John Dessauer Investments, Inc.

John Dessauer's market review and update as of Wednesday March 31, 2021

The numbers are staggering. The federal government is on track for a $3 trillion fiscal 2021 deficit. And the Biden Administration is proposing an additional $3 trillion in spending, this time for "infrastructure." Critics say only a small part is actually for "infrastructure." They say the truth is that this proposal would be the biggest step towards a welfare state since LBJ. One thing is clear - the spending would require the additional sale of trillions of dollars in U.S. Treasury securities. This raises the question of how much can the U.S. borrow? There was a warning, as I wrote last week, when in February the sale of seven-year Treasury notes almost failed for lack of demand. The easy answer is that the Federal Reserve, which is now buying $80 billion worth of Treasury securities every month, could ramp up their buying to help if there is a significant demand shortfall. But a closer look at how the Fed goes about buying Treasury securities shows that this is not such an easy answer.

The Federal Reserve was created by the Federal Reserve Act signed into law on December 23, 1913. The Act specifies that the Federal Reserve may buy and sell Treasury securities only in the "open market." The Federal Reserve cannot buy directly from the U.S. Treasury. Lawmakers included this prohibition so the Federal Reserve would be a completely separate agency and not evolve into an arm of the Treasury.

As a practical matter it is the Federal Reserve Bank of New York that buys and sells securities for the Federal Reserve. The transactions are done with a group of so called "primary dealers." This includes major commercial banks and large financial firms like Goldman Sachs. The "primary dealers" buy Treasury securities directly from the

Treasury. Their appetite for Treasury securities is not unlimited. And new regulation enacted after the 2008 financial crisis imposed a 5% capital requirement on banks so shareholders and not taxpayers would pay for loans that went bad. The Federal Reserve took this capital requirement one step further and adopted a rule called the Supplementary Leverage Ratio or SLR which included risk free Treasury securities in the capital requirement. This did not cause problems until the federal government began its massive spending programs to fight off the economic damage caused by the COVID-19 virus. The additional trillions of dollars' worth of Treasury securities coming to market put pressure on the "primary dealers" to increase their purchases of Treasury Securities. At the same time, the commercial banks were being flooded with deposits. So you might think there was no problem for banks to be buying more Treasury securities. And that would be correct if not for the Fed's SLR rule. Finding the additional capital to comply with SLR proved not to be so easy. The Fed then relaxed the SLR rule allowing banks to acquire Treasury securities without having to raise more capital. That relaxation expires March 31, and the Fed says it will not extend the relaxation. Why not continue the relaxation?

U.S. Treasury securities are the most risk-free assets on planet earth. The answer is that Senator Elizabeth Warren, leading other progressive lawmakers, does not understand the reasons for requiring banks to hold additional capital.

In regard to extending the SLR relaxation she said:" The banks' requests for an extension of this relief appear to be an attempt to use the pandemic as an excuse to weaken one of the most important postcrisis regulatory reforms." Sorry Senator, that isn't true. There is no need for additional capital on Treasury holdings. Do you really think the

U.S. Treasury will default and leave banks with losses? Unfortunately, legislators do cause problems. The 5% capital requirement means that there are now artificial limits on how much the “primary dealers” can buy from the Treasury. That is the last thing we need with federal government spending going through the roof.

Keep in mind that we are not the only country fighting the effects of the pandemic. Just about every country on earth has been hurt by the virus. And many governments are following the U.S. lead and increasing spending to provide relief. That is a lot of credit market competition. For now, we are OK. U.S. banks have roughly $200 billion in excess capital that can be used to cover additional buying of Treasury securities. But that may not be enough to cover all the Biden administration’s spending plans and private sector loan demand as the economy recovers. Ironically the SLR, that progressives like, will act as a restraint on future economic growth. To get the economy all the way back to normal will require banks with enough capital to make badly-needed loans to businesses and individuals. It is possible that we are headed for a time when banks will have to choose which assets they are willing to increase - private sector loans or Treasury securities. Treasuries are risk-free and may turn out to be the banks first choice. In that case the recovery will run into limits for lack of enough bank capital. I doubt Senators such as Elizabeth Warren are aware of how they may well be diminishing the benefits of all the spending by supporting SLR.

For now, everything is looking good. There was a dip in economic activity in February. That looks to be due to the severe winter weather that caused a major blackout in Texas and kept consumers at home in much of the country. March data when available will likely show the recovery is still on track. Credit-card data already suggest that retail sales have bounced back. And March surveys of manufacturers indicate that factories are struggling to keep up with demand.

Expectations of 6.5% growth this year are still looking good. Next year, the consensus among economists is for slower growth. How much slower will depend on how banks will respond when loan demand rises. For now, our best strategy is to hold our stock positions.

I will have the next market review and update one week from today on Wednesday April 7, 2021.

All the best,

John Dessauer