The End Of Monetary History

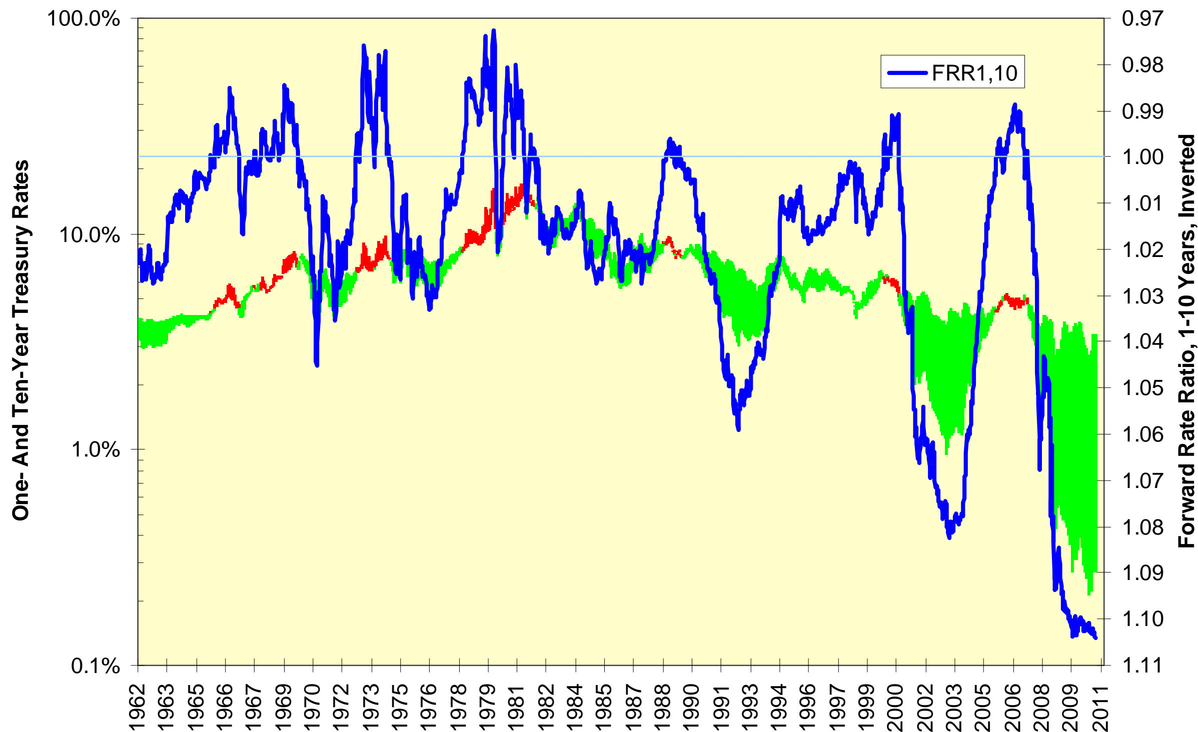
One of the great early and wrong calls of my lifetime was Francis Fukuyama's 1992 "The End of History," a paean to the triumph of liberal democracy and market capitalism over the other stuff. We have several similar calls now in the realm of public service union pensions and their chokehold on municipal finances: Politicians kicked the can down the road and now we are at the end of the road.

I call this the Marshall Tucker moment after their blistering line in Can't You See, one that resonates to every man over sixteen who ever had his heart broken:

I'm gonna buy a ticket now / As far as I can
Ain't never coming back
Ride me a Southbound / All the way to Georgia now
Til the train run out of track

When it comes to solving every macroeconomic problem and financial market hiccup with the always-and-evermore response of lower short-term interest rates, the train indeed has run out of track. Let's illustrate this with the history of one- and ten-year Treasury yields and the forward rate ratio between them ($FRR_{1,10}$). This is the rate at which we can lock in borrowing for nine years starting one year from now, divided by the ten-year rate itself. The more this ratio exceeds 1.00, the steeper the yield curve is. The $FRR_{1,10}$ is plotted inversely on the chart below.

The Yield Curve And Yield Levels



Now what about those red and green, primarily green, shaded areas? The shaded areas themselves represent the gap between one- and ten-year rates. When they are red, as was the case in 2006 and part of 2007, the yield curve is inverted. When they are green, the yield curve is positively sloped. These are plotted along a logarithmic scale. Please notice how U.S. interest rates have been failing at lower highs since the early 1980s; each time they drive lower, they move exponentially lower. Their level last October, 0.21%, is at the point where a further drop will take an exponentially greater level of monetary irresponsibility.

When did the $FRR_{1,10}$ reach its high? That would be on January 21, 2011, a level of 1.1042, thanks for asking. The rising fear of inflation pushes the yield curve ever steeper and into an unstable zone. All it will take to unwind domestic yield curve trades and global carry trades is even a whiff of higher short-term interest rates.

The reason for this instability is simple and straightforward: Years of ever-lower rates cum ever-steeper yield curves have embedded lower yields in the capital structures of corporations, governments and households. We saw in the 2008 credit crunch just how much economic damage can be produced by the liquidation of leveraged assets. So what did we do? We drove rates lower and expanded leverage even more.

What will happen then? As nominal rates are unlikely to turn negative, although that is not an actual limit, and as we have already conjured more than $1.7 trillion out of thin air in various money-printing escapades, we are at the limit of what money can do.