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QE2 – WHAT DO WE THINK?

(in particular, the November 3rd FOMC meeting event)

It's been talked about for quite a while. It's on everyone's mind. So we thought we'd summarize our thoughts on the prospects for QE2.¹

Basically we asked ourselves these four fundamental questions.

1. What has the Fed already done?
2. What could the Fed do?
3. How could the markets respond?
4. Why is any of this important to us?

1. What has the Fed already done?

From the Dec 15, 2008, FOMC statement:

"The focus of the Committee's policy going forward will be to support the functioning of financial markets and stimulate the economy through open market operations and other measures that sustain the size of the Federal Reserve's balance sheet at a high level. As previously announced, over the next few quarters the Federal Reserve will purchase large quantities of agency debt and mortgage-backed securities to provide support to the mortgage and housing markets, and it stands ready to expand its purchases of agency debt and mortgage-backed securities as conditions warrant. The Committee is also evaluating the potential benefits of purchasing longer-term Treasury securities. Early next year, the Federal Reserve will also implement the Term Asset-Backed Securities Loan Facility to facilitate the extension of credit to households and small businesses. The Federal Reserve will continue to consider ways of using its balance sheet to further support credit markets and economic activity."

From the Mar 18, 2009, FOMC statement:

"In these circumstances, the Federal Reserve will employ all available tools to promote economic recovery and to preserve price stability. The Committee will maintain the target range for the federal funds rate at 0 to 1/4 percent and anticipates that economic conditions are likely to warrant exceptionally low levels of the federal funds rate for an extended period. To provide greater support to mortgage lending and housing markets, the Committee decided today to increase the size of the Federal Reserve's balance sheet further by purchasing up to an additional \$750 billion of agency mortgage-backed securities, bringing its total purchases of these securities to up to \$1.25 trillion this year, and to increase its purchases of agency debt this year by up to \$100 billion to a total of up to \$200 billion. Moreover, to help improve conditions in private credit markets, the Committee decided to purchase up to \$300 billion of longer-term Treasury securities over the next six months."

From the Aug 10, 2010 FOMC statement:

"To help support the economic recovery in a context of price stability, the Committee will keep constant the Federal Reserve's holdings of securities at their current level by reinvesting principal payments from agency debt and agency mortgage-backed securities in longer-term Treasury securities. The Committee will continue to roll over the Federal Reserve's holdings of Treasury securities as they mature."

The Committee will continue to monitor the economic outlook and financial developments and will employ its policy tools as necessary to promote economic recovery and price stability."

So, with the most recent data, what does the Fed hold?²

- Around \$830 billion in US Treasuries (\$18.4 billion in bills, \$48 billion in TIPS and the rest in nominal notes/bonds)
- Around \$1.06 trillion in US MBS
- Around \$150 billion in US Agency debt
- Around \$92 billion in “Other” (various bailout funds, in particular)

How did we get from \$300 billion in Treasuries to \$830 billion?

First, MBS and Agency debt has been maturing and refinanced, with some fraction shifted into Treasuries based on the August 10, 2010 FOMC statement. That accounts for around \$55 billion increase in US Treasury holdings (reducing MBS and Agency debt by a total of around \$63 billion) since August 10th.

Second, on Mar 12, 2009, the Fed already held \$475 billion in Treasuries, so they’ve only added around \$355 billion in new purchases.

2. What could the Fed do?

While we don’t explicitly forecast what the Fed will do at the next (November 3, 2010) or later meetings with regard to QE2, we have evaluated the possible actions the Fed has at its disposal, ranging from “Nothing” (though that’s an admittedly rare forecast) to “A Lot” (possibly as much as \$2 trillion in Treasury purchases).

So the options we’ll explore are:

1. Do Nothing
2. Do Something
3. Do A Lot

Do Nothing

The Fed has already begun to lay the groundwork for “Doing Nothing”. In particular, they’ve made it clear in recent meeting minutes³ that one of the policy tools now explicitly part of the arsenal is just communication. Consider that over the period when the mere possibility of “quantitative easing” was raised⁴, the S&P500 jumped by 5.75%, the 10-year Bond Yield fell by 23 basis points and the US dollar fell by 4.7%, and that’s with no change in the Fed Funds Target Rate (still at 0 to 25 basis points).

One additional point to make is that the Fed’s use of monetary policy (either conventional or unconventional) is for economic purposes (and not simply to move asset prices). It’s their way of “priming the pump” to get the US economy growing more. Falling bond yields have led to the lowest

mortgage rates on record. The falling US dollar has changed the export/import dynamic of US manufacturers versus many of our trade partners (pushing whatever consumption there is towards domestic US goods and away from the now more expensive foreign ones).

That may not be enough, but since growing the economy is not a one quarter goal of the Fed, they could afford to be patient (i.e. they could continue to indicate “concern” at future FOMC meetings, etc.).

Do Something

The Fed could do a bit more than “Nothing”. Quantitative Easing (QE) is often implemented by the central bank outright purchase of assets, typically sovereign debt. The Fed could buy more US Treasuries (\$500 billion or more) to add to their existing stock, or they could target an intermediate term interest rate (1 year to 3 year maturity) and simply set asset purchases to achieve that target.⁵

Lowering “borrowing costs” in that area of the yield curve by 50 basis points could be another way of continuing to “prime the pump”.

Do A Lot

The Fed could use a more direct approach, looking at the various economic measures (“slack” in the economy, capacity utilization, unemployment, etc.). We have seen it suggested the Fed would need up to \$2 trillion in new purchases to lower the effective interest rate by the hundreds of basis points (rather than just 50 basis points) implied by certain theoretical policy rules⁶.

It is within the Fed’s purview, for example, to print enough money to buy up all the US Treasury debt, if they so wished.⁷ The issue then is not “can they create inflation?” but instead “how will they control it once they create it?”

While the Fed has introduced language recently that points to an increased concern regarding too low inflation (or even deflation), they’ve always had that concern. Don’t forget that Ben Bernanke became known as “Helicopter Ben” on the back of a talk⁸ he gave about the mistakes in Japan in the past two decades.

3. How could the markets respond?

The problem with this question is that asset prices aren’t set by the Fed. They’re set by market participants like all of us. The old adage of “buy the rumor, sell the fact” is what’s at play here.

Since markets have already responded to the talk (or “fear”)

of QE2, we have to answer not only “What will the Fed do?”, but also “What has already been priced in?”

And it’s the second question that is often forgotten. The Fed could “disappoint” the markets by announcing less QE2 than expected. In which case one would expect both US equities and Treasuries to fall and the US dollar to rally¹⁰, unwinding much of the recent movements in those markets.

Much like the child’s game “One of these things is not like the others; one of these things just doesn’t belong” the US dollar has a third question associated with it, “What will the other central banks do?” The US dollar is a relative asset, not an absolute one. It, like all other currencies, is measured against other currencies and not “in a vacuum”.

In 2009 the US wasn’t the only major economy to purchase their own sovereign debt. The BoE purchased GBP175 billion in Gilts as well, for example.

There is talk now as well of “Currency Wars” and actual interventions of various forms (the BoJ intervention in the JPY in mid-September). Also recall that in the face of the Sovereign Credit crisis in the EMU in May, one of the ways we pointed out¹¹ that the EMU-zone could help ease the impact of the crisis was to let the euro fall, increasing the competitiveness of EMU (German, in particular) goods, which would provide some stimulus to the EMU economies and so reduce the risk (real or apparent) of a sovereign default.

There is one other thing to consider in the context of “QE2”. The day before the November 3rd FOMC meeting are the mid-term elections for the US Congress. If the result of those elections is a “split” congress (or one where there’s no clear majority), the likelihood of additional fiscal (as opposed to monetary) stimulus for the US economy would fall.

What effect might that have on the various asset markets? It still depends on essentially the same two questions we asked before. “What will the elections bring?” and “What has already been priced in?”

Our view is that it is more likely the Fed will either meet or fail to meet expectations and less likely that the Fed surprises “to the upside” (i.e. announces a larger QE2 than expected). With the asset price moves already seen, it appears that a great deal of QE2 has already been priced in.

4. Why is this important to FQ?

Will any of this cause problems or create opportunities for us? Yes and no.

As the US dollar has fallen over the last couple of months, our Relative Valuation measure has moved from neutral on the US dollar to modestly bullish. That change has been offset by poorer Unhedged Export Flow prospects.

As we sit here today¹², our GTAA portfolios are only slightly long US Treasuries (from quite bullish much earlier in the year) and only modestly long US dollar (from quite bullish earlier in the year as well).

What does seem likely is a modest amount of volatility in the various markets (both in absolute and relative terms) for the rest of the year. It’s no longer about “risk” driving that volatility. It’s as much about “uncertainty” now...



Endnotes

- ¹ “QE2” = “The second round of quantitative easing by the US Federal Reserve.”
- ² The Fed publishes this data weekly (in the H.4.1 release <http://www.federalreserve.gov/releases/h41/Current/>). The most recent data is for Wednesday, October 20, 2010.
- ³ The FOMC meeting minutes from the September 21, 2010 meeting, the last sentence prior to the “Committee Policy Action” section reads, “As a general matter, participants felt that any needed policy accommodation would be most effective if enacted within a framework that was clearly communicated to the public. The minutes of FOMC meetings were seen as an important channel for communicating participants’ views about monetary policy.” (<http://www.federalreserve.gov/monetarypolicy/fomcminutes20100921.htm>).
- ⁴ Using the August 10, 2010 FOMC announcement as the start of the period.
- ⁵ Officially that’s how they set the Fed Funds rate. They set a target, then manage the overnight market to achieve (hopefully) that target. This would just mean using instruments well beyond “overnight”.
- ⁶ The “Taylor Rule”, for example.
- ⁷ See http://www.econbrowser.com/archives/2008/10/deflation_risk.html for a perspective on such a concept.
- ⁸ At a talk before the National Economics Club in Washington D.C. on November 21, 2002 (<http://www.federalreserve.gov/BOARDDOCS/SPEECHES/2002/20021121/default.htm>).
- ⁹ Note that, in the fact of “economic uncertainty” (which is what the prospect of QE is), equities and bonds are positively correlated. Please see our upcoming perspective on this effect [reference].
- ¹⁰ Assuming nothing else happens in the world.
- ¹¹ Levanoni, et al, “A Euro Perspective”, May 2010, First Quadrant Perspective.
- ¹² October 25, 2010.

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