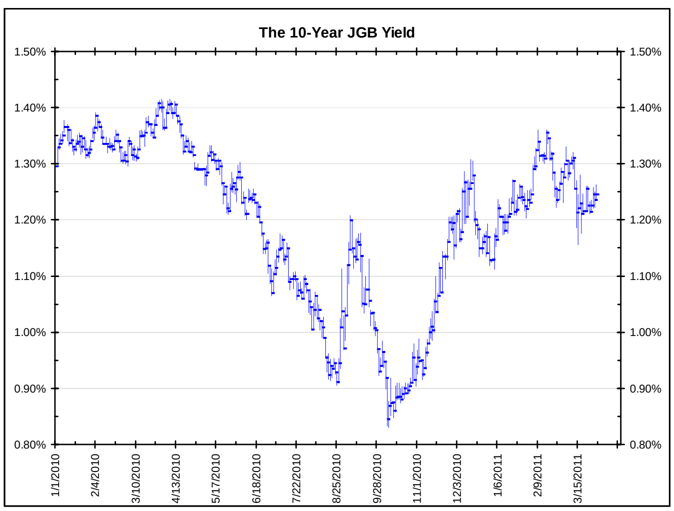
How can the Bank of Japan increase its balance sheet so quickly this way? It's all loans. For those of you in the U.S., remember back in September of 2008 when our balance sheet rose higher, it was that alphabet soup of health – the CPFF, the Money Market Investment Fund (MIFF), and the Asset Liability Management Fund (ALMF), too -- and all of those other in the alphabet soup of lending facilities, that everybody could come to the Fed and take out loans. Most of those have been closed by now. And that is what happened here with Japan. It's just that they surged out and lent out reserves to the banks to a degree that they have not seen.

Well, the Marketplace understands what this means. In the case of the Federal Reserve, as was the case with Japan, a surge in loans eventually gets replaced by a surge of securities buying, which has the operation of getting money out of, in their case, the JGB Market/in our case, the Treasury Market, and more toward risk on markets. That is where the surge in the Japanese Stock Market, I believe, is coming from, is that the Bank of Japan is creating all of the money that is going to eventually make its way toward the Tokyo Stock Exchange, and the purchases of those stocks are in anticipation of this coming. This is much like the purchases of stocks here have been driven by liquidity. The only slight difference in Japan is that the liquidity is a little bit more anticipatory as opposed to actual that we're seeing right here.

What upsets this scenario in Japan? Again, they are on the fast track to the Nobel Prize in Economics, as well, as long as they don't have inflation.

Why Is The Market Rallying - 2

If we look at the chart on Page Nine, here is shown the 10-year JGB. In the chart, the 10-year JGB has not been surging even though credit default swaps in Japan have been doing so. They have looked at the wall of money. They have been comforted in the 10-year JGB that it is not going to be inflationary.



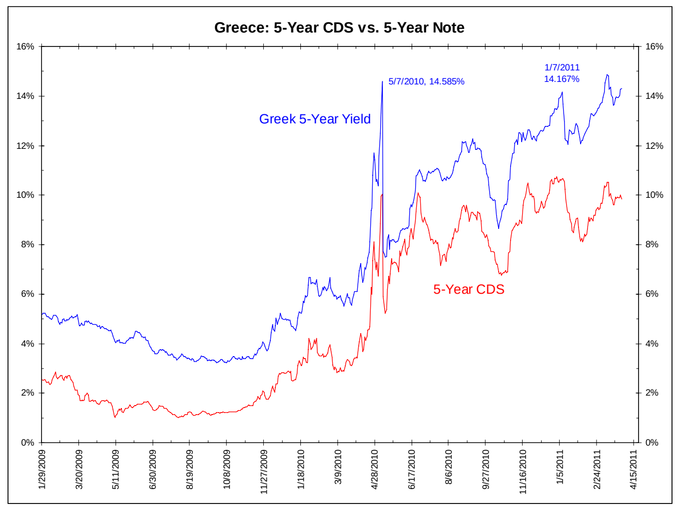
This is much like with the United States. As long as the perception is that there is not going to be inflation, then this whole quantitative easing exercise is an exercise that will work or is believed to work and push asset prices higher. If you get to the other side of the tipping point – and that is that this wall of money starts to lead into higher inflation expectations – then it becomes all bad at that point.

But, for the moment, in Japan, we are not seeing this wall of money as being inflationary; we just see it on its way toward the Tokyo Stock Exchange, which is why stocks are being bought. So I don't need to torture the argument. The wealth of the economy of Japan is going down. This is a negative for their economy, full stop. It is. I don't need to torture that statement. All that I have to ask is then why are their stocks going up? It is because they have created tremendous liquidity to create a liquidity rally, and the 10-year JGB is fine with it because their yields have not been driving up.

Another version of systemically significant positions is what has been happening with European debt. This issue is a little bit different and a little more complicated than the other two because, ultimately, the fix cannot be more liquidity because we are beyond that problem with more liquidity.

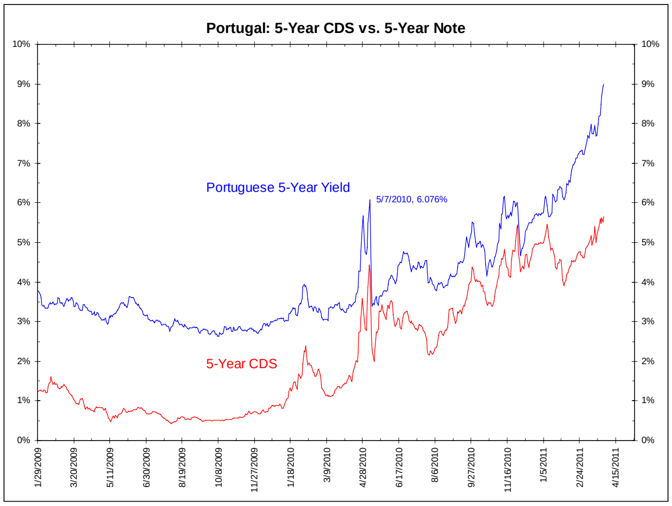
European CDS

As we look at the charts on Page 10, we see the problems in Europe. We see that the blue lines on all of them show the yields in Europe, and the red lines show the credit default swaps in Europe.

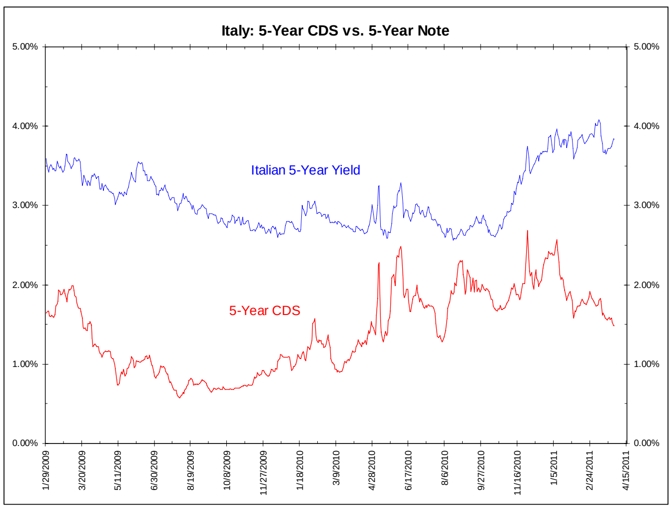


The upper left shows Greece's Market, and, yes, the five-year is still over 14 percent in Greece.

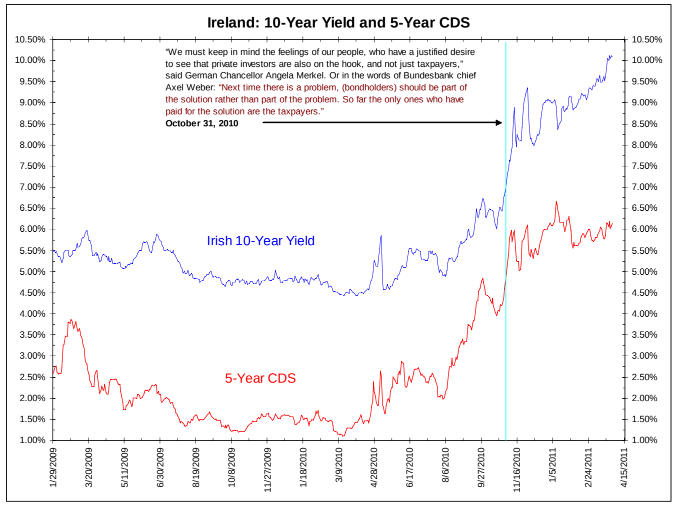
In the upper right, we show Portugal, which is on its way toward Greece's type of yields at nine percent, as well, with their credit default swaps moving up very close to highs for the move.



In the lower left, we show that in Italy, another one of the countries about which we have been worried, the risk seems to be receding a little bit in terms of credit default swaps. Although, their yields have been hovering just a little bit under four percent.



Finally, in Ireland, their yields are up over 10 percent, too. Although, their credit default swaps have held steady.



Europe is a little bit different because, ultimately, the fix here on their systemically significant positions of sovereign debt is not going to be the ECB printing money; although, they have tried that. The ECB has also been a little bit sickly about trying that because they have a bit more of an inflation worry in Europe than either Japan or the United States has. So maybe what we are seeing there is a harbinger of what happens when you have an attempt to have a liquidity solution and a bit of a worry about inflation. The liquidity goes, and you cannot use that solution.

So the Market wants austerity. The Market wants for these governments to borrow less or the bondholders are going to have to accept less than par, which is what you are seeing with all of these yields going higher.

The problem there is that the politicians do not want austerity. Ireland is a great example of that. When the Irish Market started to implode on itself in October and into November, all of the politicians stood hand in hand, agreed to a bailout, agreed to austerity. Then the Market was perceived to be getting better or at least not worse, the euro started to strengthen, and then everybody lost their resolve. Then the markets get worse.

We have seen this pattern repeat: the markets worsen, and everybody says that they will take the tough medicine; the markets gets better, and then the tough medicine doesn't happen; the markets worsen, and they promise that they'll give us the tough medicine; then, the markets get better, and they don't give us the tough medicine. Welcome to European debt for the next several years. It is going to vacillate back and forth between, "We promise to fix the problem and do what is necessary," to, "The markets then believe you and rally, and we won't do it." And then they worsen, and we promise again that we are going to do it all over.

But what I think is the big difference here is the question of why doesn't the ECB just print their way out of the problem? It is because they have a bit more of an inflation concern than we do in the United States.

What Does Bernanke Think?

That brings me to Page 11 – "What Does Bernanke Think?"

Bernanke thinks that inflation is not a problem. Bernanke has said that he thinks that inflation will remain quite low and stable for some time and that, at most, we will probably see some kind of a temporary blip because of commodity prices, though we are not to worry about it.

As long as the Market believes that inflation is not a problem, what will happen is that all of this money printing – whether it is Japan – the United States will be bullish for risk on markets. They will continue to advance as they have been throughout this period even though we have had all of these unprecedented black swans seem to hit the Market almost every day.

If we get to a tipping point where there is the perception of too much inflation, then all of the money printing becomes bad. Europe is very close to that tipping point right now, which is why money printing cannot seem to be the solution there.

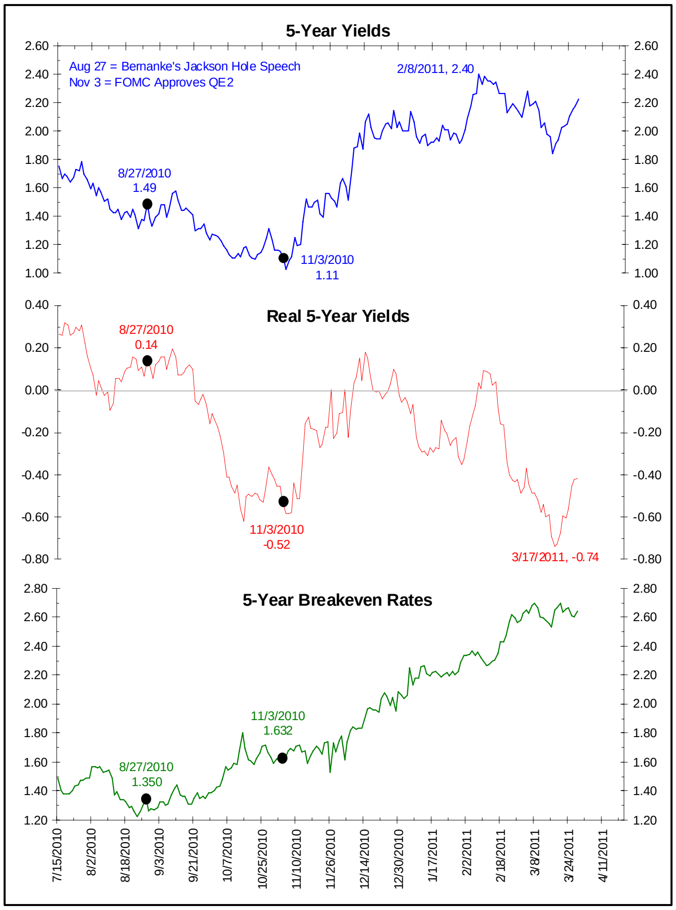
To what measure of inflation are we referring -- expected or forward inflation? This is not debate about headline or core; that is a different argument, and I'm on the headline side of that argument. This is an argument about where the Market thinks that inflation is going to be in the future. As long as it believes that inflation is under control, then it is not going to be a problem.

Inflation Expectations As Measured By The TIPS Market

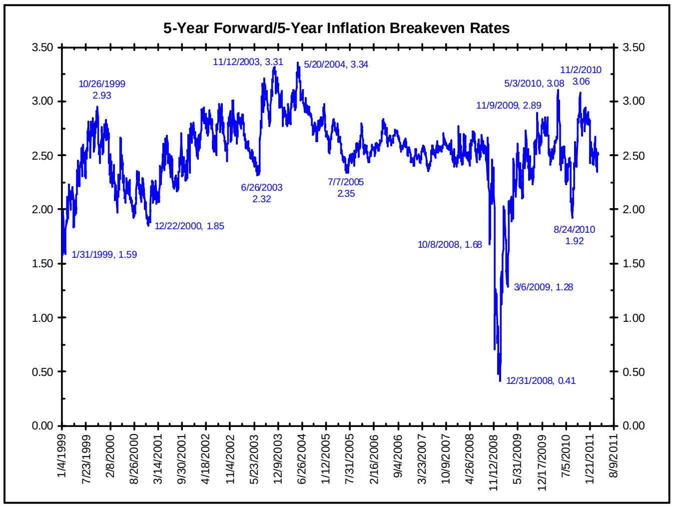
The chart on the left of Page 12 is the TIPS Breakeven Rate. The five-year yield is in blue on the top panel, on the left. The red line is the five-year real yield. Then when you subtract the two, here is a measure of breakeven rates.

The uptrend has been unmistakable since QE2 came. We expect ever-more levels of inflation. I use the five-year here because this is Bernanke's favorite measure. He has mentioned the five-year in testimony – not the five-year/five-year, which I will show in a second, but the five-year, in testimony several times. The trend has been unmistakable.

Bernanke has also tried to tell us in the past that the reason that nominal yields are going up, the reason that the five-year yield is 100 basis points higher than it was last fall when they started QE2 is because real yields are going up, which is a sign that profits in the economy are coming back. Look at the middle panel – that is just not correct. Real yields are going up.

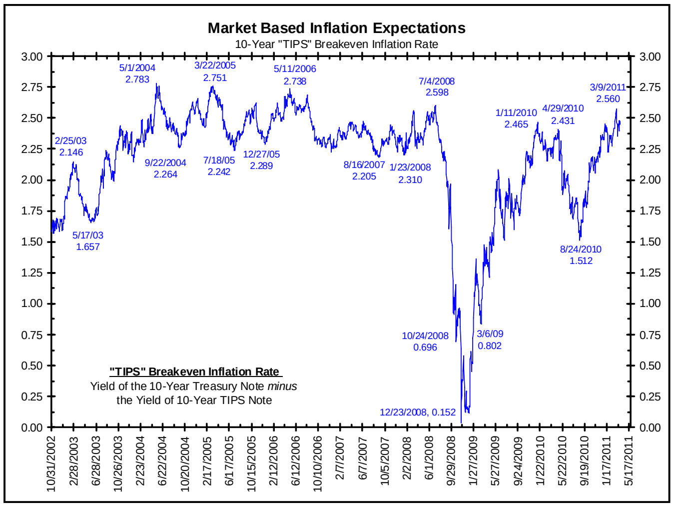


The reason that yields are rising is found in the lower panel. It is because inflation expectations are pushing yields higher.



But if you go to the upper right chart on Page 12, you will see the 10-year breakeven. I showed you the five-year because that is Bernanke's favorite measure, but the Market convention is the 10-year, so let's switch gears a little to the 10-year.

Bernanke has also mentioned this and said, "At around 2.50" – which is where the 10-year TIPS Breakeven/Inflation Breakeven Rate is – "we are back in that range that we were in prior to the Financial Crisis, and it is a sign that things are starting to return to normal." That is true, Ben, if it stops here, but then look at the trend that it took since the August low to get to this level. Neither Bernanke nor anyone else is making what I believe to be a credible case that, yes, we were going to have a steep ascent to 2.50 and then level off there.



Let's check back at the end of the summer. Let's check back in the fall. Let's see if this thing isn't out then near 2.75 or maybe even 3.0, and it's a multi-year; because, it if is, then liquidity becomes problematic. QE3 becomes less likely. The Market then demands the Exit Strategy, and then we have Goldman Sachs's cliffing phenomenon, on which the markets could start to fall.

Conclusion

Let me conclude. Money printing is bullish for risk on markets as long as inflation expectations remain muted. They have been. It will remain bullish for risk on markets.

What would upset the applecart would be more inflation as measured by inflation expectations. If we get high enough on these expectations that the Market is uncomfortable, then we've got a real problem on our hands in terms of all of the money printing. See Europe, where money printing is almost not an option because of the problems that they face with higher and rising inflation expectations.

That is where we are. The Market right now is convinced that money printing is not a problem.

Furthermore, the Market may even buy into the argument that, yes, at some point, inflation expectations will get high, and all of this will turn out to be bad. But if I'm on the right side of the systemically significant position, then I've got the benefit of central banks, the BoJ, and the Federal Reserve working in my favor to push these markets higher, and so I'll stay long and continue to watch the risk on markets continue their ascent.

That is the catch-22 in which we seem to be caught right now. Yes, I know that it is going to end badly, but it's not going to end badly tomorrow. So I am just going to stay long in these markets. That makes perfect sense, and this is the version of the 2000 trade in Tech, and this is the version of the Mortgage Trade in 2006 and 2007. It is going great, it will end badly someday, but not today, and so let's continue to stay long this until we think that we are closer to it potentially ending badly. But, right now, it is not ending badly, and we continue to see the markets moving forward.

Is there a scenario where the Fed can get out of this? Yes, if the economy were to surge enough to support the advances in financial markets, the advances in commodity markets so that, when they stop, you could justify valuations.

The Stock Market S&P is up about 30 percent since the August low. Valuation metrics are very subjective depending on how one wants to measure them. I would say that I do not think that the economy and profit outlooks have advanced enough since August to support a 30-percent rise in equities. I would say maybe outlooks could support half – a 15-percent rise in equities. So half of the rise since August has been because fundamentals have improved from last summer when we were talking about double-dip; the other half has been liquidity. So if we had a liquidity stoppage in the Market, then we would get some cliffing and maybe give back half of the rally – not the whole thing, but half of the rally.

Lastly, what happens on July 1? QE2 ends. On the poll on our website – just anecdotal evidence – it seems like Bullard is having an academic conversation with the world about ending QE2 early because nobody believes that it is actually going to end early.

Remember that Bullard is a non-voter anyway. Charlie Evans, the Chicago Fed President, who is a voter, has come out on the opposite side of what Bullard is saying. The only reason that Bullard gets any kind of notice more than any other Fed president is because he was early in the QE2 talks, so he is seen as some kind of thought leader within the Fed.

I guess that the definition of "thought leader" is that you were right on your last call, so that means that you've got a 100-percent track record now, and so we look to all of your opinions. Well, he will be a thought leader until he is incorrect on a call, and it could very well be this one saying that we are going to end QE2 early. And then the next time that he espouses an opinion, then it probably will not get nearly the attention that this one is getting right now.

So what happens on July 1 when QE2 ends?

The Marketplace, I think, believes that QE3 is a possibility. Stock prices and risk on markets can maintain their levels through the summer as long as the hope of QE3 is out there. You could even argue that QE3 has started in Japan. I wouldn't disagree with that argument, either. As long as that hope is out there, then QE3 will continue to be hoped for, and markets will continue to move higher.

But if the idea of QE3 gets squashed, then we could get the cliffing. How do we get the idea of QE3 squashed? Higher inflation expectations.

Questions/Answers

Let me stop there and thank everybody for joining us on the call.

Let me open the call to questions.

We take questions on a first name-only basis. This technology allows me to know who is asking the question. So we will keep you semi-anonymous so that we can have a frank conversation about things.

Let me open the question-and-answer session with a phone question.

Dan, are you there?

Dan: Yes, I am. Hi, Jim.

I just want to understand. Is there a middle ground to the QE3 question? I guess that what I am grappling with is that it either is, and liquidity remains in the Stock Market and elsewhere, or it is not, and we have this cliffing scenario about which many have spoken. Is there some middle ground that can emerge out of this?

Bianco: Yes, the middle ground would be – the tipping point is inflation, the expectations of inflation, not whether or not it actually materializes but only the expectations. If that does not materialize, then I think that what we will eventually see is 2.75, 3.0 on the TIPS breakevens by the fall or winter. It will become very uncomfortable for the Market to talk about all of the liquidity and all of those expectations of inflation, and it will be problematic.

If I am wrong on that, and TIPS breakevens meander around 2.50, 2.25, kind of back into that normal range that they were prior to the Financial Crisis, then there is no immediacy to say that we have to do anything with the liquidity. As long as the liquidity does not create inflation, it is not bad.

Milton Friedman's dictum was "too much money chasing too few goods." That is the argument for inflation. We are creating money. We could debate the definition or meaning of "money," but to some level we are creating money, and that would be inflationary. Well, if that money does not translate into inflation, then it is not bad, and then we could continue to move forward from here. That is your middle ground.

The warning that I would give is that the TIPS breakevens are a measure of inflation expectations. They are not the only measure, but at least they are a real-time market measure that we could use.

You can use the Michigan Inflation Survey. You could use surveys of economists from blue chip and all other different types of places, as well. But inflation expectations as measured by TIPS have been in a strong uptrend since the beginning of QE2, I believe, showing little sign that the uptrend, for the moment, is ending. But if I am wrong on that, and that uptrend is ending, then there is your middle ground. The liquidity will stay, the hope of more will continue, and the markets will be OK.

Did you have a followup?

Dan: Yes, I do. Real quickly, with regard to productivity, productivity amazes me how it is high and continues to appear to be rising. I guess that the systemic of people – the ones currently employed -- being fearful of losing their jobs. How do high productivity and the excessive manufacturing slack and employment slack factor into your thinking regarding inflation?

Bianco: Productivity is a residual of GDP divided by aggregate hours. So you basically just take the production of the United States, multiply it by the aggregate number of hours that everybody in the economy has worked, and that is where you get your productivity number.

To some extent, the statistic of how you measure productivity is going to look good when you have a sharp rise in unemployment or a lowering of employment, and you don't have a commensurate fall in the economy. So the productivity numbers look good because the economy is moving forward with fewer workers than we used to have because we have laid off seven million people.

There is no doubt that that is a sign that the economy is improving. We were two years ago at 600 on the S&P; we were at roughly 1,000 on the S&P last summer before talk of QE2 started; and we are now above 1,300 on the S&P. A good part of that advance has been that the economy, by these measures, has gotten better. That is why, as I like to say, the cliffing that you could see without QE2 could be half of the rally since August, not the whole thing.

So the economy is definitely getting better. I don't want to paint this as a binary thing…

Dan: Right.

Bianco: …That, without liquidity, we would be meandering back at the lows of last summer. We would have gone up anyway. My fear is that Bernanke is pushing too hard and pushing us off into an overvalued range or an unsustainable range without liquidity.

So I understand why the numbers are getting better – because we have lower employment and the economy has been coming back. It is symptomatic of a lot of these other numbers, as well, that basically show that the economy is improving. That, to me, is kind of the $64,000 Question – "How much of the rally since the July low is justified by the idea that the economy has gotten better, we are no longer talking about a double dip, profit outlooks have gotten better? How much of that should have justified how much of a rally versus the 30 percent that we have already had?"

My view is that the better profit outlook – and it has gotten better – and the increase in the economy – and it has gotten better, too – did not justify 30 percent in nine months, or in seven months, actually, which was when we hit the high back in February. Thirty percent in seven months -- I think that part of that is liquidity and part of that is an improvement in the economy. The productivity numbers definitely support that.

Thanks, Dan. Let me move on to somebody else.

Dan: Thank you.

Bianco: Next, let me take this emailed question from **Grant:**

"If QE2 ends, if velocity of money does not accelerate, then is Bernanke forced into QE3?"

Let me dissect the question a little bit. If QE2 ends, and all of this money that the Fed has created, that is in the reserve accounts of all of the banks, does not make its way out of the banks in the form of loans or higher M activity – to look at the velocity of money –

"Velocity" is basically where you take GDP and divide it by M3 or M2 since we no longer calculate M3. So if all of this high-powered reserve money does not make its way into the M2 statistic, then the velocity does not advance.

Does that mean that the Fed is forced into QE3 because that money is doing nothing? I wouldn't go so far as to say "forced," but I would say that it does allow QE3 to happen. If you don't get that velocity acceleration, then you leave the door open for QE3.

But I would come back to what I have been arguing about in this call, which is, if you get higher inflation expectations, then you get a TIPS breakeven sitting at 3.0, which is the highest level since the late 1990s. You get a Michigan Consumer Confidence number at an eight-year high, which is what it is at now. You get people grumbling to Bill Dudley that they cannot eat their iPads, and everybody complaining that inflation is coming back. It makes it extremely hard for QE3 to happen regardless of velocity.

If velocity stays tame and inflation expectations stay tame, then it leaves hope alive for QE3, and markets continue to move forward.

Again, I think that inflation expectations, by the fall or winter, will be at those uncomfortable levels, and we will have problems at that point. But if I am wrong, and inflation expectations do not make it to those uncomfortable levels, then risk on markets will continue to enjoy the benefit of liquidity, as well.

All right, let me jump to the next question.

The next question is from Andrew. He asks about interest rates and where the 10-year yield can go throughout the second half of the year.

The 10-year yield right now, I think, is going to show some stabilization at the end of June when we have the end of QE3 and into the summer, probably in the 3.50 to 3.75 range at the most, maybe closer to 3.50.

As we talked about on the last Conference Call, there are an extraordinarily large number of people that are bearish on interest rates. The current Bloomberg Survey of Economists interviewed almost 70 economists, and only one of 70 economists thought that interest rates would be lower in six months. All of the other economists – 69 of 70 economists, 97 percent – thought that interest rates would be higher in six months.

I might add that that is not new. That has largely been the case for years as far as the perception of interest rates is concerned. What we argued is that, while I understand that argument and am sort of in that camp because I am saying 3.50, 3.75, but I am not in this camp that a lot of these economists that are thinking rates are going to go higher are in – that 4.0, 4.5 camp, thinking there is going to be total destruction, as in Nassim Taleb's kind of argument that every human has to be short bonds, and that rates are going to go to the moon.

If rates are going to go anywhere, if we get high-enough inflation expectations, then I don't think that it is going to manifest itself necessarily in the destruction of the 10-year yield but in a rise in the front end of the Yield Curve in a massive flattening of the Yield Curve. What would be at risk is this front end, that zero on overnight money, the 80-odd basis points in the two-year; that is from where the risk would come. But even that is later this year into early next year. And we will, first of all, see if the inflation expectations move out to that level, as well, to help to get us to that hopeful point right there.

With that, we are at 51 minutes on the call, and this is a good point on which to end. If any other questions float in, then I will add them to the Conference Call transcript, which we will put out on Monday, so feel free to bring in those questions, too.

Let me end this Conference Call at this point by thanking everybody for joining us.

We will see you again in a couple of weeks at the next Conference Call.

Bye-bye.

END

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