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The Anals of Stock Proctology

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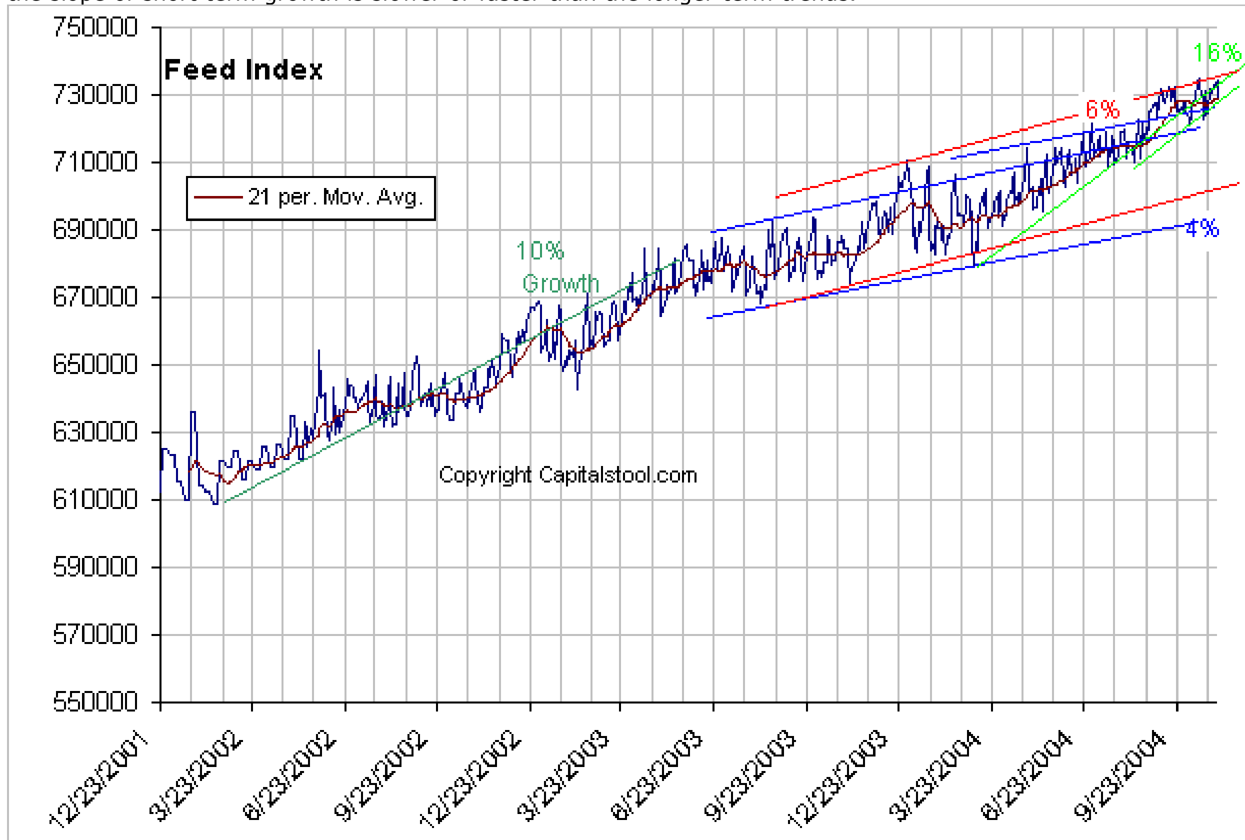
Feed 11/4/2004 MoGauge Fed Releases Turdsday

The Feed added $6.5 billion in overnight repos, and $8 billion in 14 day repos. Expirations totaled $13.25 billion, resulting in **a net add of $1 billion.** The 5 day net drain is $3.13 billion. Expirations ahead include the $6.5 billion in overnight repos, and $7 billion in 13 day repos next Wednesday 11/11.

	Added	Expired	Net	5 Day Net
10/29/2004	8.25	-9.25	-1.00	5.84
11/1/2004	10.50	-8.25	2.25	1.09
11/2/2004	4.45	-10.50	-6.05	-4.30
11/3/2004	3.67	-3.25	0.42	-1.88
Today	14.50	-13.25	1.25	-3.13
11/5/2004		-6.50		
11/8/2004				
11/9/2004				
11/10/2004				

Total Feed still remains near the top of the long term 6% growth channel but has come down toward the bottom of the short term 16% channel.

Three trends are evident on the Feed Index, which is the total Fed holdings of loans and securities. One is the 10% growth trend (green channel) beginning in May of 2001. The blue channel suggests a 4% growth rate. Look at the 4 week moving average (brown line) and compare it with the slope of the two larger channels for an indication for whether the slope of short term growth is slower or faster than the longer term trends.

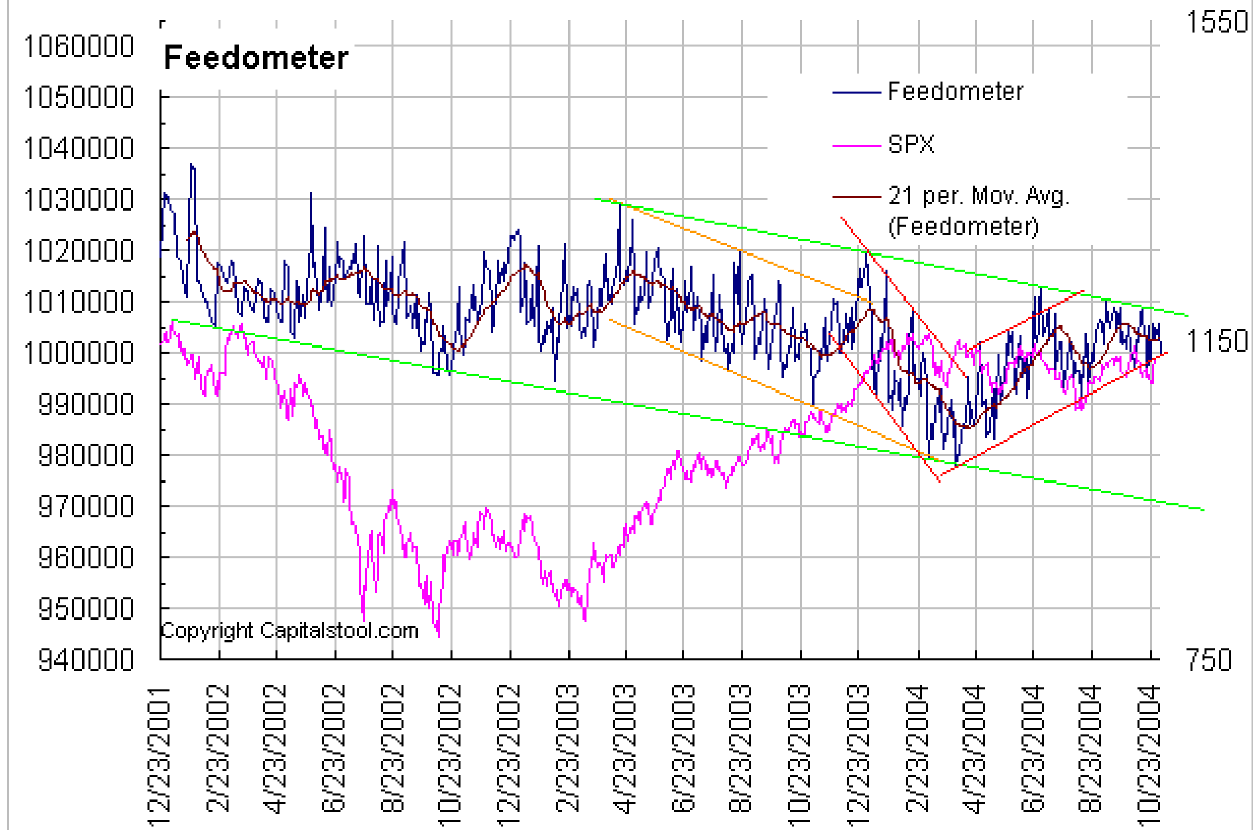


Looking back over the last 19 months there is an apparent long term channel with an annual growth rate of 6%. The 16% short term growth line stayed within that channel. This was hyperinflationary monetary policy at its best, but the Fed was pumping against the tide. Broad money measures and the MoGauge showed little sign of responding to the pumping, until the data released last week showed an uptick in broad money. This uptick was more a function of the rise in mortgage activity which followed the drop in long term interest rates that began in June. As this mini recovery in the mortgage market runs its course, the money supply blip will end. That will come after yields reverse, a process which appears to be under way now.

The Feedometer (below) is at the bottom of its intermediate uptrend channel. Each time it has hit that line since May has been a short term buy signal. Now that the election campaign is history, I wonder if they intend to tighten a little. The channel represents a generally accommodative posture toward the stock market, but, while the market did respond to short term Feed blasts, it has been running in place while the Feedometer was trending up.

In early October, the Feedometer reached the long term downtrend line (green) where Al has always started draining in the past. He drained again, but he was just playing rope a dope, dancing just below the line. Over the next few days we will find out if he pumps it up again off the intermediate uptrend line, or reverses the 7 month long uptrend. That would be a sea change, and would be bearish for the stock market. If he holds and turns up again, it would be short term bullish. He still has not tipped his hand.

The Feedometer theoretically measures excess Feed available for bond or stock market jamming. Al selects a trend level he feels is needed to reflatulate the economy. The Feedometer measures the difference between the apparent trend target, and actual day to day Feeding (Fast Feedometer), as well as a four week moving average (Slow Feedometer).



Regardless of the Fed's rate action, Al clearly has no intention of tightening. The pumping has been a vain attempt to jam the markets, as well as spur inflation. We have seen over the course of this year that such jams get far less bang for the buck on each successive attempt. Eventually, they will stop working all together. If he goes the other way, and embarks on a sustained period of draining, it would almost guarantee catastrophic shrinkage in liquidity. It would be totally out of character for this Fed. The rate rises are just a front to hide the Fed's real policy of pump and jam, which so far has worked only in that it may have temporarily prevented collapse. The day is coming when it won't.

Bond Borrowing- **The weekly data as of 10/20** shows that The Gang decreased its net long position in bonds, but still tilted toward a bullish overall position. Their position in US Treasuries was $79 billion net short vs. $74 billion net short the prior week. Excluding T-Bills however, the net short position in Treasuries was unchanged at $98 billion. Including corporates, mortgage backed, and GSE securities of more than 1 year maturity, their overall position was net long approximately $73 billion, unchanged on the week. That compares with $13 billion net short in mid July.

Since 10/18 they borrowed bonds to cover for the Treasury suctions. But other than that, their shorting has been light. They remain tilted to the bullish side.

Stay tuned to the Long Bong Hit report for the latest on bong yields.

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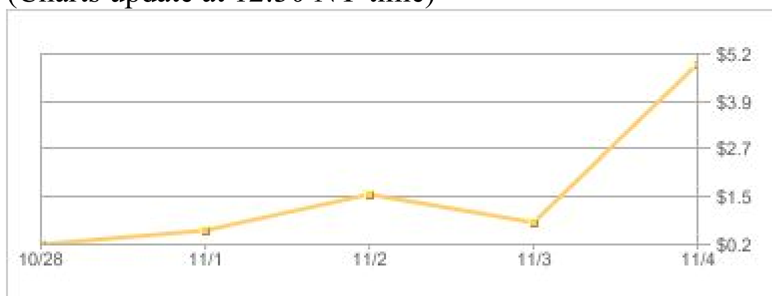
(Charts update at 12:30 NY time)



More than $1 billion per day in bond borrowing has historically signaled higher yields while during the bond market bull phase, shorting was normally less than $1 billion per day, often zero. Doesn't always work day to day, as dealers can get blindsided by hedge fund activities and intermarket and international capital flows. Heavy shorting for a week or more is almost always consistent with lower bond prices/higher yields ahead. Reduced shorting over a period of days is a sign of rising bond prices to come.

MoGauge 11/3/04

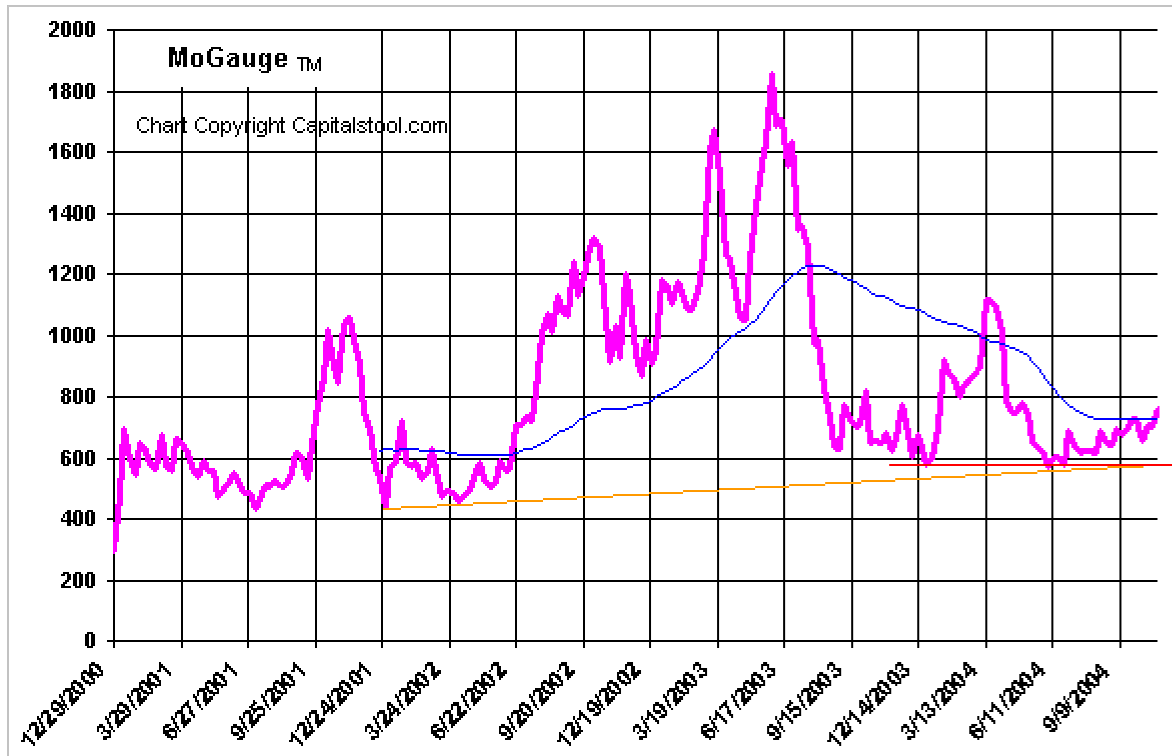
Instant replay content from prior weeks is indented in reduced size font. Normal font is updated commentary.

Preface- No single indicator has done a better job of warning us what's ahead than the MoGauge. This is the real leading indicator of how much liquidity is in the pipeline in our mortgage bubble driven financial world. You'd better believe we're not the only ones watching it. Al and the Gang have their eyes glued here too.

The MoGauge is the weekly Mortgage Applications Index released by the MoGauge Bankers Ass. of America. Mortgage applications get funded about 4-8 weeks after the application is taken. When the GSE's hold those loans in their portfolios, they then turn into money through the magic of money market fund intermediation. Broad money supply grows, and that flows into the markets and economic activity. Likewise, when mortgage activity declines, money growth slows or even goes negative. In effect, the MoGauge has the potential of telling us to what degree money will be added to the system in a month or so. Big jumps in the MoGauge tend to be followed by big stock market rallies along with big jumps in money supply. When these bulges subside, the market usually follows within a few months.

The **MoGauge broke out above the one year moving average,** continuing the mild uptrend that began in June. The weak recovery in refis appears to be faltering. Refis also rose to a new recovery high. Mortgage rates rose during the week. Did increased loan demand drive the increase, or did the rise in rates motivate borrowers to move now? Regardless, the uptrend will stimulate money and credit growth 4-8 weeks ahead. This should be a favorable period for credit bubble expansion, and therefore, as much as we don't like it, for stock prices. The wild card is short term interest rates. If they continue to creep higher, the flattening of the yield curve could impact spread trade credit creation. Any dislocation in the credit markets can prevent much of what's in the mortgage pipeline from hitting the market. So, while the pipeline is flowing, we still need to keep our eye on the day to day action in the short term and long term credit markets.

Unless the 10 year yield drops below 3.95% this may be the last hurrah in the refi game. Mortgage rates would need to drop below below 5% to generate anything resembling a new refi boom. As of October 29 they stood at 5.65%, a rise of 11 basis points from the prior week. They have come back down this week. This is the lowest level since late March, yet mortgage activity remains 35% below the level it was at then.

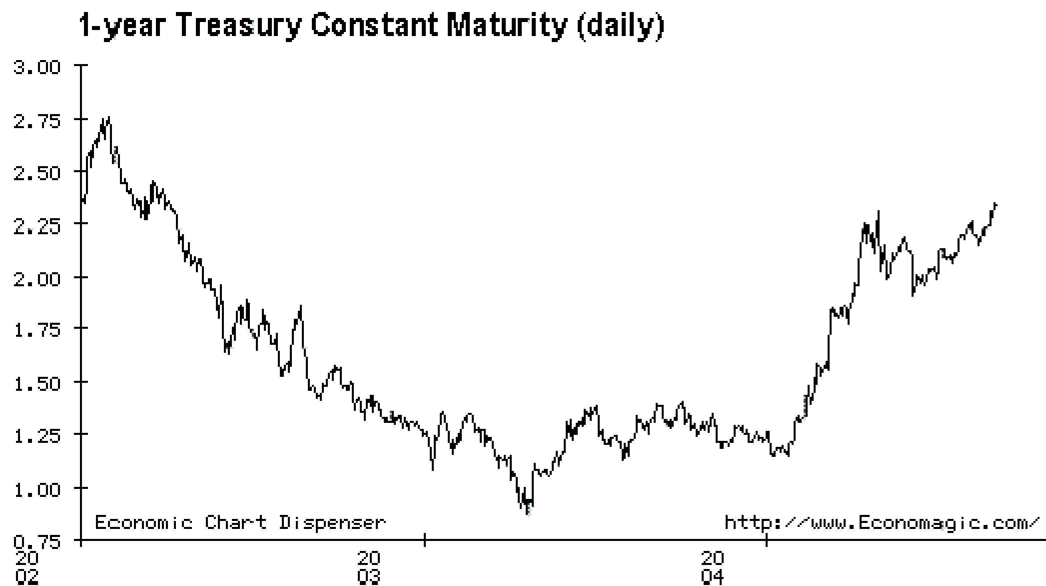


ARM rates were up 3 ticks at 3.96. In spite of the rise in ARM rates the percentage of ARMs only dropped from 34.9% to 34.4%. The market is scraping the bottom of the barrel. Ever more marginal borrowers who cannot qualify for the higher fixed rate loans, elect to take ARMs, and face a sea of troubles in the future.

The current proportion of borrowers taking ARMs is just slightly below the record of 35.2% in mid May. At the last major top in interest rates in 1994, the percentage of ARM mortgages was 10%.

Short rates have been inching up this week again, reaching a new high of 2.34 on the one year T Bill. If both short and long rates uptick in the weeks ahead, look for a sharp drop in overall activity, which would signal a general shrinkage in liquidity in 6-8 weeks. Even stable rates will result in slow death. Both long and short rates must fall to forestall eventual disaster.

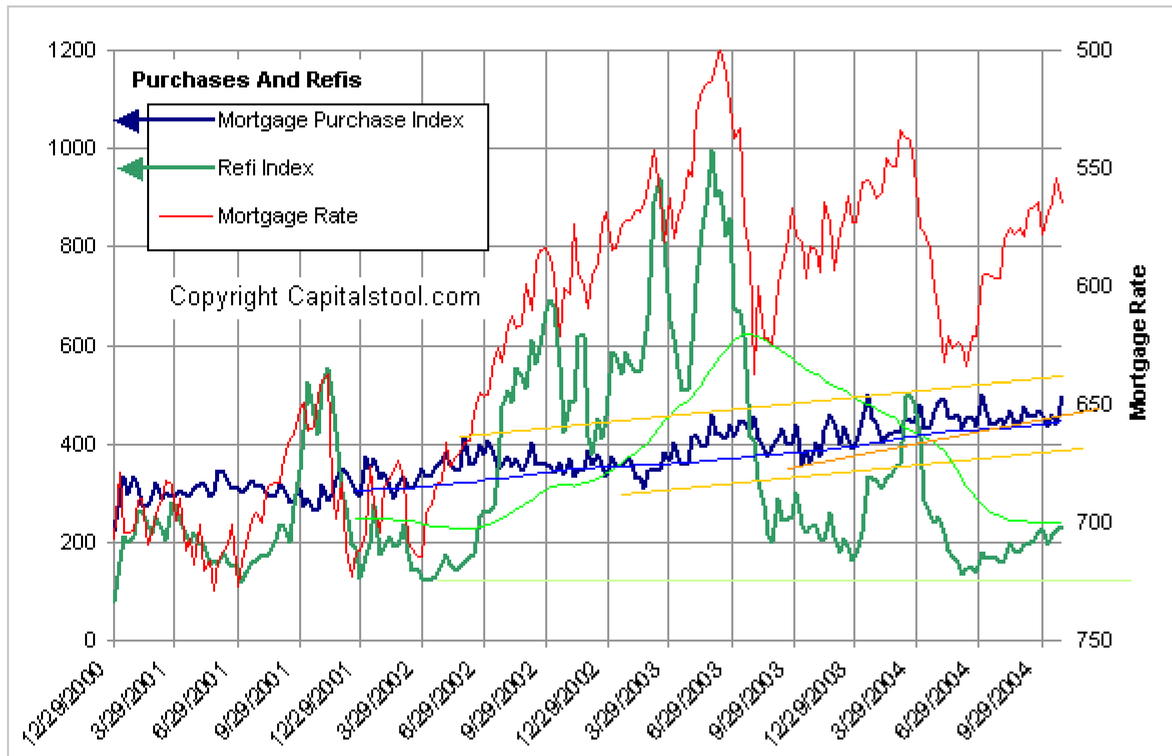
The percentage of borrowers taking ARM's remains near record levels in spite of the fact that 1 year ARM rates have risen sharply since March. Heavy ARM demand is a good contrary indicator, signaling that short term rates are headed up. The public's record on this is perfect, taking the lowest percentage in ARM's when rates are high, and vice versa.



Lenders may be eating some of the increase in the first year teaser rate, and passing some or all of it along in points. This will blow up when borrowers face their first anniversary adjustment, with the rate going to market.

Purchase mortgage activity has recovered back above the 52 week moving average. The uptrend is intact, but getting flatter. The purchase market has avoided collapse as many buyers shifted into ARMs when fixed rates rose, but the recent drop in the long end has not been stimulated the market at all. Short term stimulus comes when rates rise, a situation which obviously cannot be self sustaining.

The demand for housing has been satisfied. **Rates have fallen 75 basis points, but there has been virtually no increase in demand.** This spells big trouble for the housing bubble, even if rates do not begin upticking again. Stable rates will be accompanied with slowly diminishing demand. Any uptick in long term rates will set off a downward spiral. With ARM's constituting 1/3 of the market or more, any uptick in short term rates will add to the pressure. Recently, the market has the best of both worlds, with ARM rates low and not moving up much, and fixed rates low and falling, and it still hasn't been able to do much. Not a good sign for the housing and mortgage markets, or the credit bubble as a whole.



Without a total collapse in interest rates, any thought that the refi bubble can be reignited is pie in the sky. And without the excess liquidity provided by a refi boom, the markets are going to have a difficult time moving higher in a sustained way. At most, the markets should continue to churn in a range.

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Fed Releases 10/29/04

On Fed Releases Turdsday, Al's friends at the St. Louis Fed take the Fed releases and puts them into these great little charts for stoolies to peruse. Below are the current charts, with brief comments from Doc.

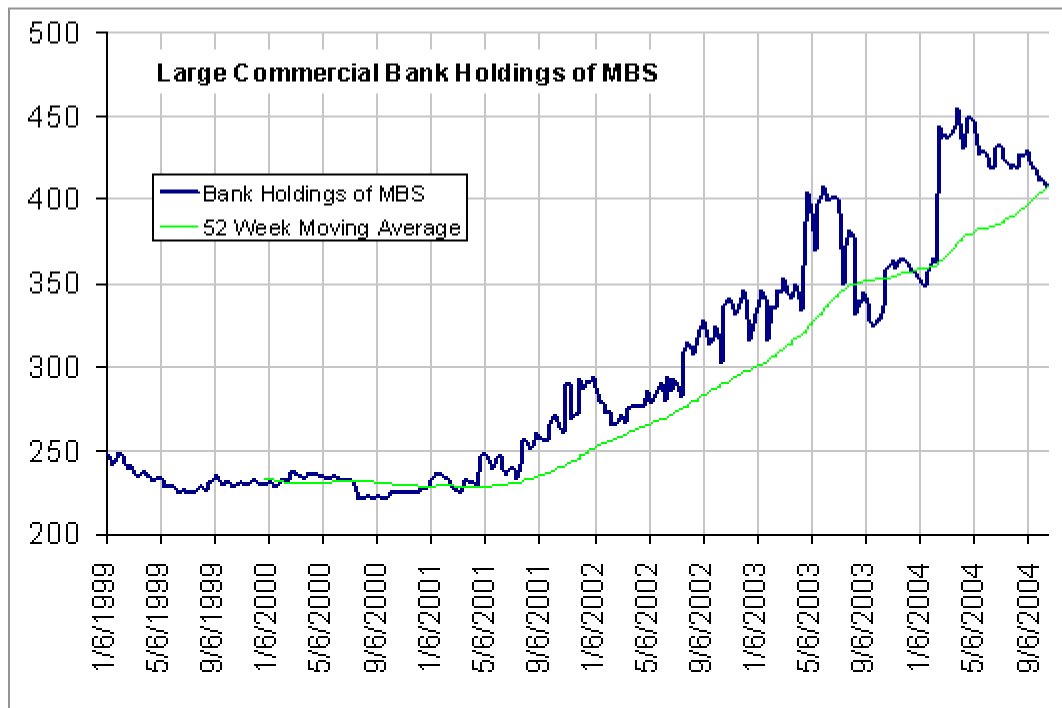
Instant replay content from prior weeks is indented in reduced size font. Normal font is updated commentary. Money supply and component data below is as of 10/18/04. Commercial paper data is as of 10/27. Bank Credit data is as of 10/20. Keep the varying degrees of lag in mind when viewing the data, and relating it to market action.

Broad money supply measures were mixed last week. M2 rose to a new high, buy M3 and MZM stayed within the flat ranges they have been in since May. Since total money supply has not grown, the rise in M2 merely indicates a shift from one class to another. Bond yields were down sharply in the week concurrent with these measures. In spite of falling long term interest rates they haven't been able to pump up the money supply.

Bank credit measures rose a bit to a new high on the strength of the increase in securities values, but loans and leases were down slightly. Bond yields and short rates remain the barometer of the credit market. They both must fall in order for money and credit to expand. In the absence of declines on both long and short rates credit and money growth will remain stalled, or worse, and stock prices will reflect that. The problems with the GSE's, Fannie, Freddie, et. al. will continue to have a negative impact on liquidity, and the slowdown in foreign central bank handouts to the US beggar nation, will, have disastrous consequences, if not reversed.

> The failure of the money supply to move very much on the recent expansion of credit in the banking system suggests that the real engine of money creation, GSE mortgage credit, which is not reflected in banking data, may be faltering. We were talking about this before the OFHEO report on the problems of FNMA became public. The MoGauge has been sputtering for months. Actual retained portfolio data from the GSE's themselves is only released with a 6 week lag, (Fannie, Freddie) so it is not of much help in terms of what's happening in real time. The announcement that Fannie will have to hold higher cash reserves is the precursor to tighter liquidity in general.

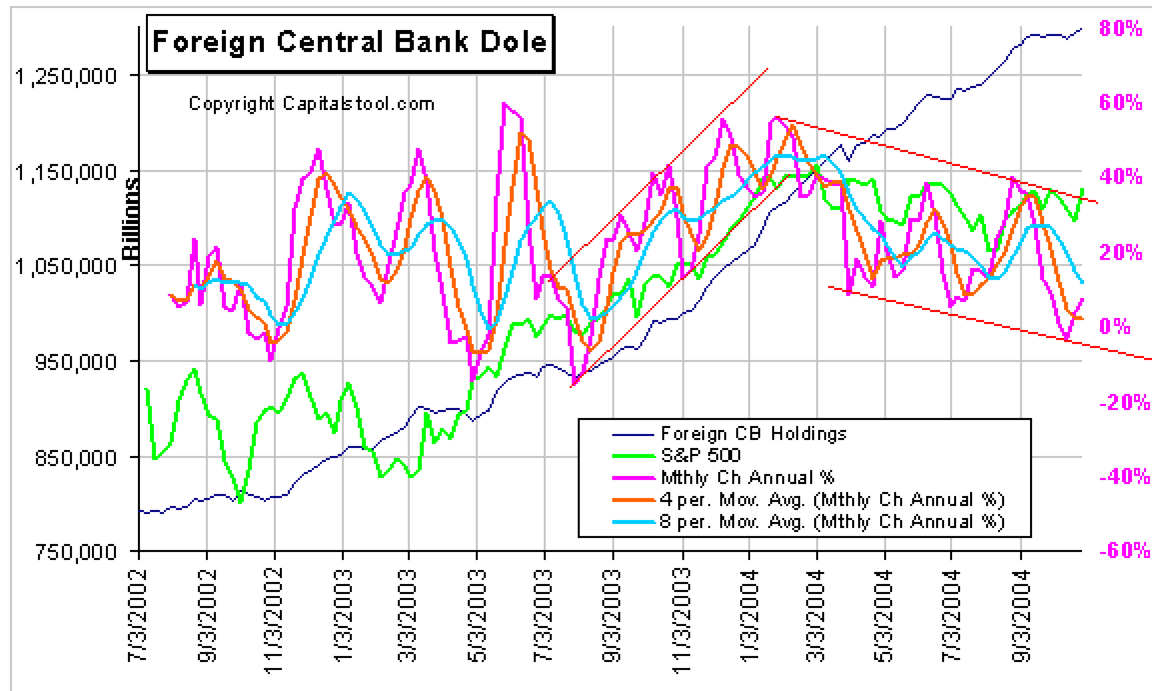
Based on the divergence between increasing total bank credit, and the flat money supply, we know there's a leak in the system, and I think it has to do with the problems at the GSE's. A line in the bank data gives us a near real-time window on this. **Holdings of federal agency MBS by large commercial banks were down again in the week ended 10/20 continuing a downtrend which began in April**. In fact, if we take out the large spikes, in April of 2003 and February 2004, which probably represented large sales to the large commercial banks, from non-banks, then this series would have already broken the 3 year uptrend. The same thing was certainly happening with the GSE's on a much larger scale, shrinkage of portfolios through liquidation at a time when the value of the securities was increasing. This explains why recently surging bank credit, and Fed pumping, is not showing up in the money supply. Now that Fannie is being forced to shed holdings, we wonder who will pick up the slack. Certainly not the commercial banks. That leaves foreign and domestic investors. Hmmmm.



Sufficient demand to drive expansion of the bubble will only be forthcoming if rates continue to fall. The demand for credit at rates at, or above, current levels has been met. Further declines are only likely if foreign central banks keep the US government on the dole. There have been signs at recent Treasury Suctions that they may be pulling the plug, or at least cutting back. Recently as well, the Fed's custodial holdings of Treasury securities for foreign governments has stopped growing, an indication that Uncle Fukui, Uncle Dung and others are slamming on the brakes? What does that matter? Simple. Without the subsidization of our markets by foreigners, in particular the central banks of Japan and China, and organizations like OPEC, the prices of US financial assets, in particular stocks, will fall.

The Fed reports every Thursday night the dollar value of US government securities it holds in custody for foreign central banks and international organizations such as OPEC. Changes in the level of these custodial holdings reflects the buying of Treasuries by Uncle Fuku, Uncle Dung, et. al. The correlation between foreign central bank buying of Treasuries and the performance of US stock prices is direct and undeniable, as the chart below illustrates. Since May of 2003 the SPX has directly mimicked the 8 week moving average of the 4 week rate of change in the Fed's foreign custodial holdings.

In the week ended 10/27, foreign central banks were buying. A little technical analysis shows that there is a line representing a minimum trend level at which they begin to increase their buying. It was hit two weeks ago. In retrospect, that was a buy signal for the stock market. Once they begin to buy, they apparently continue to do so for one to two months, until they reach the top of the current trend. This implies two to six weeks of support for US markets, ahead. Note that, while there is a directional correlation, there is no short term proportionality between the size of the move and the amount of foreign central bank buying. Too many other factors are at work.



The US gummit, thieving corporations, thieving corporate insiders, and the Wall Street distribution machine are creating such an enormous supply of securities all the time, that unless foreign central banks continue to add to their holdings at an annualized rate of increase of 30% or better, there is not enough demand to support all the new toilet paper flooding the market. To those who say that our foreign benefactors will keep this up indefinitely I say, Gimme a break! The evidence of the last 6 months says that either they will not, or they cannot. They will enter the market from time to time when they have accumulated too many dollars resulting from their burgeoning trade surpluses.

Broad money supply measures tend to follow the MoGauge, and the MoGauge is directly related to long term interest rates. The last surge in the MoGauge was in mid-March. The last of that money came out of the pipeline in mid June. The sharp drop in mortgage rates may stabilize mortgage creation, but unless rates drop below the March lows, it will not be enough to stimulate a renewal of the refi boom. Therefore money supply and credit measures should remain in either a stagnant or slow growth mode. If rates should begin to tick back up, liquidity will dry up. At 4% or above, there is little chance the bubble can be reflated.

The Fed has been working feverishly to pump in more liquidity into the system, keeping total Feed near record levels. Weak economic data gave them some help in the long end of the market. The Fed made noises about shifting to a tighter policy, but their actions have said otherwise. Al and his cronies remain easy. They know that tightening now would only exacerbate a general contraction that may already be starting. So it seems unlikely that they would tighten unless they have decided to deliberately induce recession now.

Evidently believing that the economy was "gaining traction" Al began reducing Feed in early September, and continued until early October, just before the bad jobs numbers came out. I would expect to see more of a stop-start-stop policy reflecting the Fed's apparent confusion. This could lead to a magnification of instability in the financial markets, with wide swings in both directions in the coming months. It is hard to envision a crash in view of the Fed's pumping whenever they get nervous. Whether that pumping is enough to stave off a slow motion, stop and start decline is another issue. The answer to that question will depend on the bond market, and the actions of foreign central banks accumulating the US dollar, which by extension inflates the bond market and keeps long term interest rates in the US on an unnatural subsidy.

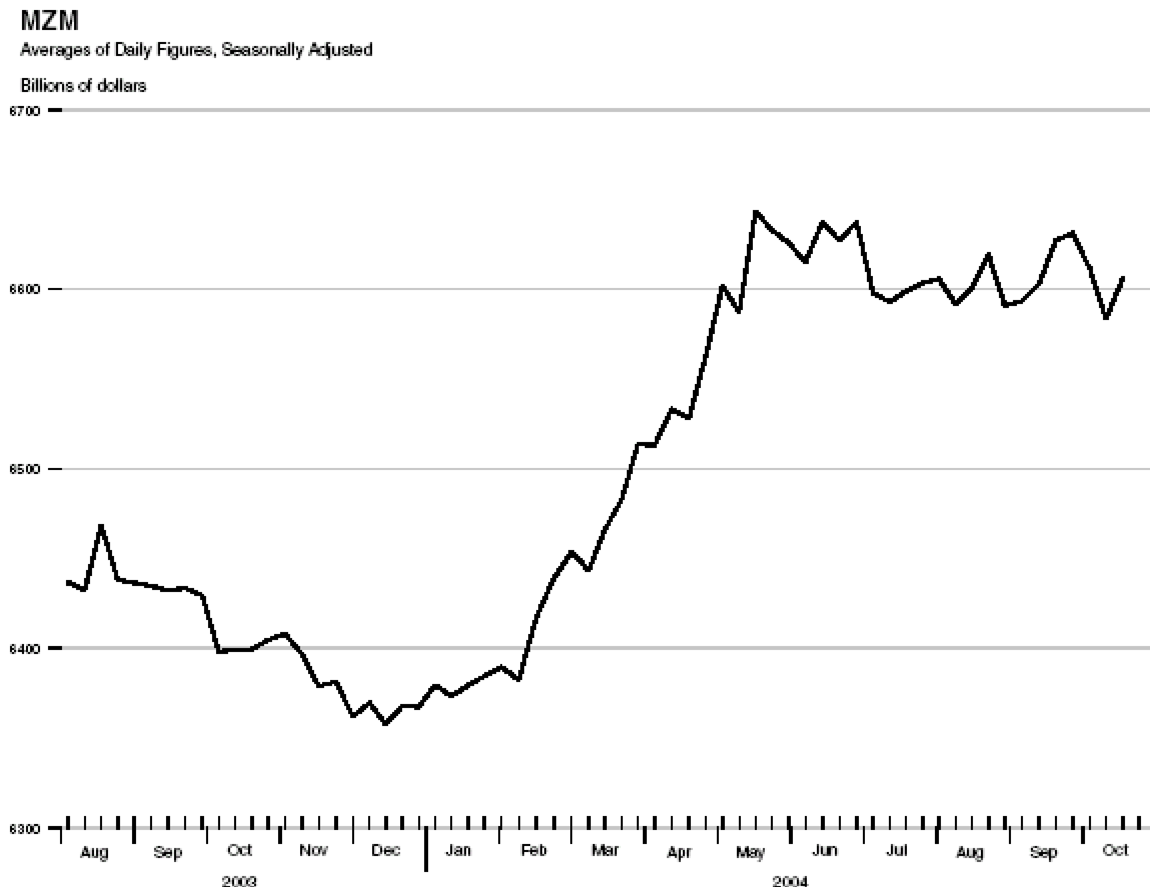
The bubble has run out of its natural gas, the huge flood of liquidity gushing from the mortgage markets. Subsidies from foreign central bank buying of US T.P. (treasury paper) are keeping it on life support. Most types of credit stopped growing in February and March. In recent weeks credit growth snapped back. The sharp drop in bond yields prevented collapse, and spurred a renewal of modest credit growth, but much lower long term rates would be required to generate a renewed refi boom. Without that, the stock market is unlikely to rise to new highs. As long as bond yields continue to decline, liquidity flows should be sufficient to prevent a collapse. Once the decline in mortgage rates stops, the mechanics will once again be thrown into reverse, because even this modest refi flow will again dry up quickly. The markets cannot afford any uptick in bond yields whatsoever, because the pool of potential borrowers at rates above current levels, is empty.

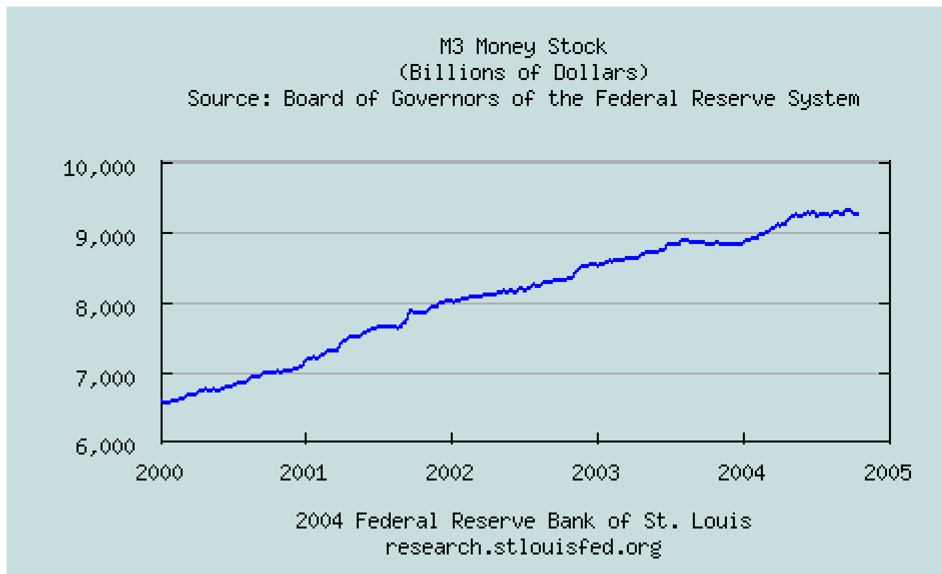
In effect, the weak economic data helps the Fed in trying to get long rates falling again, but so far there seems to be strong resistance to dropping below 4%. If they can't decisively break that barrier, game over.

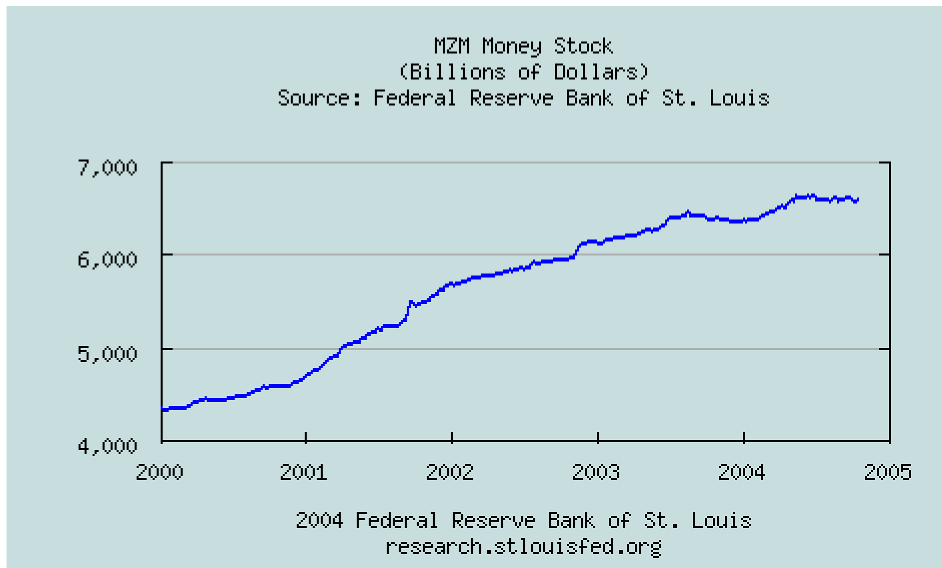
Ironically, the fall in long rates may cause bigger problems with the spread trade which drives the entire credit pyramid scheme. Short rates have not been dropping along with long rates. Tightening spreads at some point means that there is no "vig." That in itself could cause the credit markets to suddenly seize up. The Fed and the system as whole is on a tightrope. One false move, and it's over. In fact, it seems almost impossible to believe that something hasn't gone hugely wrong already, that's being swept under the rug. Time will tell. In order to get through this "soft patch" without crashing on to the rocks, the Fed has to engineer a decline in both long and short rates.

Which is exactly the opposite of its currently stated policy, and probably not possible in the face of Fannie having to raise cash, and foreign cb's not buying as much as in the past. It's no wonder the markets have been schizo.

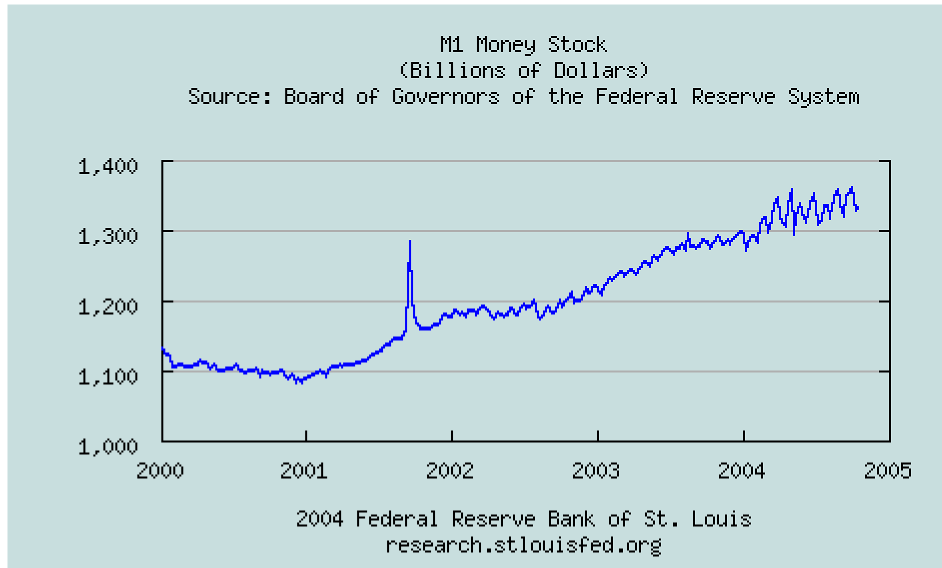
MZM, the measure of all the most liquid forms of money, **M2,** and **M3,** the broadest measure of all forms of money as measured by the Fed, were all up in the week ended October 18. M2 is at a new high. M3 and MZM are in the middle of the range they have been in since May. Overall money growth remains stagnant.



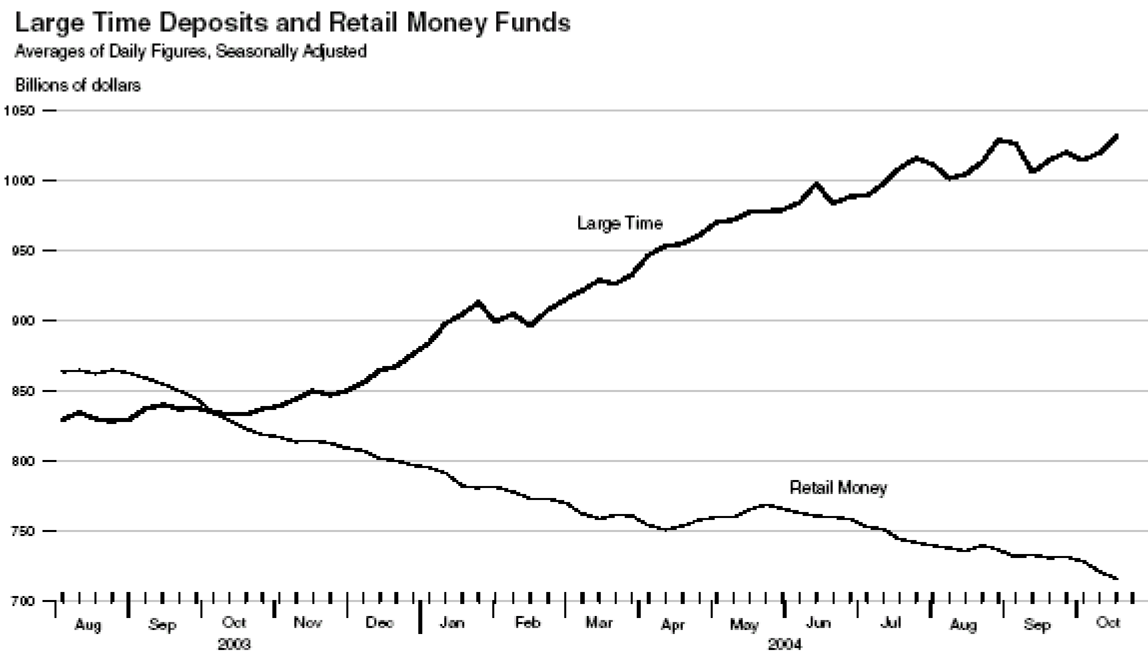


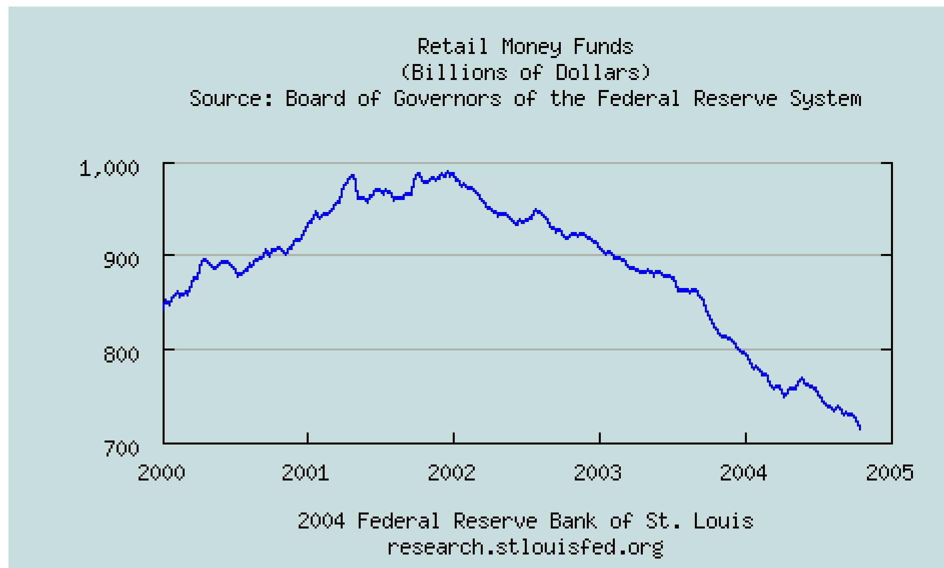


M1 rose as the Fed was pumping on balance, the week of October 18. M1 remains in the middle of its range since May in spite of the Fed having grown its assets (Total Feed) by over 4% since the beginning of May. The Fed's massive pumping has done nothing to stimulate money growth, even in the measure where it has the most direct influence. While the Fed has been blasting its asset base to new highs, M1 has remained flat, once again, evidence of a leak in the system. In recent months there has been an ominous, sustained rise in the currency component of M1, as bank deposits remained stagnant. Since May 3 demand deposits have fallen by $38.6 billion while currency has risen by $23 billion. Where is all the cash going, and why? Iraq perhaps? One thing we know is that the more cash is in demand, the less liquid is the system.



Retail and **institutional money funds** declined sharply again, and **large time deposits** rose. Money funds remain in a sustained trend of liquidation. Stocks were down during that week, so the liquidation of money market funds didn't benefit stock prices. This suggests debt liquidation.




Retail Money Funds
(Billions of Dollars)
Source: Board of Governors of the Federal Reserve System
1,000
900
800
700
2000
2001
2002
2003
2004
2005
2004 Federal Reserve Bank of St. Louis
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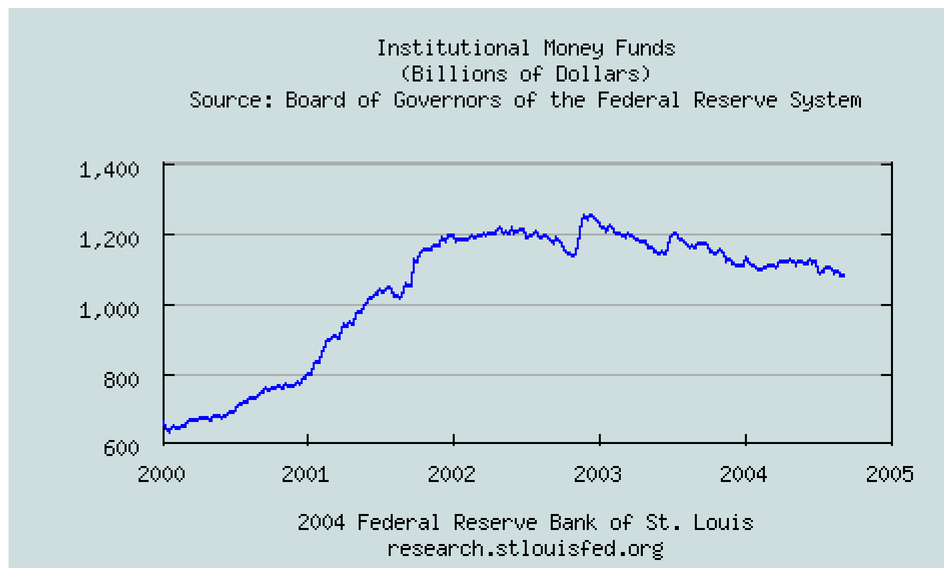
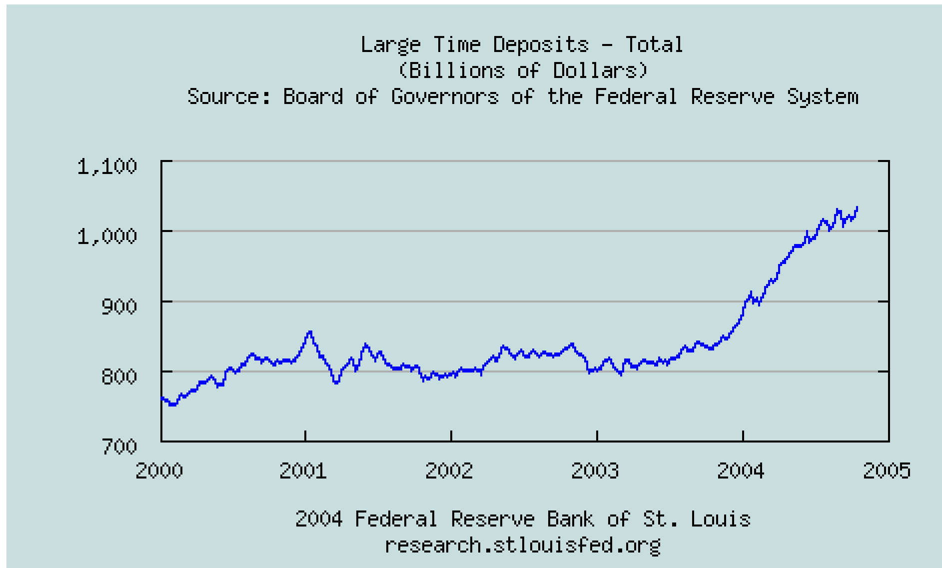
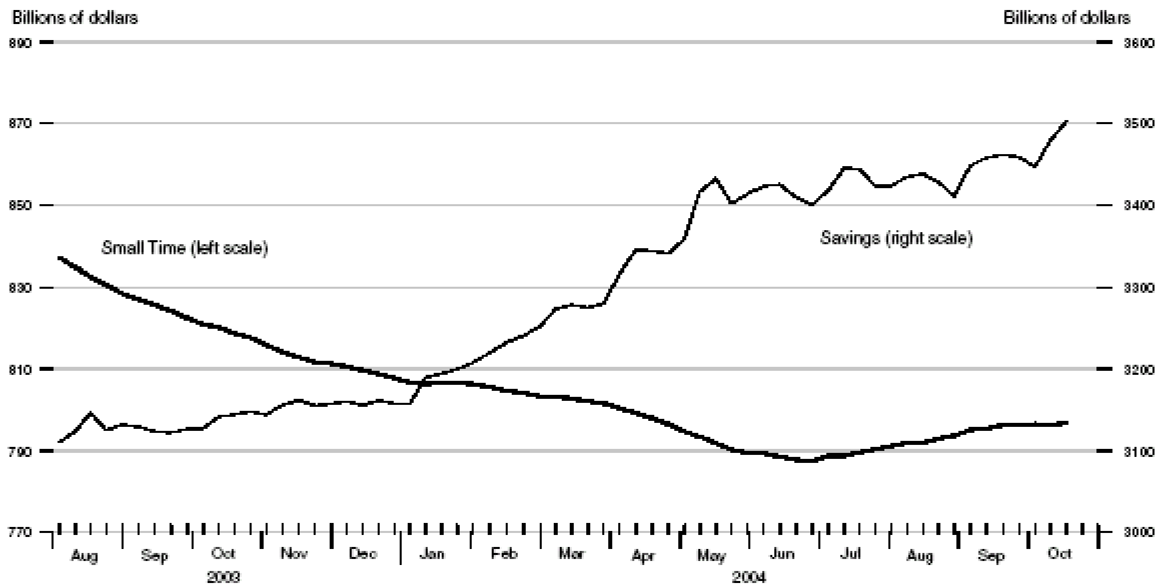

Institutional Money Funds
(Billions of Dollars)
Source: Board of Governors of the Federal Reserve System
1,400
1,200
1,000
800
600
2000
2001
2002
2003
2004
2005
2004 Federal Reserve Bank of St. Louis
research.stlouisfed.org



For the first time in years, **small time deposits have been in an uptrend**. They were down minimally in the week ended October 11, but rebounded the week of 10/18. This series has been on the upswing since June. This is an ominous sign for the markets and the economy.



The link between the decline in MMF's and debt liquidation should not be ignored. In addition, the recent rise in short term interest rates is helping banks pull deposits from MMFs. One year Treasury yields were around 2.29% up 6 basis points on the week on Thursday. The one year yield was around 1% in March. Rates on 90 day commercial paper, a staple of money market funds were up 6 bp last week, to 2.07%, 105 basis points higher than a year ago. 6 month cd's rose rose 8 bp's to 2.25, up from 1.10 in March, and the highest cd rate since short term rates began rising this year. After expenses, savers can get more interest at the bank than in their MMF, but the gap is narrowing. Unlike bond yields, short term rates have remained firm in recent weeks. At the margin where change occurs, to the individual investor, a 2.25 yield also looks inviting compared to a stock market where gains have been elusive all year, and some popular sectors have been trashed.

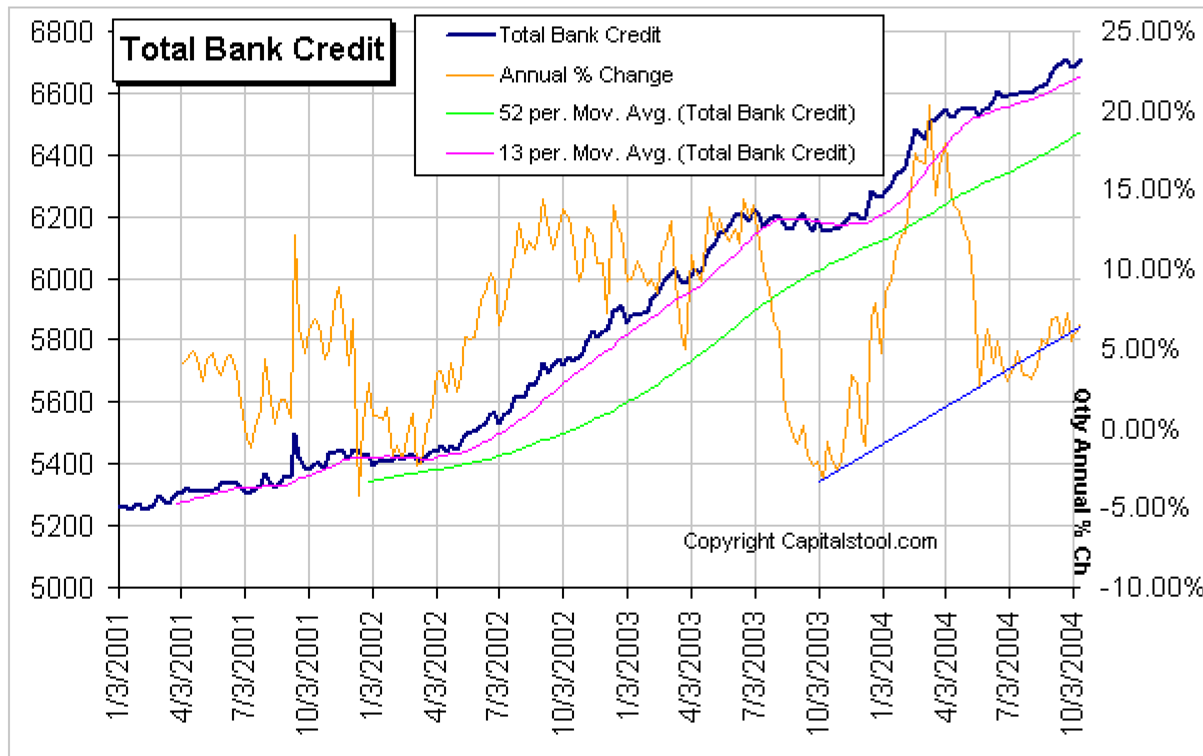
Of course it means nothing to professional portfolio sphincters, whose only goal is to be fully invested in stocks. As soon as they have even a tiny cash build, they put it all back in the market, which is why the market has a big rally every quarter. But with a small stream of marginal individual investors steadily pulling money out, the "pros" will not have the firepower to drive the market to new highs.

Gramma and Grandpa saver had been forced to speculate on high risk stocks because they couldn't earn a fair return on their capital in savings and money market accounts. The corollary is that companies had easy access to capital which they don't need for capacity expansion. So what did they do with it? They engaged in financial speculation, whether in their own stocks, or derivatives. Wall Street, always happy to oblige, assisted in the creation of ever more securities and derivatives for them to speculate in. The result was an oversupply of worthless paper.

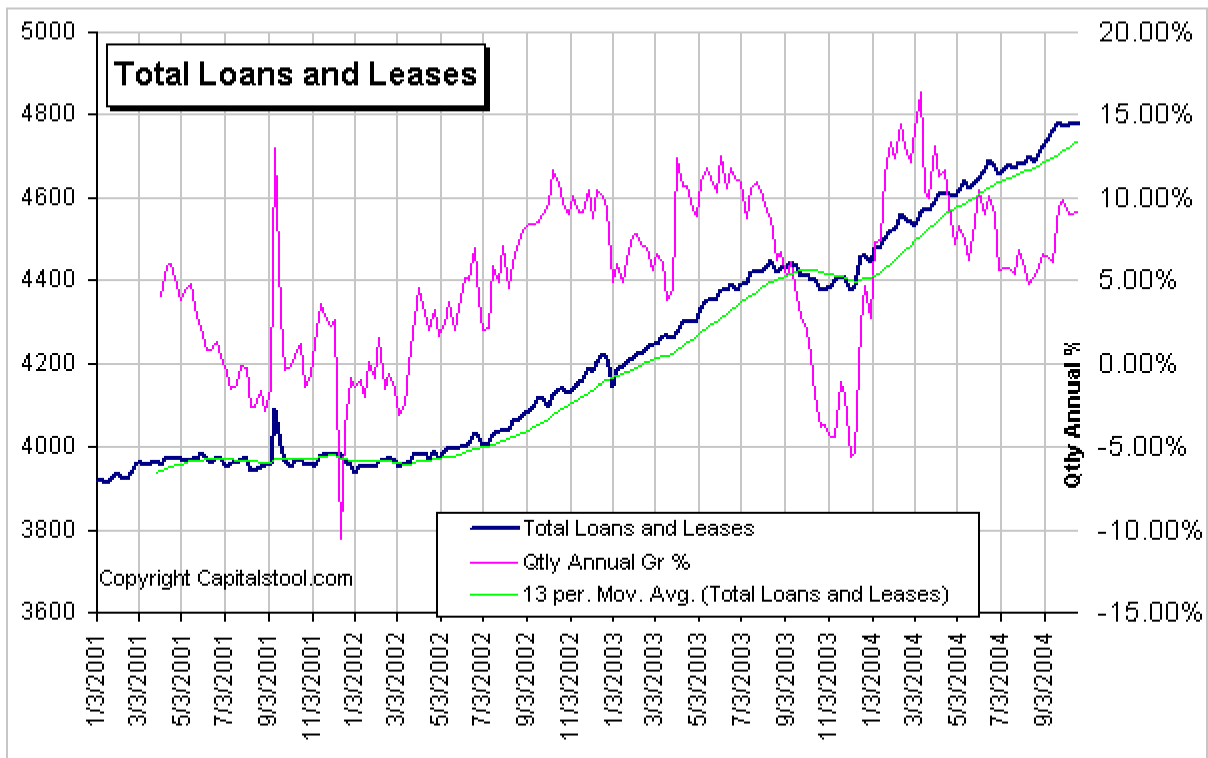
The shift from conservative savings into speculative ventures resulted in malinvestment. The longer it goes on, the worse the repercussions when the inevitable cleansing comes. This is also a mechanism of the transfer of wealth via the public's 401K accounts to corporate insider option grantees. It is how the great 401K pyramid cannibalizes itself.

Savings in the banking system have been flat over the last two months. Small time deposits have had the first real uptick in the slow secular descent in eons. If people are beginning to shift back to passbook savings, this is a bad sign for all financial asset classes and the economy as a whole. The fact that small savers are showing signs of moving back into savings instruments is an ominous indicator for the stock market. Small investors may no longer be believers in the false promises made by Wall Street hucksters. The stock market has been generally in decline since June, at the same time as investors were pulling money out of money market funds. This is an indication of a possible shift in liquidity and investment preferences. **If small investors use liquid assets to pay expenses, or pay down debt, they are not going to be pushing up stock prices.**

Total bank credit, which includes all types of securities, was up in the week ended 10/20/04, to a new high, on the strength of the increase in portfolio values driven by the bond market rally. The mid October drop coincided with an uptick in bond yields, showing that the uptrend is only sustainable if long rates continue to fall, which they didn't this week. 4% has been established as a benchmark. If they can't get long rates below this level, credit growth will again stagnate, and at some point will begin to contract. Any uptick in long bond yields could be be the catalyst for a catastrophic chain reaction contraction.

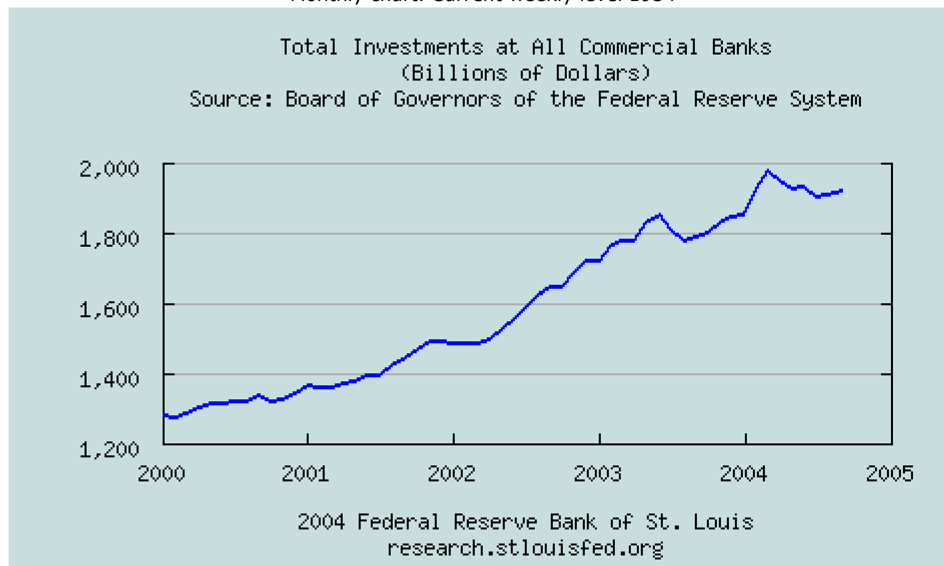


Loans and leases fell in spite of the good market. They were down $5.76 billion to $4,780.3 billion. Permanent real estate loans, and the "other" category were down, while Commercial and Industrial loans, home equity loans, consumer loans, and the volatile security loans categories were up.



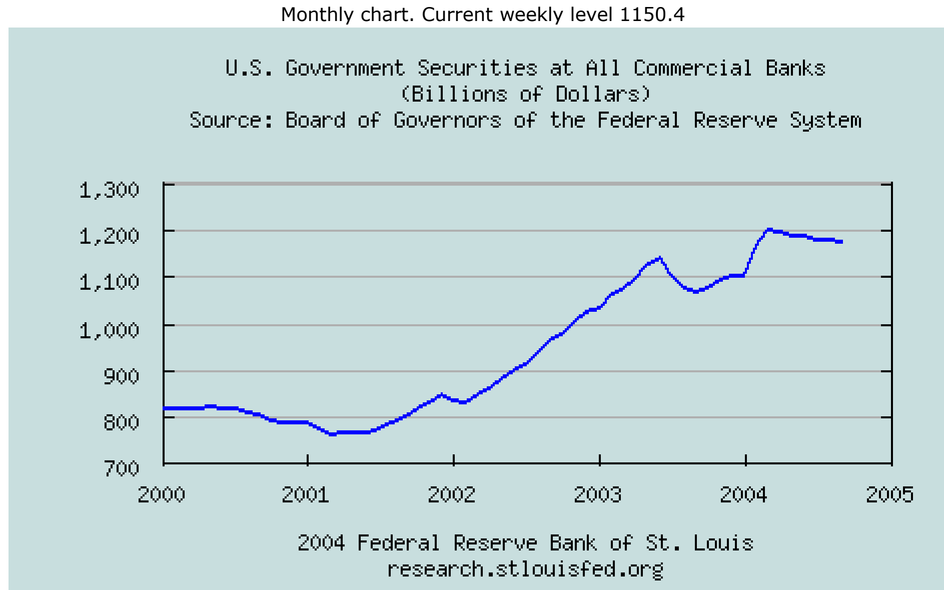
Banks' securities holdings rose by $4.9 billion to $1,934 billion as bond prices surged during that week. Total securities holdings are still down by $29.1 billion from the peak level of $1,963.1 billion (adjusted for portfolio reclassifications) reached in March. From March 2003 to March 2004, total securities holdings had risen by a total of 11.4%. The 3 year uptrend driven by increasing fixed income securities values has ended. While portfolios benefited from higher bond prices over the last several months, the drop in the value of holdings indicates that banks were selling into strength, and shifting into direct lending. They do not appear to have the ability, nor the will, to increase both their securities holdings, and the loan base at the same time. If rates do not continue to decline, another round of contraction in the asset base is likely.

Monthly chart. Current weekly level 1934



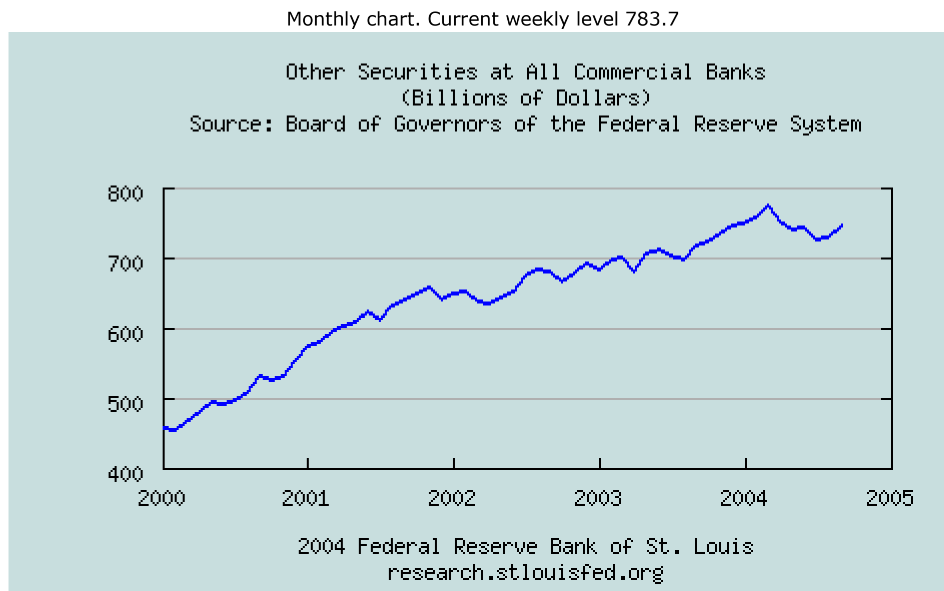
Commercial bank holdings of US Treasuries (Monthly chart does not reflect most recent weekly data.) **fell by $2.9 billion** to $1,150.4 billion, in the week ended 10/20, and are down $61.4 billion (5.1%) since March 31 ($1,211.8 billion).

Monthly chart. Current weekly level 1150.4



Other securities holdings rose by $13.1 billion to $783.7 billion. Other securities have broken out above the March 24 high of $756.8 billion (adjusted for reclassification of ABS). The annualized growth rate is now around 7% since March 24. This compares with a 13.3 % gain from March of 2003 to March 2004. Banks have been selling Treasuries and Agencies lately, and shifting into other types of securities. What other types? It's hard to say. Could be corporates, muni's, stocks, or ABS. We know it isn't MBS.

Monthly chart. Current weekly level 783.7



The **value of trading accounts of securities other than Treasuries, in large commercial banks, rose $7.2 billion last week** to $216.8 billion, a new high. In **government bond trading, they dropped $300 million** to $41.0 billion. On May 12 US government bond trading accounts peaked at $50.3 billion. They dropped to $35 billion on August 4, and clawed back to a new high of $53.9 billion, the week of 9/15. The big banks have been gradually shifting out of governments to trade the deluge of new non-government paper. I guess the spreads are better.

Net unrealized gains or losses on marketable securities (large commercial banks) came in at a a gain of $3.2 billion, up from $2.5 billion, the previous week, helped by the bond rally. That should narrow next week. This was the ninth weekly gain in a row after having a string of 16 weeks of net losses. The recovery in recent weeks was largely from the improvement in the bond market. If that recovery wanes, this item could go negative again. As long as rates continue to fall, this line item should continue to reflect narrow gains. Any renewed weakness in bond prices could start a new spiral of losses and liquidation.

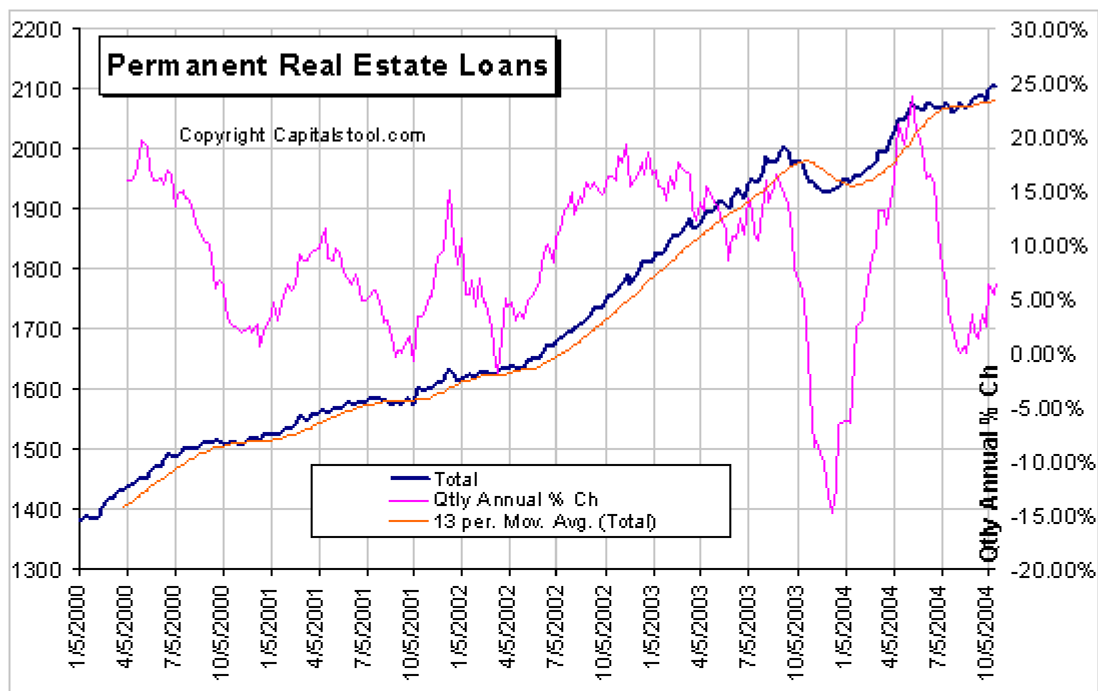
> The last time the banks began to report a string of such losses was in June of 1999. They continued to report growing unrealized securities losses until June of 2000. They gradually whittled that loss to zero by June of 2001. The stock market was under pressure for the entire period. Although the losses are smaller so far, this time around, the mechanics are similar. Until this number goes positive again, it will force some liquidation at the margin. That's all it takes to keep markets under pressure.

The spread between the **"fair value" of gains and losses on off balance sheet items, aka derivatives,** dipped slightly in the week ended 10/20 to $11 billion from $12.2 billion. It had run as high as $25 billion, a 22% margin, each week when times were good. Recently, it **has been getting uncomfortably tight**, falling below $10 billion in June, a 10% margin on smaller totals. It subsequently dropped even further, hitting a low of $7.2 billion on August 25, but has recovered in recent weeks on the heels of the bond market rally.

Foreign related banks in the US have reduced their exposure to the US market since June of last year, when their total credit holdings in the US peaked at $679 billion. In the week ended 10/20, that figure was $667.7 billion, up $5.6 billion on the week. Here again, the again was almost entirely in the volatile category of "other securities." After a massive binge of foreign investing in US Government securities beginning in the mid 90's, since May of 2003, the value of their holdings of US Government Securities is down from $127.4 billion to $92.5 billion, (-27.4%) coming off a low water market of $87.9 billion the week of 9/29. Holdings rose in value by $800 million in the week of 10/20, due to the rally.

> In light of these data, it is no surprise that the Fed has been pumping aggressively. Even the slightest reduction in purchases by either foreign central banks, the domestic banking sector, or foreign institutions, could cause major dislocations. If all are restricted, the effect could be cataclysmic. That would put the Fed to the test in its abilities to control a crisis. They have repeatedly promised unconventional actions. So far, it's all talk. If they really do try and use these unconventional actions, instead of merely trying to BS the markets, will they be effective? Short term interest rates continue to uptick, and the question of whether the decline in yields can be sustained is still open. So far the money supply and credit data does not bode well for a sustained reflation.

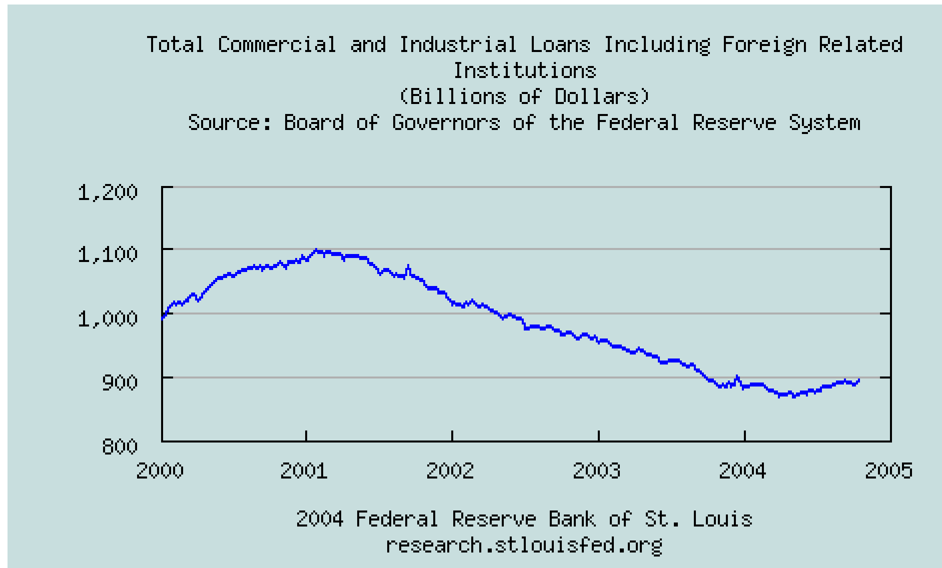
Real Estate Loans fell by $1.8 billion in the week ended 10/20. Permanent real estate loans fell by $4.2 billion to $2,102.9 billion. As the quarterly annualized rate of change shows clearly, real estate loans are tracking the MoGauge with just about a 2 month lag. That means that the liquidity flows from the latest series of upticks in the MoGauge can be expected to continue at least into early December. That will keep the system on life support. Direct real estate loans account for 37% of the assets in the commercial banking system. Mortgage backed securities account for another 6%. As goes real estate, so goes the system.



We know that Real Estate Loans lag the MoGauge. The MoGauge began a mild uptrend in late June. In addition, some loans which were in the pipeline and had been shelved by higher rates, are reactivated and funded when rates drop, as they have in recent weeks. These loans which have been underwritten, but not funded, are a form of life support for the system, trickling in whenever rates drop. The slight rise in new applications means that the total loan base will show a small degree of growth. But a sustained decline in long term interest rates would be necessary to reflate the balloon. The field of available borrowers has been picked pretty clean at current rates. Any backup in rates would cause new applicants to disappear and could trigger shrinkage in the loan base.

Real Estate lending is particularly important because it accounts for more than half of all bank loan value, and is nearly 4 times the size of the next largest category, consumer loans. Bank real estate loans also give us a reflective window into the non-bank GSE real estate lending sector which creates most credit and money today. If the banking system catches a cold, then it's safe to assume that the GSE's have pneumonia.

C&I Loans rose $2.30 billion, to $896.2 billion. C&I loans have stabilized from their long slump as securitized credit swaps have become less attractive, but rather than representing a recovery it is just a shift in the type of debt being created. C&I loans are a relatively small part of the credit bubble asset base.



While Total Loans and Leases were continuing to grow over the past couple of years, C&I loans were collapsing. Consumer lending and real estate lending kept the bubble bubbling. The consumer is now showing signs of being tapped out, as the free money real estate spigot has slowed to a trickle.

Consumer loans rose by $2.1 billion to $670.6 billion. Consumer borrowing, (and hence, consumer spending) has plunged in the last few months. When the cash from the refi bulge came through between March and May, consumers reduced their direct unsecured borrowing. That ended May 12, at a real estate loans peak. Consumers then went on a credit card binge. The record for this series was set on June 16, at $678.7 billion, up 7% in the prior 12 months. Since then the trend has been flat to down, suggesting that consumers are tapped out.

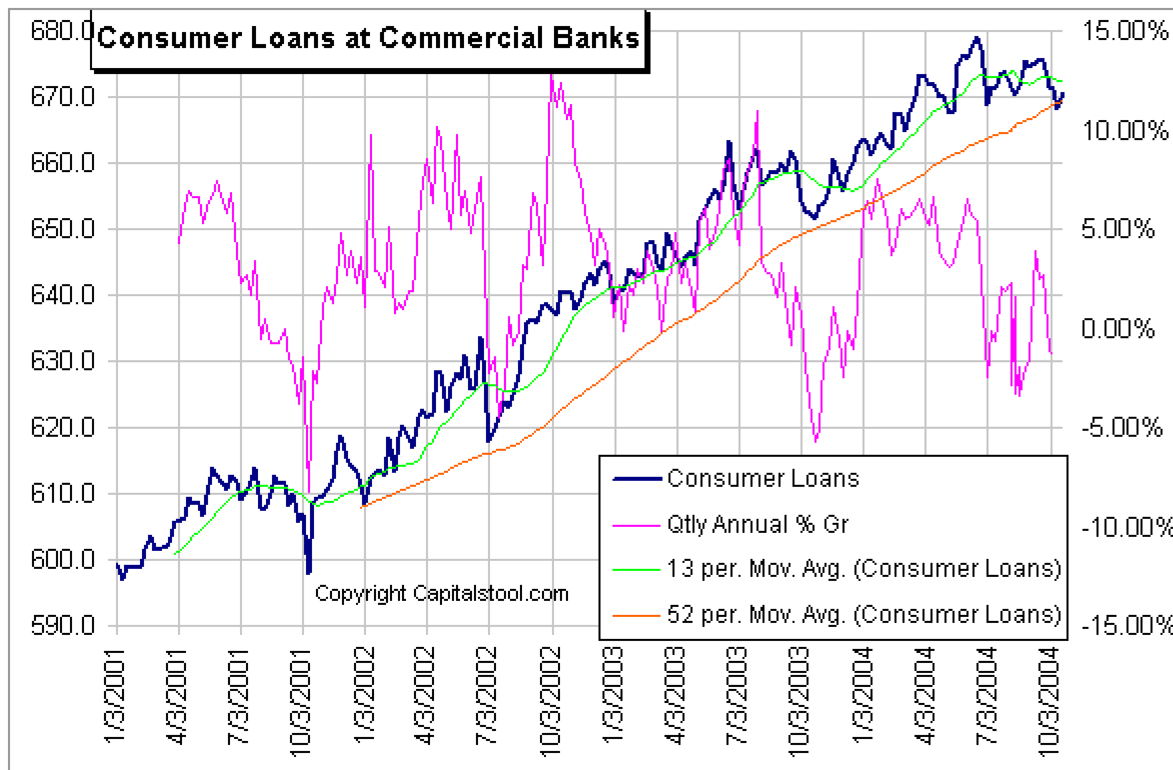


Chart adjusted for asset reclassification in July 2004, and an 11/03 anomaly.

This chart includes all consumer debt, reported monthly.

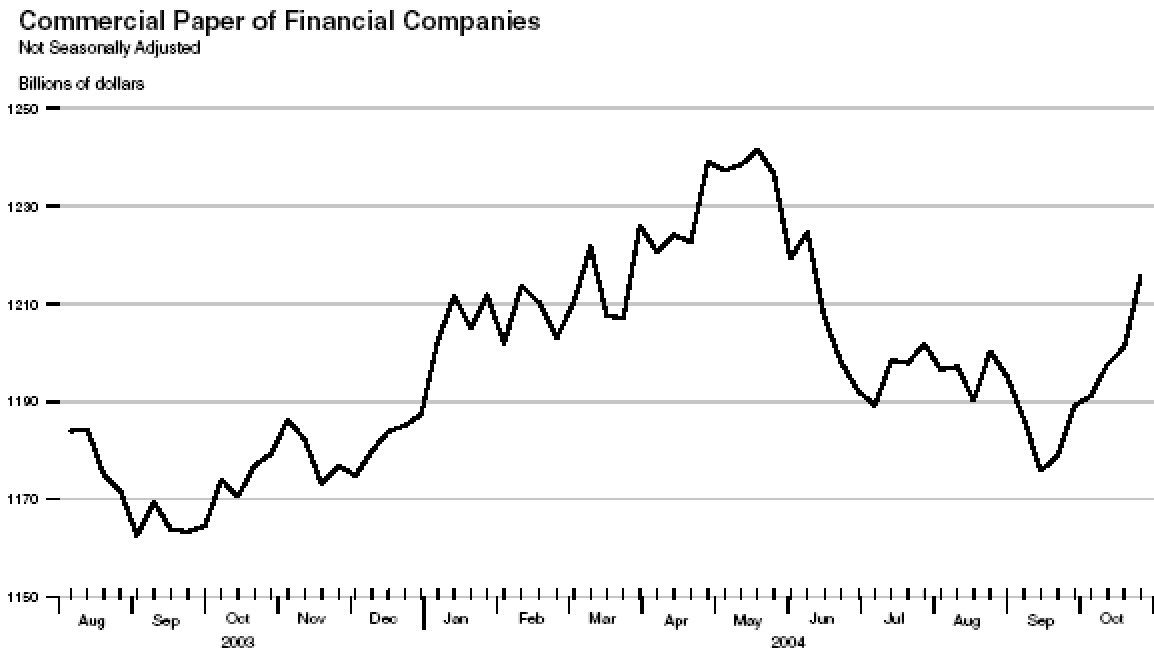
The **panic into revolving home equity loans** rolls on, rising by $2.4 billon to $381 billion. Last week's small increase looks like a one week wonder. The growth rate over the past 4 weeks is still 35.8% annualized, compared with the 36.8% growth rate of the last year. If you want to know what has sustained consumer spending, and the economy as a whole, there is your answer. Homeowners, in the aggregate, have been pulling $2 billion to $3 billion a week out of their home equity credit lines, week in and week out, month in and month out. When the real estate bubble finally cracks, the holders of all those home equity lines are going to be left holding the bags. Not the borrowers, the lenders. And since these are second mortgages, the bags will be empty. There will be no recovery of the loan asset in many cases.

Even though the refi market has dried up, home owners are still cashing out their "equity", perhaps out of necessity. That gravy train will come to an end. As the real estate market slows, the concept of "equity" will prove to be an illusion produced by the credit bubble. Because of the slow response of real estate markets, and the even bigger lag in real estate data hitting the information stream, the topping out of this series could take up to a year. Banks will be cashing out home "equity" long after the "equity" is no longer there.

The **"Other" category** (autos, boats, RV's etc.) dropped by $9.2 billion, to $483.3 billion. This series is extremely volatile. In the year prior to February 11, 2004 when it peaked at $489.5 billion, Other Loans and Leases had grown by 21.4%. It was flat from February to September, but broke the February 11 high in September, setting a new high of $502.4 billion on 9/22. This series is now back below the February 11 level. That's zero growth in over 8 months.

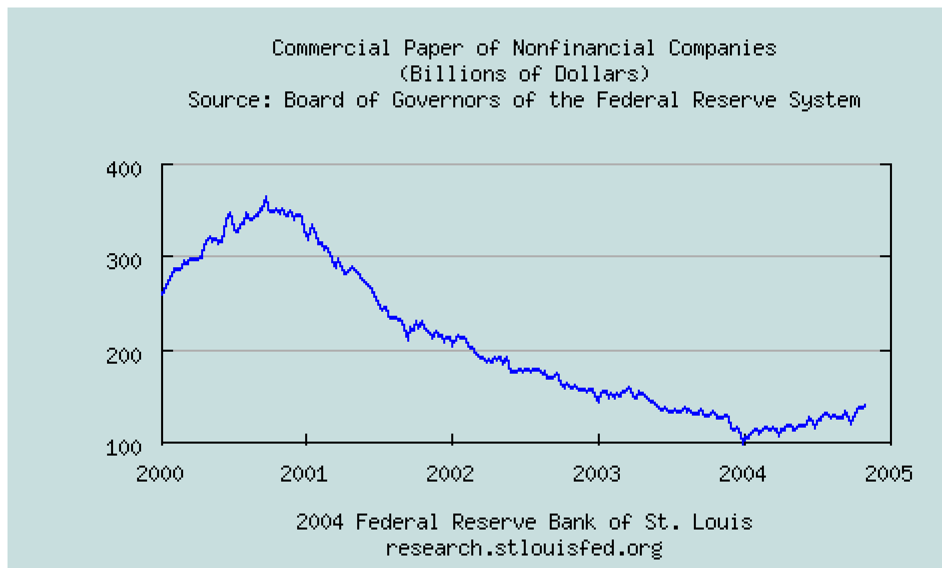
The Financial Company commercial paper market, (data as of 10/27) upticked sharply again after hitting a new low for 2004 in September. As long as this series is not hitting new lows, the system is still limping along on life support. When it is rising, the system is reflating, at least temporarily. By the same token, the rise in this series coupled with the decline in money fund assets results in upward the pressure on short term interest rates, which we have seen expressed in the market.

These are the companies that do the lending to everyone else, and the feedstock of money market funds. Changes in the growth rate of the money supply correlate closely to the direction of this series. This series also tracks the rise and fall in real estate loan applications closely. The drying up of the mortgage refi market has led to a reduction in the issuance of financial company commercial paper. The sharp drop in long term rates could arrest the current decline if there is a sustained pickup in mortgage demand. Any backup in mortgage rates could send this index through the floor. The narrowing spread between long and short rates is also putting the squeeze on.



The rate for 30 day financial company AA paper rose 7 basis points to 1.89, Thursday. It had been 1.02-1.04 as recently as June 8. 90 day paper was at 2.07, up 6 bp's from the prior week. On April 9, 90 day paper was 1.04. The Fed does not set short term interest rates. The market does. The longer the maturity, the less influence the Fed has. The Fed's announced changes in Fed Funds targets tend to follow changes in the short end of this market.

The **Nonfinancial Commercial Paper Market** (data as of 10/27) is only a fraction of the size of the Financial Company CP market. It has been in a small recovery since the beginning of the year, but the amounts are insignificant, both in terms of the preceding 3 year decline, and relative to the financial company CP market.



Rising short rates and falling long rates have been putting the squeeze on the carry trade. As long as CP rates remain low it is a powerful incentive to financial companies to increase their borrowing. This game will only work as long as money rates do not rise. Fed assurances that rate increases will be measured are meaningless if the market races ahead of the Fed, as it has been doing. While long yields were dropping, short term rates continued to inch up, making the spread trade less profitable, and increasing the risk. At some point, spreads become so narrow that the spread trade business simply comes to a halt. That could put the credit markets in a choke hold at any time. We are on the razor's edge.

> Soft economic data has been the catalyst for short covering in the bond pits, bringing down long term rates, but short rates have not played ball. If the short end of the commercial paper market continues to ratchet up, a crack is inevitable.
>
> So far there has been some response to the big rally in the bond market, primarily in real estate lending, and in the volatile securities series, both of which will quickly reverse on any increase in long rates. In order to keep the flow of new loans coming, both long and short rates must decline. If they don't, credit growth should stop dead, which should lead to a new round of liquidation. At some point that can become self feeding, which is what the Fed may be trying to preempt with its manic pumping.
>
> The recent big drop in bond yields stopped the ongoing collapse of the mortgage bubble. We'll watch the MoGauge for signs that life after death is continuing. It's doubtful that the corpse can do much more than sit up in its grave. It is unlikely to climb out, unless bond yields collapse from here. The problem is that even though the collapse has been halted, there is not enough mortgage credit growth the keep the money supply growing.
>
> Credit in the banking system was up in recent weeks, as the value of securities and loans went up, and there was some pickup in lending, but the money supply remained flat, and notably, banks did not appear to want, or be able to expand both the loan base, and securities holdings at the same time. Unless the mortgage bubble can be reflated, this is a ticking time bomb. The data for the week ended 9/29, when long rates bottomed mid week, showed a sharp drop in credit. The mortgage bubble can only be reflated if rates drop substantially from current levels, to below the lows of the past year, a highly doubtful proposition.
>
> Narrowing profit spreads in derivatives are a sign that rising short term interest rates may be causing some stress in the system, or vice versa, systemic stress may be causing short term rates to rise, and derivatives profits to erode. This is something to keep an eye on in the weeks ahead. If long rates drop and short rates do not, there is going to be a serious problem.

Foreign central banks and foreign investors still hold the key top part of this. Since we produce far more paper than we can absorb domestically, the bond market would have cratered long ago were it not for the subsidy from Uncle Fuku and Uncle Dung. Burgeoning trade deficits and the weak dollar cause foreign banking systems to accumulate dollar reserves, and thus their huge support of Gary US Bonds. Foreign exchange reserves of US dollars around the world will continue to grow as a result of the massive trade deficits. It could start the vicious spiral of a weak dollar coupled with falling yields all over again. Private investors, both foreign and domestic may not like the Gary Bonds tickets at these prices, and will refrain from buying. If that is the case, the drive to lower yields will stop, and so will credit growth.

Foreign central banks virtually disappeared from participation in the regular US Treasury suctions in September. They had virtually halted their purchases of Treasury securities in recent weeks. If this continued, it would spell big trouble for the entire US Ponzi financial system. There just aren't enough domestic greater fools left to keep the scheme afloat indefinitely. But in the week ended 10/20, overwhelmed with their ever growing flood of US dollars accumulated in trade with the US, they were back in the market buying Treasuries. The excess liquidity flowed into stock prices. If their past behavior is any guide, they will need to keep buying for 4-6 weeks. At the very least, that should keep a floor under stock prices, and possibly send them upward.

Rallies will end whenever credit creation stalls on an uptick in interest rates, or when foreign central banks withhold their support from our markets. Or both. Rising long rates, and the withdrawal of Uncles Dung and Fuku would be an absolute killer if it were to happen. The markets are the real-time meter. Market action will tell us when the time has come. With all the Uncles' handouts at the moment, things will continue to perk along as if nothing is wrong. But we know that is a false facade. The foundations of the system are rotting away.

What about if long rates continue to fall? That will surely be a problem if short rates do not fall as well. The carry trade is a key element in the well being of the bubble. That requires adequate spreads between short and long rates, and at least a stable market, or one in which both long rates and short rates fall. If either long or short rates rise, or both, the system must liquidate.

The continuing life of the credit bubble boils down to two things, the behavior of three stooges, Al, Fukui, and Dung, and one other thing: Real Estate. Consumers are pulling $3 billion out of home equity week after week after week. Speculators continue to borrow to buy real estate, regardless of how ridiculous the price. They move from market to market, looking for something, anything, to buy. Meanwhile consumers are dead in the water and have stopped borrowing on anything other than their real estate. This system is grinding to a halt, and the foreign monetary authorities who have been sustaining it are all that is keeping a good face on it.

Residuals from the refi boom, wild consumer borrowing, tax cuts, and speculative bubbles in the stock market and especially in real estate, had been driving the "as good as it gets" leading index data. There was no expansion of real business investment. This was not "economic recovery." It was the residual effect of debt bubbles being transmitted from sector to sector, a rolling Ponzi scheme. Apparently "improving" data were a result of a wild speculative mania fueled by financial imbalances resulting from artificial suppression of interest rates, and foreign central bank monetary machinations keeping bond yields low. As credit market conditions deteriorate, more seepage is likely on this chart. Chart from Businesscycle.com

Anals Home Cycle Tables Intraday Feed Dow Long Bong
Hit SPX Nasgap Golden Stool Uncle Buck
Stoolwethers and Suctor Watch

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