Tim Mullooly: Welcome back to the podcast. This is episode number 395 of the Mullooly Asset Management podcast. This is Tim Mullooly back in action with you today. And I'm here with Tom. How you're doing?

Tom: I'm good. Happy to be here.

Tim Mullooly: Yeah, me too. It's been a while since I've been on a podcast and done an intro like that, so good to be back in the saddle. We're going to talk about the Fed, but not in the way that they've been in the news for pretty much this entire year. We're going to talk about a side of the Fed that I think people aren't really talking about too much.

Tom: Yeah, it's called the truth.

Tim Mullooly: Yeah, or just-

Tom: Or I should say the facts.

Tim Mullooly: Or yeah, the rest of the story-

Tom: Good.

Tim Mullooly: ... I think.

Tom: Good, that's better.

Tim Mullooly: Yeah.

Tom: Before we get into that, one of the points that I wanted to say that's not going to fit neatly into this discussion. It's a little awkward, but I want you to think back, listeners to someone you knew growing up who used to just take a headline off the TV news or see a headline in the paper, they wouldn't read the whole story. They wouldn't read any of the story. They would just see the headline and they would run with it, shooting their mouth off. And they, you would scratch your head and say, "God, that person's really naive. Or just uninformed." Multiply that times 100 million on social media today, and this is what we're up against. It's not fair, because people are hearing whoever is the loudest voice screaming out there, and they have a lot of bad information, or incomplete information, or just plain wrong information.

Tim Mullooly: It's difficult, I think, especially as advisors, because what you just described could apply to any industry or any walk of life, whether it's entertainment, music, movies, celebrity gossip, or more important stuff like financial news and financial headlines. And it's difficult because it's pushing people to make decisions with their money that have serious consequences. It's difficult to set people straight.

Tom: Just parse through the truth. Find out where the answers really are.

Tim Mullooly: Yeah. And everyone just takes a headline nowadays and it's been happening for a while, but they just extrapolate, "This headline, what's happening now, it's going to happen forever."

Tom: Right. It's going to Doomsday.

Tim Mullooly: Yeah. And things just get taken to the extreme and it's our job to throw some water on that fire.

Tom: Yeah. And just to help our clients not make bad decisions. Rash decisions or decisions based on an incomplete or inaccurate story. So, let's talk about the treasury and let's talk about, for 10 years we've heard about QE, quantitative easing. And now we're at the stage where it's called QT, quantitative tightening. And people are just losing their minds.

Tim Mullooly: Yeah. To kind of give a background on what we're about to talk about. When the pandemic hit in 2020, the Fed started taking action and they started buying up all of these bonds and these fixed income securities and mortgages. For the listeners out there, can you kind of explain their thinking behind that and why they did that in the first place, before we dive into what they're doing now?

Tom: Sure. So when the Fed started, everyone calls it printing money. They didn't actually print money. What they did was they went into the open market and they said, "We are going to buy treasury securities and we're actually going to buy some mortgage-backed securities." Now, they're not buying Tim or Tom's mortgage. They're buying mortgage securities that are under or backed by Ginnie Mae, which is a government agency. It's not even a government-sponsored agency like Fannie or Freddie, it's a government-sponsored agency. So they're in there, buying government securities. What happens when I buy a security from you? What do you get?

Tim Mullooly: Money.

Tom: Money. And so when these banks started participating with the Fed to sell their treasury bonds and their government bonds to the Fed, the banks got cash.

Tim Mullooly: So during the time of the pandemic when there wasn't a lot of economic activity going on, they were taking these actions to give money to the banks, to pump money into the system. To keep things moving. So, that brings us to today, fast forward, two plus years later. I believe it starts technically June 15th. So, in a few weeks this QT is going to begin. Do you want to explain what that is?

Tom: So, the Fed now has all of these securities, these mortgage-backed securities, but mostly they've got a lot of government bonds. They've got bills, notes and bonds. Bills, treasury bills don't come with a coupon, they're short term, they come due in nine months or less. They don't pay interest. You buy them at a discount and they come due. Treasury notes, treasury bonds have coupons attached to them, so they're called coupon securities. And that'll be important as we kind of move through this discussion. And so, what the Fed is now doing is they're saying, to use the headline, "We're going to now sell, we're going to start with $95 billion worth of treasury securities. And then we're going to escalate that to $128 billion worth of securities per month for the foreseeable future." For maybe 60 months, five years of this.

Tom: And people are just, when they only read the headline, they are just losing their minds, because they're like, "Who is going to be buying all of these bonds? And if there's more and more bonds for sale, what happens to the price? There's more in the market, so the price is going to go down. People are just going to just lose money, lose money, lose money everywhere, in bonds. And then that'll spill over into the stock market and the economy. And we're all going to jump off the cliff."

Tim Mullooly: Right. And so that's the headline version of it. But when you kind of dig down a little deeper, a lot of what they're doing isn't necessarily selling, they're just not reinvesting the proceeds of these bonds that are coming due.

Tom: Yeah. This is really important.

Tim Mullooly: It's not a sale. It's just not a buy.

Tom: Not reinvesting. That's right. And so, it's important to just grasp for a second the magnitude of what the Fed, what's happening with the Fed, the interaction between the Federal Reserve and Treasury, okay? So, the Federal Reserve now holds something above $8 trillion. Their balance sheet is just, it's never been this big. And so every month they've got $128 billion coming due. God-

Tim Mullooly: Its a lot of cash.

Tom: Yeah. So what they've been doing is, every month for the last two years is as 120 some odd billion dollars comes due they've been reinvesting it. They've been taking that cash and buying more bonds, bills and notes in the open market. All right. And so they've been continuing to grease the wheels. So now what they're saying is, "Hey, starting in June with our money that comes due, our bills that come due that month, we're not going to reinvest it."

Tim Mullooly: So I think, on the most basic level in 2020, they put money into the system. And now here in 2022 they're taking money out of the system, or just not continuing to put money into the system?

Tom: They're not continuing to do it at the level that they have been doing it. And so what they're going to do starting this month is they're going to receive $128 billion in proceeds from their treasury bills, notes, and bonds. But they're only going to reinvest $98 billion in the same thing. So, that means that they're just going to buy $30 billion in fewer bonds. So they had been reinvesting 128 billion a month, now they're going to do $98 billion a month. So there's 30 billion that the market has to soak up. Now look, between friends 30 billion sounds like a lot of money. But for a market like the treasury market that is quite literally a drop in the bucket.

Tim Mullooly: Right. Why are they choosing to do this now? What kind of benefit does this have to the market overall, or the economy? Does this kind of work hand in hand with what they're doing with rate hikes?

Tom: Sure. So it's important to listen to the Fed, When they do come out with their announcements, they really are giving us the answers to the test. And if we can get the raw answer from J. Powell without CNBC or the New York Times or someone else interfering and mangling the message, you really do get the answers to the test. So, the Fed has been saying now for months that the economy can stand on its own, it doesn't need this support. And so they want to begin shrinking the size of the balance sheet at the Fed. Now, the balance sheet is over $8 trillion, it's ginormous. And so shrinking it $30 billion a month is really nothing. What they want to do, their target is to get down to something in the mid-sixes in terms of $6 trillion. So they have to run off $1.8 trillion and they plan to do it over 60 months, that's five years. That is a really low key plan to just slow down the amount of cash that's being infused into the market.

Tim Mullooly: Yeah. And do you think that this is something that investors have been anticipating and potentially getting super nervous about, or overreacting to?

Tom: They're getting nervous. They're overreacting. And if they knew this, they shouldn't be. I just think that people need to slow down and just look at the facts. Because I mean, just in the last few days we've seen, oh, we're going into June, it's QT, quantitative tightening, and it's the end of the world. And people are just losing their minds. And I just don't think that's really the case.

Tim Mullooly: Why do you think that this hasn't been talked about more? Because I feel like we here have known that they're going to be doing this for a while now. But I feel like it's not being discussed as heavily as the rate hikes. Because I honestly don't think people could talk about the rate hikes more at this point. Every time they meet it's the only thing that people talk about. The Fed has become super popular. So, why do you think that people seem to be potentially glossing over what's happening right now with this?

Tom: It's a complicated story. There's no doubt about that. One of the things that, I don't want to make this podcast two hours long, but one of the things that a lot of people don't understand is this account that exists at the Fed. To keep it simple, we'll just call it the Fed's checking account. It's TGA, which is, I don't even know. But that is their tax receipts and their basically their checking account. Prior to the pandemic the Fed used to keep about $400 billion at all times just sloshing around in this emergency fund. At the present time, after two years of all of this stuff, sending in their checking account is $900 billion.

Tim Mullooly: Right. So more than double the normal amount.

Tom: Right.

Tim Mullooly: Which at the time before the pandemic people considered a lot of money to have in the checking account to begin with?

Tom: Yeah. And so what folks, they're just not connecting the dots. One of the things that we heard a lot of early this year, now we're recording this in early June. One of the things that we started hearing at the end of last year and the first quarter of this year is, "I can't believe the amount of money I'm paying in taxes." Those tax receipts go somewhere. So they go into the treasuries cash fund. All right. The amount of, again, I'm getting a little off topic with this, but the amount of receipts that came in from taxes paid in 2021 for 2020 was off the charts, like a record high, okay? The tax receipts so far in 2022 for 2021 are 35% ahead of last year's record number. And so, I don't think people understand that the government has a ton of money. A ton of money.

Tom: And so what that means is, the government, the treasury is not going to need to issue short-term T-bills for financing their government. Sitting in their checking account. It's already there. They've got two and a half years of basically their expenses just sitting there. Ready to be drawn down. So the Fed doesn't have to issue as much debt as they had been all along. So, that's going to relieve a lot of the pressure. Plus the Fed is doing this controlled sales of their portfolio. So I really think that people just need to calm down about this quantitative tightening, that the people in charge know what they're doing. And they also know that they've got something that if they just weren't paying attention could set off a nuclear bomb in economic terms. So they know the danger of flooding the market with bills, notes or bonds.

Tim Mullooly: Yeah, I think it goes back to what we were talking about in the beginning with extrapolating current circumstances into the future forever. Before the pandemic, when this account was sloshing around at 400, things were fine. The economy was running. The world wasn't melting. But now, people got used to having all this money in the market. First it was, "I can't believe they're pumping all this money into the system. How reckless of them." And now they're freaking out because they're taking money out of the system. We heard for so many months in the beginning how everyone wanted to get back to "normal." And it's like, "That's kind of what they're doing right now." It's, they're just slowly, very slowly trying to undo what they did to help save the economy in 2020.

Tom: That's right.

Tim Mullooly: So I feel like people kind of just got used to operating under the pandemic economy, so to speak. And now they're kind of worrying that, they're just worried about change.

Tom: That's part of it. So the other side of this is if there's so much sitting in TGA in this basic checking account, you want to call it, for treasury. That means that as I mentioned, a moment ago that the treasury doesn't have to issue lots of bills, notes and bonds. I just want you to put your thinking cap on. They're messing with the supply side of their inventory, bills, notes and bonds. Again, not a recommendation whatsoever, but all I'm going to say is if there's going to be a limited supply of bonds, what's going to happen to the price?

Tim Mullooly: They're going to go up.

Tom: Yeah. I encourage people, right now if you're a bond holder or a bond investor, and you're looking at this saying, "I thought bonds were relatively safe. I can't believe that some of my bonds are down eight, nine, 10%. What's going on?" I'm going to say what I've been saying all along, your patience is going to be rewarded, because I think that these are going to do just fine over the future. I can't get pinned down to saying over the next 3, 6, 12 months, but there's a limited amount of new bills, notes and bonds that are going to be issued. And so, just think that through for yourself. What's going to happen? There's going to be a lot of people looking for bonds over the next few months.

Tim Mullooly: Yeah, and that kind of answers one of my next questions I was going to ask. What does all of this mean for the people listening, for the everyday person? Are they going to feel the impact of this in any way? Or is it just something to be aware of, to kind of, once you understand it'll help you be at ease with some of your investments? Or what does this mean for people?

Tom: So historically, I'm not going to predict the future, but historically when we get into these markets in turmoil kind of periods, like we've had the first six months of this year, bonds tend to get really sloppy and then stocks tend to get sloppier. And so the first thing to firm up is usually the bond market. And so if you are a bond investor, I think you're going to be a lot happier in the near future. That also portends that stocks are going to improve. Let's face it, they can't be much worse. And what we've seen over the first few months of this year. And so we go through these periods of time. I'm not going to even going to talk about 2008, but 2011, we did this in 2015. We did it in the fourth quarter of 2018. And of course, 2020 we had a short drop down and it came right back up.

Tom: But 2011, it was a tough year. It was a very tough year. 2015 we were fielding lots of calls from people who were like, "I'm losing money in bonds and I'm losing money in stocks. How is this possible?" So it does happen. And I'm going to sound like a broken record, but I lived through 1994 and saw this happen. And again, not trying to predict the future, but bonds got whacked in the first quarter of 1994. By the end of the year they were flat, stocks were flat. And it set us up for a beautiful 1995, '96, '97 into 1998. So, I will share, we'll link to this thread by Andy Constan. He puts out this report that we've referenced a lot in this talk. He writes a report called the Damped Spring Report. I don't know what it stands for.

Tim Mullooly: Me neither.

Tom: But he did, he started his career at Bridgewater Associates, that's Ray Dalio's firm, and really has a great reputation in the industry for knowing what's happening in the bond market. This guy's a genius. So very happy to share that. I know that I've read his work especially recently and I'm a lot more optimistic.

Tim Mullooly: Yeah, and I think that a thread in a report like this is good for people to understand, especially if you're super worried about the markets in general, or specifically what action the Fed is taking to help the economy and inflation and pretty much just the moves that they're making, or their game plan. Because I feel like a lot of people are focusing on the interest rate decisions. But there's another side to what they're doing as well. And this is managing their balance sheet, which I think is pretty important too. So, this was a good topic to discuss, because like I said before, I feel like it's not as frequently discussed as the interest rate game plan that they have.

Tom: I want to just close by saying a couple of things. First, the last thing that the Fed wants is a recession. They'll do everything in their power to avoid a recession. Just think about that for a second.

Tim Mullooly: I mean, if the economy's bad enough, they will lose their job?

Tom: Well, yeah. And they'll take steps to make sure that it doesn't fall into a recession. Two years ago, this is the most recent example. Two years ago we had a pandemic and we had to shut down the economy for 15 days to flatten the curve. Everybody remembers that. It was a man-made slow down, shut down of the economy. What happened? The Fed saw that and took action. And they basically changed the direction of everything, okay?

Tim Mullooly: Right, they weren't planning on doing what they did. That wasn't the game plan moving into 2020,.

Tom: 1987 stock market crashes 22% in one day. Fed steps in and says, "We're going to guarantee we're going to backstop the U.S. economy." Everything started coming right back. So, when things happen, when bad things happen, the story will change. The story will change. And so, extrapolating these news headlines out into the foreseeable future is just a really bad plan.

Tim Mullooly: Yep. Yeah, nothing is forever.

Tom: Got that right. All right, thanks for listening to episode 395 and, Tim, we're getting closer to number 400.

Tim Mullooly: Yeah, it's a lot of podcast.

Tom: It is. It's a lot of talking.

Tim Mullooly: Yep.

Tom: Thanks for listening.