Could Bernanke Spark a Run on the Dollar?

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Treasury yields are "blinking red", but the Fed keeps acting like nothing's wrong. What's the deal?

Let's explain: Fed chairman Ben Bernanke's bond purchasing program (QE2) has sent the yield on the 30-year Treasury skyrocketing. At the same time, the the 2-year Treasury is stuck at a lowly 0.61. That means, the "yield curve" between the two bonds has grown steeper, which normally happens at the beginning of a recovery because investors are moving out of "risk free" bonds to riskier assets like stocks. Typically, the yield on the long-term bond will start to go down on its own because investors expect the Fed to raise short-term rates to curb potential inflation. But that's not happening this time. Why? And why should we care?

The reason we should care is because the yield curve is signaling one of two things; inflation or default. What it is NOT signaling is a robust recovery.

Remember, the Fed's main job is "price stability" which means keeping a lid on inflation. When the yield on long-term bonds spikes, then it's up to Bernanke to show the market he'll do what's necessary to fight inflation, that is, raise rates. It's a question of credibility.

But Bernanke isn't interested in credibility. In fact, he's not only said that he will keep rates low for an "extended period of time" but also pledged to continue his $600 QE2 program until there's a "significant improvement in labor market." He was joined in his commitment by all of the active members of the FOMC.

Now, granted, QE2 has boosted stock prices, but the extra liquidity has also inflated commodities prices (making it harder on consumers) and wreaked havoc in emerging markets forcing trading partners to control capital flows or raise rates to tamp down inflation. But QE2's greatest shortcoming is that is really doesn't create jobs as advertised. It's just more supply side, "trickle down" monetary theory designed to goose the market while workers languish in unemployment lines. Here's how the Wall Street journal's Kelly Evans summed it up:

"…the limits of monetary policy are becoming clearer. History suggests any further easing probably would do too much for the stock market and asset prices, and too little for jobs.

The only real fix is to lower the cost of U.S. workers relative to foreign rivals and machines, or else raise their bang for the buck. The latter, while clearly preferable, requires education and training that won't turn things around overnight." ("The Fed's Magic Show Appears to Be Over", Wall Street Journal)

In other words, the Fed is planning to give every working man and woman in the US a big pay-cut so they can go nose-to-nose with foreign labor. You can see how this blends seamlessly with Obama's State of the Union Speech where he focused on "competition" as his central theme. More importantly, Obama reiterated his pledge to double exports in the next 5 years. The only way that can be achieved is by destroying the dollar. Here's a clip from an op-ed by Judy Shelton that explains what's going on:

"Beware of President Obama's call for a doubling of U.S. exports over the next five years as a way to reduce the unemployment rate. The obvious quick route to export success for any nation is to depreciate its currency. Dollar depreciation is already being pushed by the Obama administration as the key solution for resolving our massive trade deficit with China.….

….The government will continue to run a large budget deficit, which must be financed by issuing more government debt. The debt is monetized when the Federal Reserve purchases it from the public. The effect is to increase the money supply. Inflationary monetary policy goes hand-in-hand with a falling dollar in foreign-exchange markets." ("The Wrong Way to Double Exports", Judy Shelton, Wall Street Journal)

So, while working people and pensioners see their savings sliced in half to accommodate the globalist dream of an evenly-depressed world labor market; the investor class will get regular injections of Fed liquidity via QE2 to keep stocks "bubbly" and profits high. But large-scale monetary manipulation does involve some serious risks, as Deborah Blumberg points out in her WSJ article "Is Steep Yield Curve Signaling Pain to Come?". Here's an excerpt:

"Some bond experts believe yields in the Treasurys market are signaling the U.S. could one day be stripped of its triple-A status as it confronts a bloated budget deficit with no clear plans to reduce debt.

A peculiar distortion in the benchmark U.S. government-bond yield curve, which is the gap between two-year and 10-year yields, is pointing to worries that the U.S. could see its top-notch credit rating downgraded within several years, according to some experts….

…. "We've never seen these moves when we've had better economic data, and with Fed [rate] hikes on the way," she said. The yield curve is flashing "concerns about an unsustainable fiscal deficit and an eventual potential ratings downgrade," said Priya Misra, head of U.S. rates strategy at Bank of America Merrill Lynch….

In the past, steep yield curves have been associated with sovereign-debt-ratings downgrades. Japan was stripped of its triple-A status by Moody's in 1998 and Standard & Poor's in 2001….The consequences of a U.S. credit-ratings downgrade could devastate the economy, pushing up borrowing costs and threatening the dollar." ("Is Steep Yield Curve Signaling Pain to Come?", Deborah Lynn Blumberg, Wall Street Journal)

The United States will not default because it pays its debts in its own currency, (and the Treasury can always just print more money) but the prospect of a ratings downgrade is quite real. That means it would cost considerably more to finance the debt. Also, long-term interest rates will rise sharply. That will crimp consumer spending, slow economic activity, and deal a death blow to the struggling housing market.

Bernanke's playing a dangerous game. If he's not careful, he could trigger a run on the dollar.

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