

August 24, 2011

## Bernanke at Jackson Hole

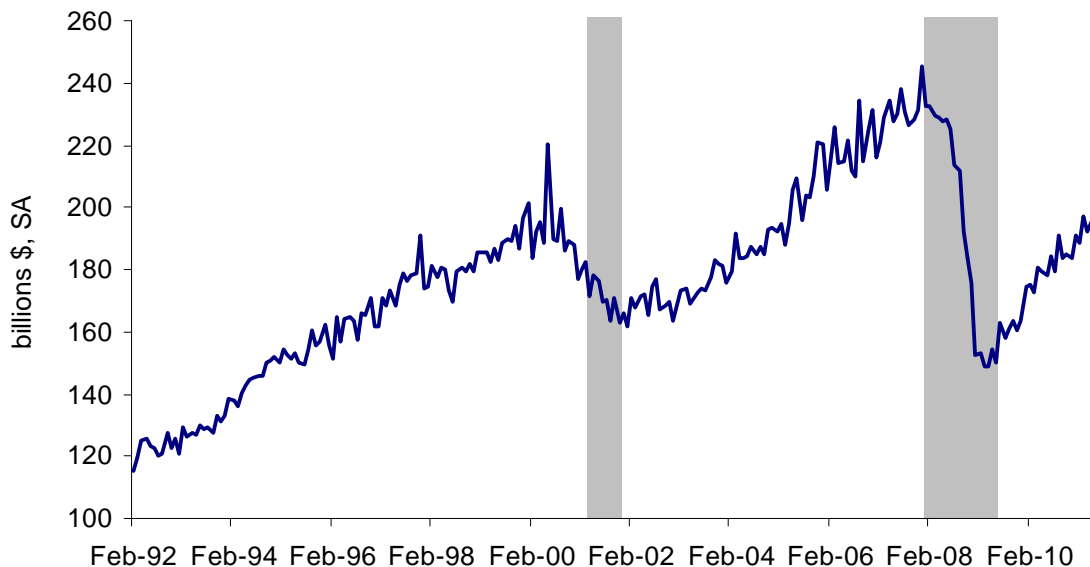
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**We don't think Fed Chairman Bernanke will hint at QE3** -- an enlargement of the Fed's \$2.9 trillion balance sheet through additional Treasury bond purchases paid by excess reserves -- in his Jackson Hole remarks on Friday morning.

- **The August 9 FOMC statement was already an aggressive open-ended policy statement:** "The Committee discussed the range of policy tools available to promote a stronger economic recovery in a context of price stability. It will continue to assess the economic outlook in light of incoming information and is prepared to employ these tools as appropriate."
- **With July durable goods orders and auto sales holding up, auto production rising and inflation stuck at 3.6%, it will be hard for Bernanke to go beyond the FOMC statement yet.**

### Durable Goods New Orders (last obs. July 2011)

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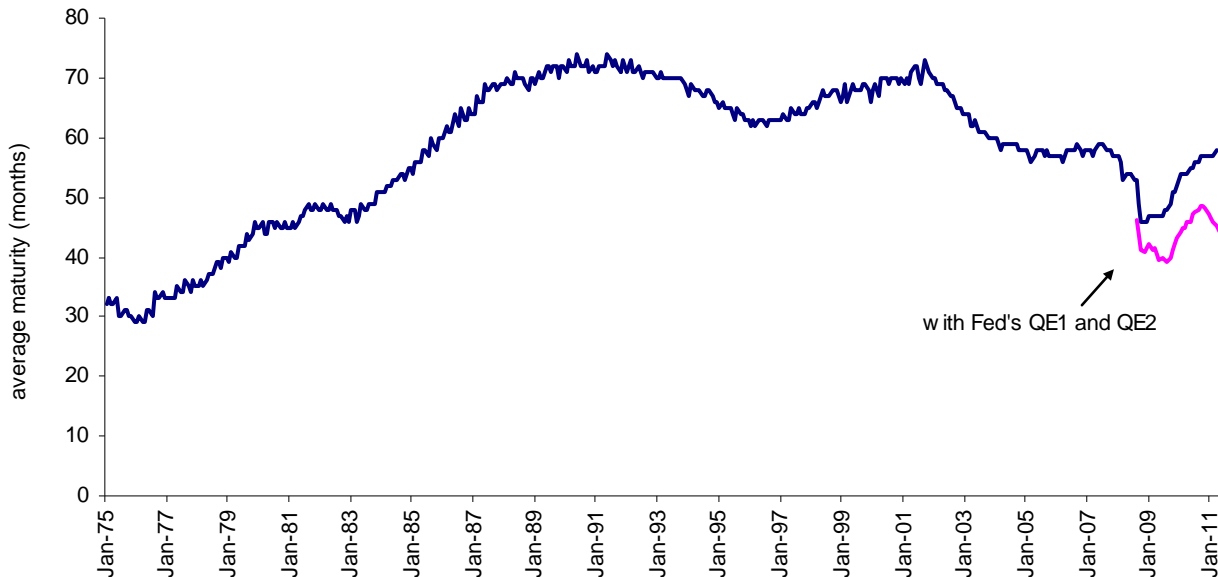


Source: Bureau of Census; Encima Global

The market would love more pre-announced Fed bond purchases in part because it can buy the bonds ahead of the Fed. **To avoid market disappointment about QE3, Bernanke might:**

- 1) **Open a discussion about lowering the 25 basis points being paid to commercial banks on excess reserves (and required reserves).** We don't think he would argue for a zero percent rate given the time and energy he invested in 2008 in getting Congress to allow interest payments, but **he might argue for something closer to the current 10 bp rate for banks lending into the fed funds market.** The 25 bp started on December 18, 2008 after a Board of Governors statement that it "will continue to evaluate the appropriate settings of the rates paid on balances in light of evolving market conditions and make adjustments as needed." We think the Fed will lower the rate below 25 bp. It might occur at a meeting of the Board of Governors perhaps coincident with the next FOMC. **We think markets will perceive a lower rate on excess reserves as mildly stimulative – encouragement to banks to lend. We think it would also raise concerns about inflation and be supportive of gold prices.**
  
- 2) **Express support for lengthening the duration of the Fed's bond holdings (by buying longer-duration bonds as shorter-duration bonds mature.)** The August FOMC statement said: "The Committee will regularly review the size and composition of its securities holdings and is prepared to adjust those holdings as appropriate." **We think extending the duration will have a minor flattening effect on the curve, like a very small QE3.** As discussed in our earlier pieces, we think QE2 was sterilized by a dollar-for-dollar buildup in the Fed's excess reserves. Rather than providing monetary stimulus, **QE2 was the functional equivalent of Treasury shortening the duration of its debt issuance.** As a result of QE2, the consolidated Treasury-Fed government debt after QE2 includes less Treasury bonds held in the private sector and more short-term government debt because of the Fed's liability to banks for excess reserves. **We think lengthening the Fed's duration would be a continuation of that process, further shortening the average duration of the government's outstanding debt.** As a result, it adds risk to the financial system without adding much growth.

## Maturity of Government Debt (last obs. March 2011, estimated through July 2011)



Source: Treasury; Encima Global

- 3) **We don't think Bernanke will discuss the discount rate.** At a high 0.75%, the discount window is used very little. However, lowering the rate might suggest that there are banks at risk or that the Fed is somehow gearing up to support at-risk European banks through their U.S. branches (which have access to the discount window.)
- 4) Our earlier pieces have discussed the surge in M2 money supply to a 25% annual rate. We think it's related to unease about the safety of money market funds and is not stimulative. In past decades, this high a money supply growth rate would have dominated the Jackson Hole discussions, but **we think M2 growth is not a factor in the current policy debate.**
- 5) **We wish Chairman Bernanke would talk extensively about growth and the government impediments to it from the tax code, regulatory policy and rapid federal spending. Bernanke's often said that there's only so much that monetary policy can do.**

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