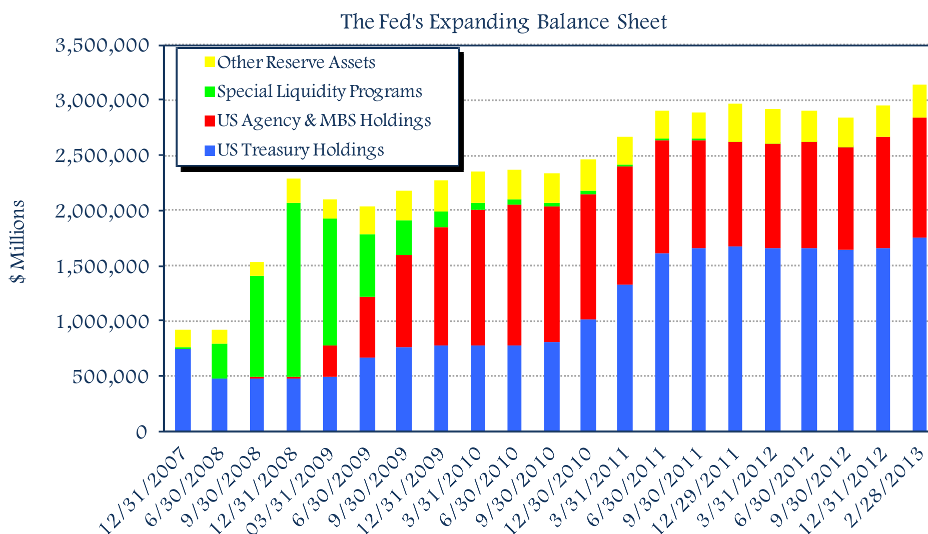
MARCH 2013

INVESTMENT UPDATE

In mid-January, a new milestone was passed in the history of the US financial system, as the assets on the Fed's balance sheet crossed over the $3 trillion mark. We had gotten close once before, in December 2011, but the Fed stopped asset purchases at year-end 2011, before resuming them again in their "QE3" program in October 2012.

But we're getting ahead of ourselves; let's back up a bit and explain why all this matters.

If you were a finance major in college, you learned that the Federal Reserve traditionally has had a fairly limited set of tools that it can use to manage the growth of the US economy. These tools include the buying and selling of short-term reserves (overnight lending to member banks), which they use to lock in overnight lending rates—the Federal funds rate and the discount rate. Raising or lowering these short-term interest rates, in turn, helps steer the economy: lower rates encourage borrowing and stimulates the economy while raising rates has the opposite effect of suppressing economic growth.



All well and good. The manipulation of short-term rates served the Fed well for most of the past 30 years, helping the US to achieve a long period of steady, non-inflationary growth.

But in the second half of 2008, with the world reeling amid a global financial crisis, the Fed came face-to-face, for the first time in the modern era, with the limitations of its conventional tools. An ultra-low Fed funds rate could not keep the international banking system from locking up. The Fed was forced to put in place a series of special liquidity programs to keep the domestic and international banking systems running, opening up their credit window for the first time to broker/dealers and non-US banks, taking in commercial paper as collateral for liquid funds, and taking over portfolios of crummy loans and securities from bankrupt companies like AIG and Bear Stearns.

As the chart on this page shows, institutions took advantage of the Fed's special liquidity programs, which had the effect of more than doubling the size of the Fed's balance sheet in less than six months. But the resulting cash that was supplied to the financial system did little more than act as monetary gravel to fill the various financial craters left by the collapse of junky residential mortgage loans (and the securities that were backed by these loans). Nevertheless, the Fed had demonstrated that they would use the full power of their balance sheet to shore up the financial system, and the markets firmed up.

As the crisis passed, and these programs began to roll off, the Fed realized that there was still the thorny problem of how to stimulate an economy that was losing jobs by the hundreds of thousands each month. Even though the Fed had dropped the funds rate to zero, there was absolutely no demand for borrowed funds (in fact, households and institutions were actively shedding debt), forcing the Fed to deal with something they hadn't seen since the Great Depression—an environment where there was no demand for borrowed funds, even if the borrowing rate was next to nothing.

Ben Bernanke, before his days at the Fed, was an economics professor whose expertise was the historical failures of central banks in dealing with financial crises. He had written extensively about the mistakes the Fed made in the Great Depression, and the more recent failure of the Japanese central bank to adequately deal with their long-running economic recession that lasted for two decades (and lingers to this day). He was already well-acquainted, at least in theory, with the concept of quantitative easing (QE)—the use of unconventional methods

for stimulating economic activity once traditional tools had been used up.

And so, in the first quarter of 2009, as the Fed's balance sheet began to shrink with institutions no longer needing emergency funding, the Fed initiated a new plan, the "large scale asset purchase program" (LSAP) to buy up mortgage securities issued by the three government-sponsored entities, GNMA, FNMA and FHLMC. This was the first round of QE, and it was designed to have two major effects: to bring down the rates on mortgage securities (and thus, mortgage lending rates), and to further liquefy the banking system in a period where capital was still scarce. Purchases of Treasuries began soon thereafter, and, as the chart shows, by the third quarter of 2009, Treasury and MBS holdings passed the $1.5 trillion mark, while the special liquidity programs had whittled down to approximately $300 billion.

Further rounds of quantitative easing have been put in place since 2009, each adding to the Fed's holdings of Treasury securities and MBS, so that today their holdings of marketable securities exceeds $2.8 trillion. These holdings, the result of the Fed's quantitative easing programs, have ballooned the Fed's balance sheet to the point that it is approximately $1.75 trillion larger than it would be under "normal" conditions. In other words, if the world suddenly changed tomorrow, and the US and global economies were running at full tilt, the Fed would find themselves with a portfolio worth many hundreds of billions of dollars that is no longer needed to stimulate the economy.

Which brings us around to the meat of this discussion: If the economy is indeed beginning to pick up, what does that mean for the Fed's bloated portfolio, and, more importantly, how does that effect the bond market?

The answer is, "It depends." Up until fairly recently, the conventional wisdom of Fed-watchers was that the Fed would go through the process of moving from an accommodative to restrictive monetary policy in stages, with the chronology roughly in this order: First, the Fed will begin to communicate about how to shift monetary policy ("open mouth operations"); Next, the Fed will set a time period for the end of LSAP, and thus, the end of quantitative easing; Next, the Fed will begin the process of raising the Fed funds and discount rates as the demand for credit rises to more "normal" levels; Finally, the Fed will initiate the process of selling off the holdings from the LSAP.

We are already moving into the first stage of this shift, with the Fed having provided somewhat clear ("clear" is a word rarely used when it comes to the Fed) guidelines for what would trigger an end to the QE program. But the buying of securities continues at a pace of $85 billion per month, and is expected to continue for the next few months, as we are still far away from the benchmarks the Fed has laid out for the end of the LSAP, which is either a sufficiently low level of unemployment or a measurable increase in inflationary pressures. More importantly, recent comments from Fed Chairman Bernanke indicated that the Fed may not, in fact, actively sell off the portfolio, as had been expected, but may choose to allow the holdings to mature or (in the case of the MBS portfolio) pay down. So much for clarity.

The idea of letting these holding "roll down the yield curve" is a departure from previous Fed comments, including a fairly detailed discussion of their own plans in a publication last summer, "The Federal Reserve's Balance Sheet: A Primer and Projections," where the Fed reiterated their June 2011 projected timeline that the balance sheet would be "normalized" over two to three years once asset sales begin. And while we should be used to changeable strategies from the Fed, and appreciate the importance of flexibility in dealing with an unpredictable economy, the capital markets don't like uncertainty.

On the one hand, holding these bonds to maturity risks overstimulating the economy by holding down rates too low for too long (some of the bonds the Fed holds don't mature for 30 years), while a rapid liquidation of the portfolio risks just the opposite reaction, and could send the economy into a tailspin as investors dump bonds ahead of the Fed, which could cause interest rates to spike. This could be particularly risky for the housing market, which is a critical component of the US economic recovery.

The reality of the situation is that neither the Fed nor the investment community knows how this thing is going to play out. The Fed wants to keep all its options open, but the longer it keeps buying up bonds, the bigger the ultimate unwinding will be, and the more variable the possible outcomes for the financial markets. From our standpoint, we'd like to see an end to the LSAP by mid-year, and at least a six month moratorium on additional asset purchases. Let the capital markets absorb the supply of new bond issuance without central bank intervention for a while, with the Fed not reinvesting the flow of dollars from maturing bonds, coupons and paydowns over this period. In other words, let's take the training wheels off and see if the US economy can remain upright on its own. The Fed doesn't have to start raising the Fed funds rate for a while, and they don't have to begin selling off these bonds yet—we may, in fact be better off allowing them roll off on their own—but we need to see where this economy stands today.

As we've recently seen from the sequestration and tax hike scares, the outcome may be a lot less damaging than the demagogues would like us to believe. The US economy, after stumbling around for more than half a decade, may be just a little bit more resilient than we think. Halting the asset purchases for a while is the best way to find out.