Are the Dollar and U.S. Debt at a Tipping Point?

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Fed Exit

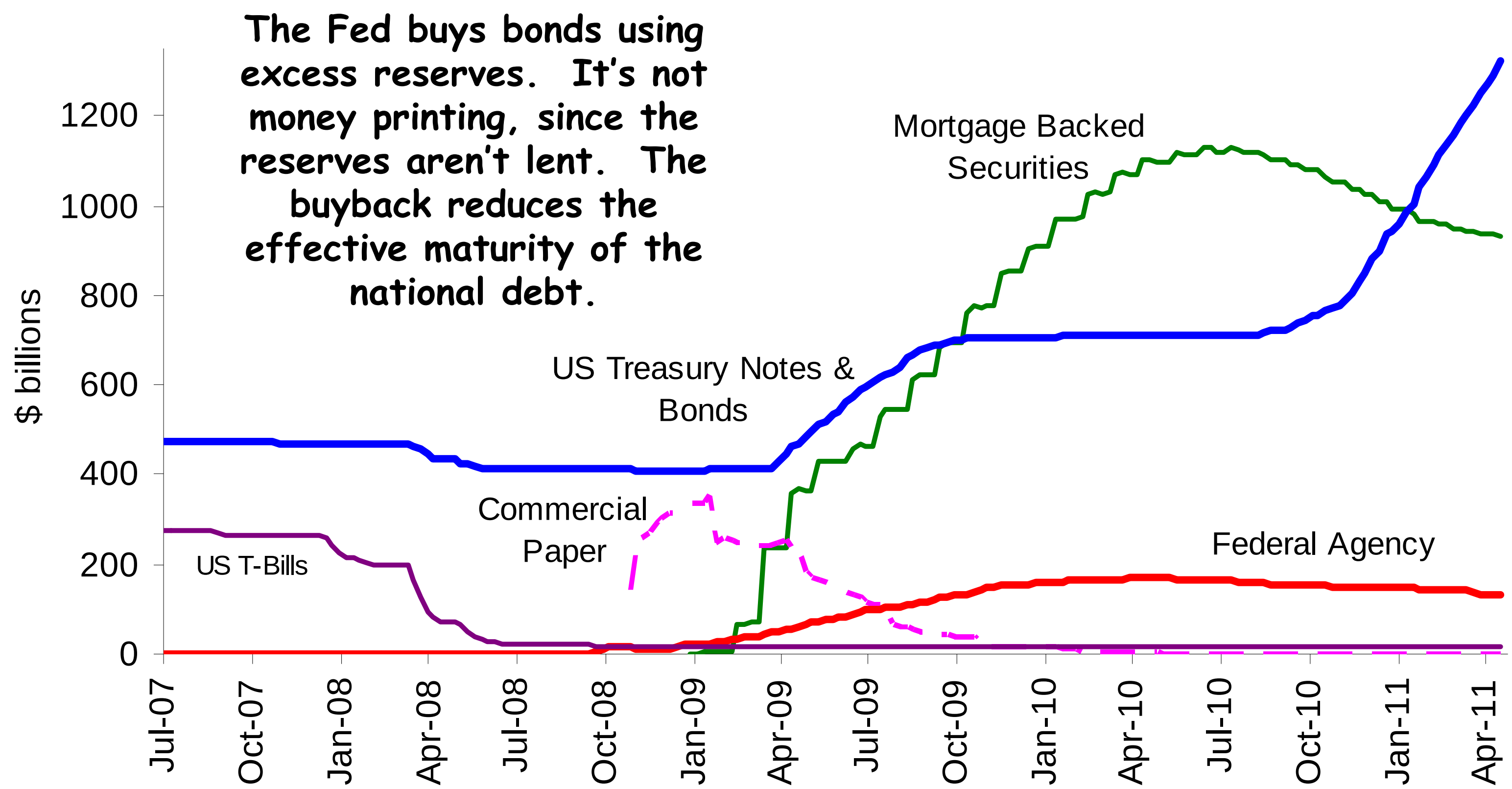
- We don't expect the FOMC statement or the press conference to break new ground on key issues like the weak-dollar policy, rising gold and oil prices or the timing of rate hikes.
- We expect the Fed to complete QE2 in June and continue monetary accommodation after that through the Fed funds rate. We don't think the wind-down of QE2 will have much impact on the economy or markets. The Fed stepping back from this Treasuries shouldn't impact price unless the Fed simultaneously changes monetary policy -- its outlook on inflation, the dollar and the Fed funds rate -- which we don't think is likely.
- The Fed will probably continue buying enough new Treasury bonds after June to offset maturing MBS and Treasuries, maintaining the balance sheet at roughly $2.9 trillion. The Fed will probably keep the Fed funds rate near zero at least into the fourth quarter of 2011 despite ECB rate hikes and rising CPI inflation, citing low core inflation and high unemployment. In 2012, we think the Fed will pre-announce a gradual reduction in its Treasury holdings, mostly by attrition.
- During 2012 and 2013, the Fed is likely to gradually raise the Fed funds rate and, in conjunction, the interest rate paid on excess reserves. We think the Fed can maintain sufficient liabilities without too much added expense.

Bond Yields

- Bond yields are being pushed down now but will go higher in the second half due to growth and inflation. For now, yields are being pushed down by the lack of headroom in the statutory debt limit, the likelihood of a cutoff in the supply of new Treasury securities and confusion about the economic impact of ending quantitative easing. We expect a jump in Treasury bond yields once the debt limit is increased similar to the jumps in 2003 and 2004 as the expansion broadened.
- We don't think the exit from QE2 is as important as the near-zero Fed funds rate itself. QE2 is the economic equivalent of Treasury shortening the maturity of its issuance -- the Fed is buying back the Treasury bonds using overnight loans from banks, the equivalent of Treasury issuing fewer bonds and more bills. Either approach causes taxpayers to absorb interest rate risk, but doesn't have a big impact on the outlook.
- QE can also be thought of as a SIV (Structured Investment Vehicle) in which the Fed has created a long-lived investment fund inside itself, separate from monetary policy. The 'Fed investment fund' borrows short from banks and lends long (through its ownership of Treasury bonds), earning profit unless interest rates rise sharply. There's no big impact on the outlook except to the extent that it undermines confidence in this and future Feds.
- In contrast, the near-zero Fed funds rate is critical for the dollar, inflation, market distortions and the transition to a neutral monetary policy. Rising inflation is driving the real Fed funds rate more deeply negative, presenting a host of new problems.

Fed assets are increasingly long term

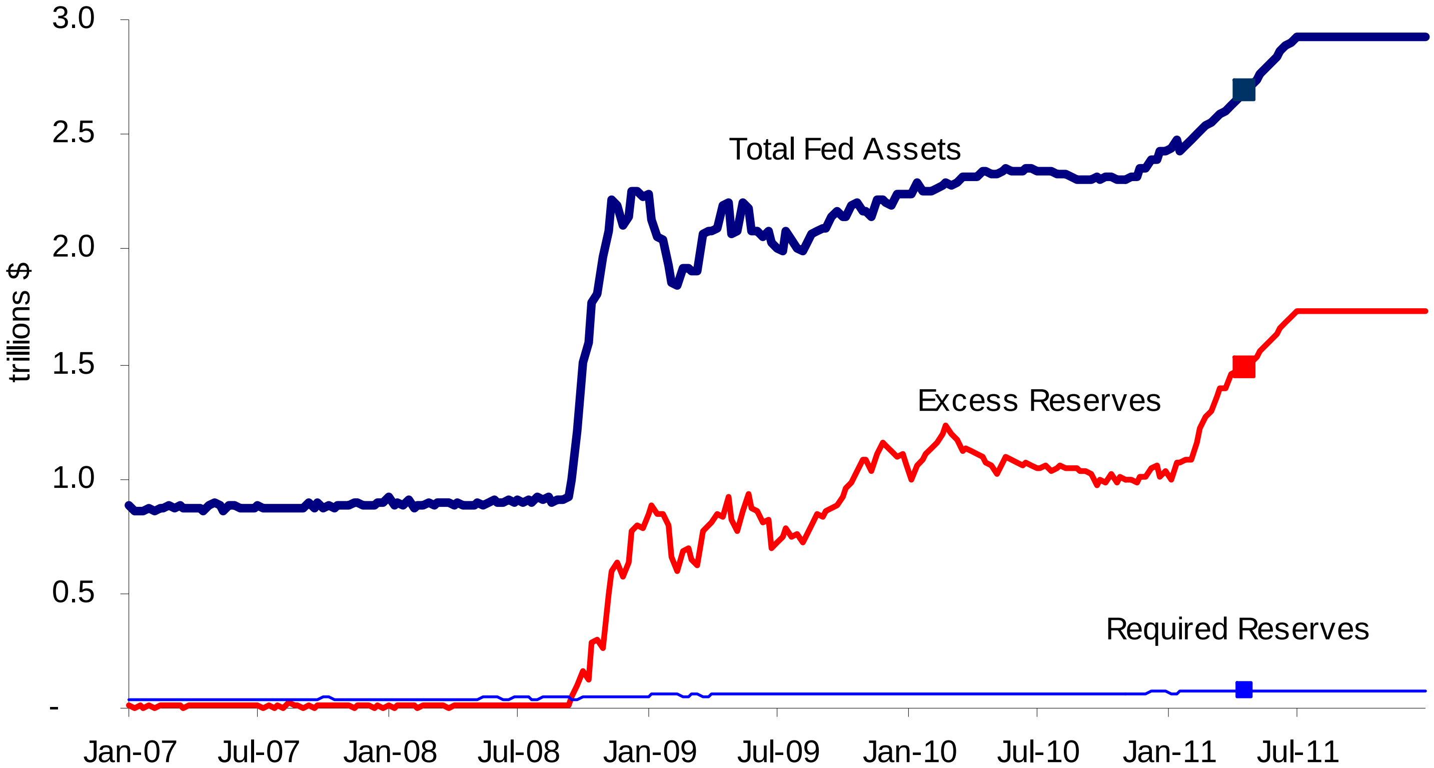
(last obs. April 20, 2011)



Source: Federal Reserve; Encima Global

Fed Assets and Reserves

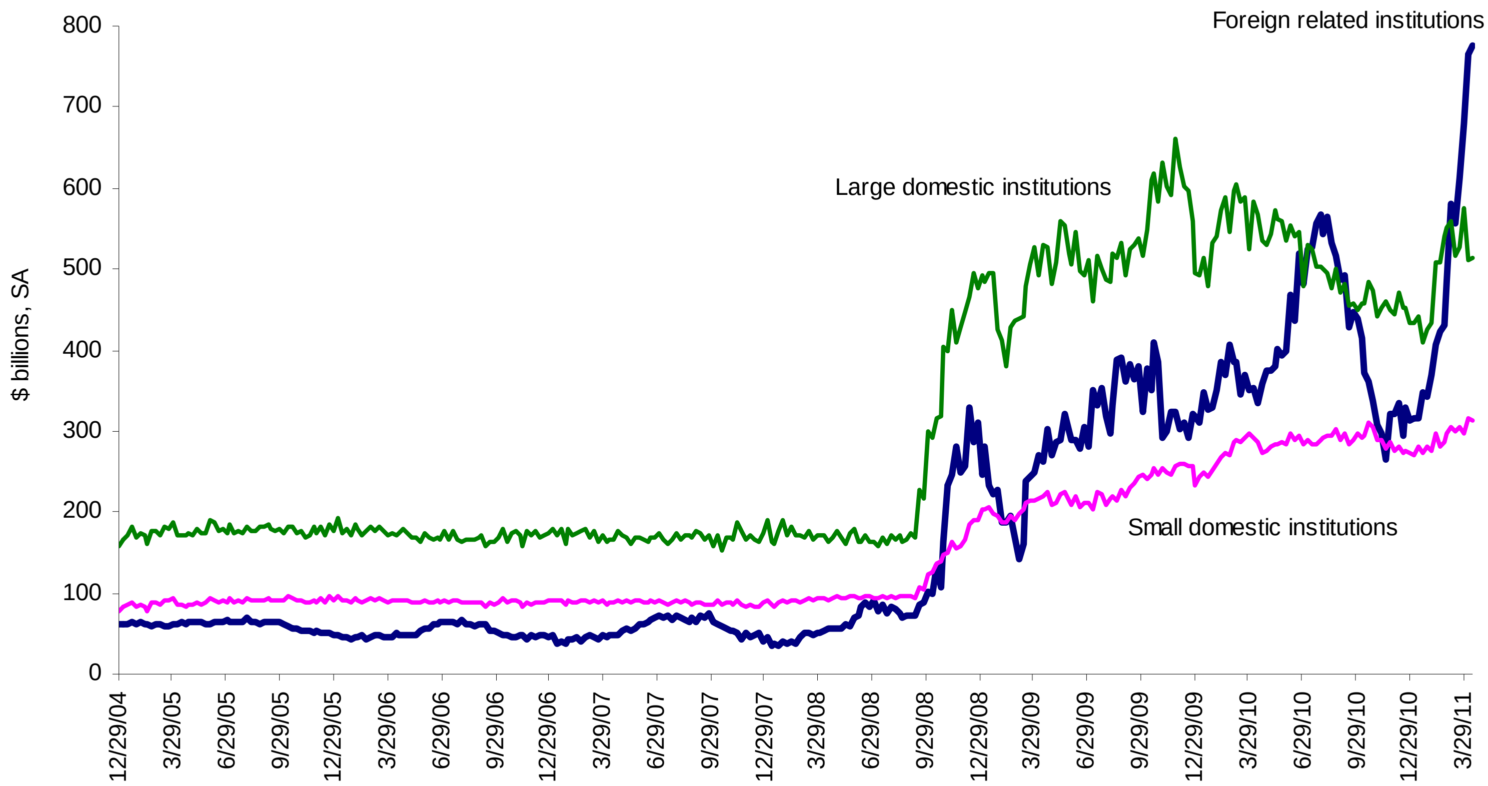
(last obs. April 20, 2011, projected through December 2011)



Source: Federal Reserve; Encima Global

Bank Cash (Mostly Excess Reserves at Fed)

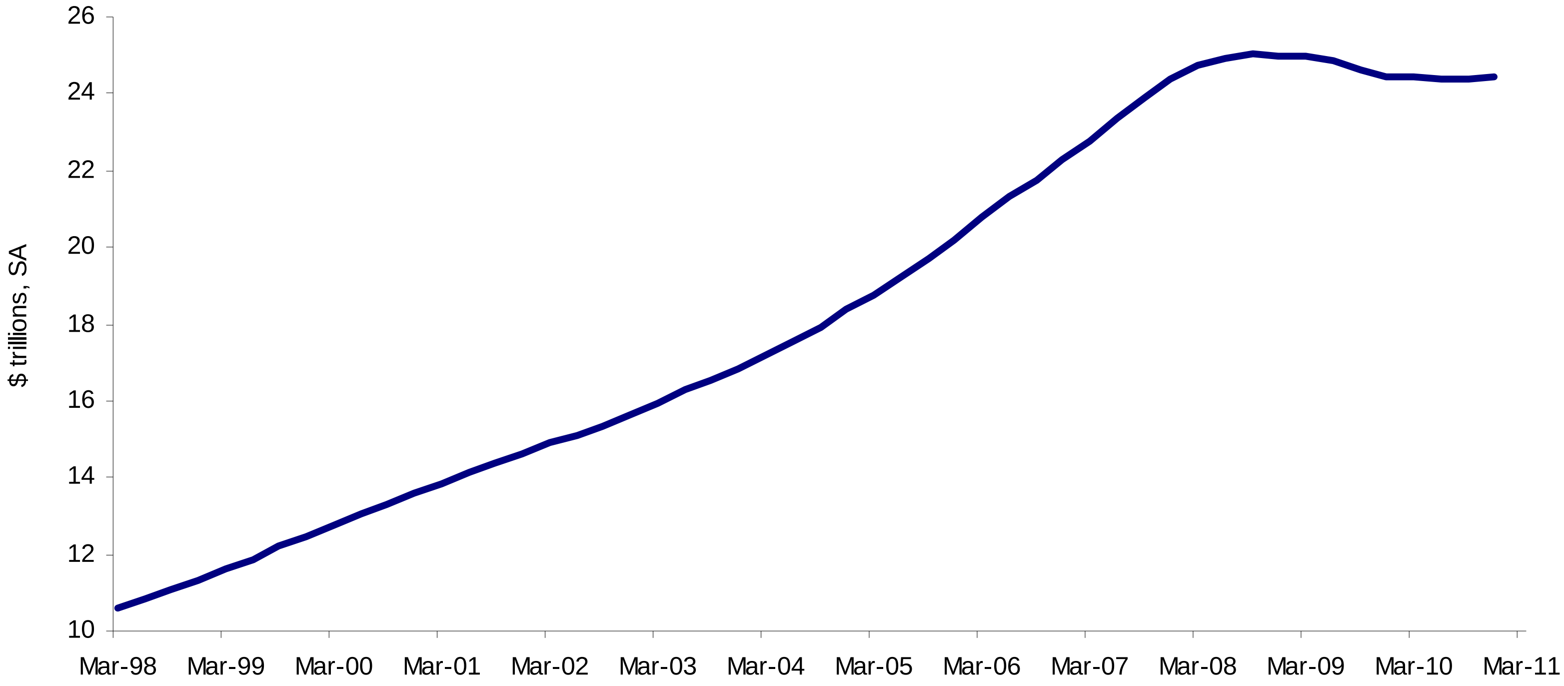
(last obs. April 13, 2011)



Source: Federal Reserve; Encima Global

QE2 Didn't Increase Private Sector Credit Much

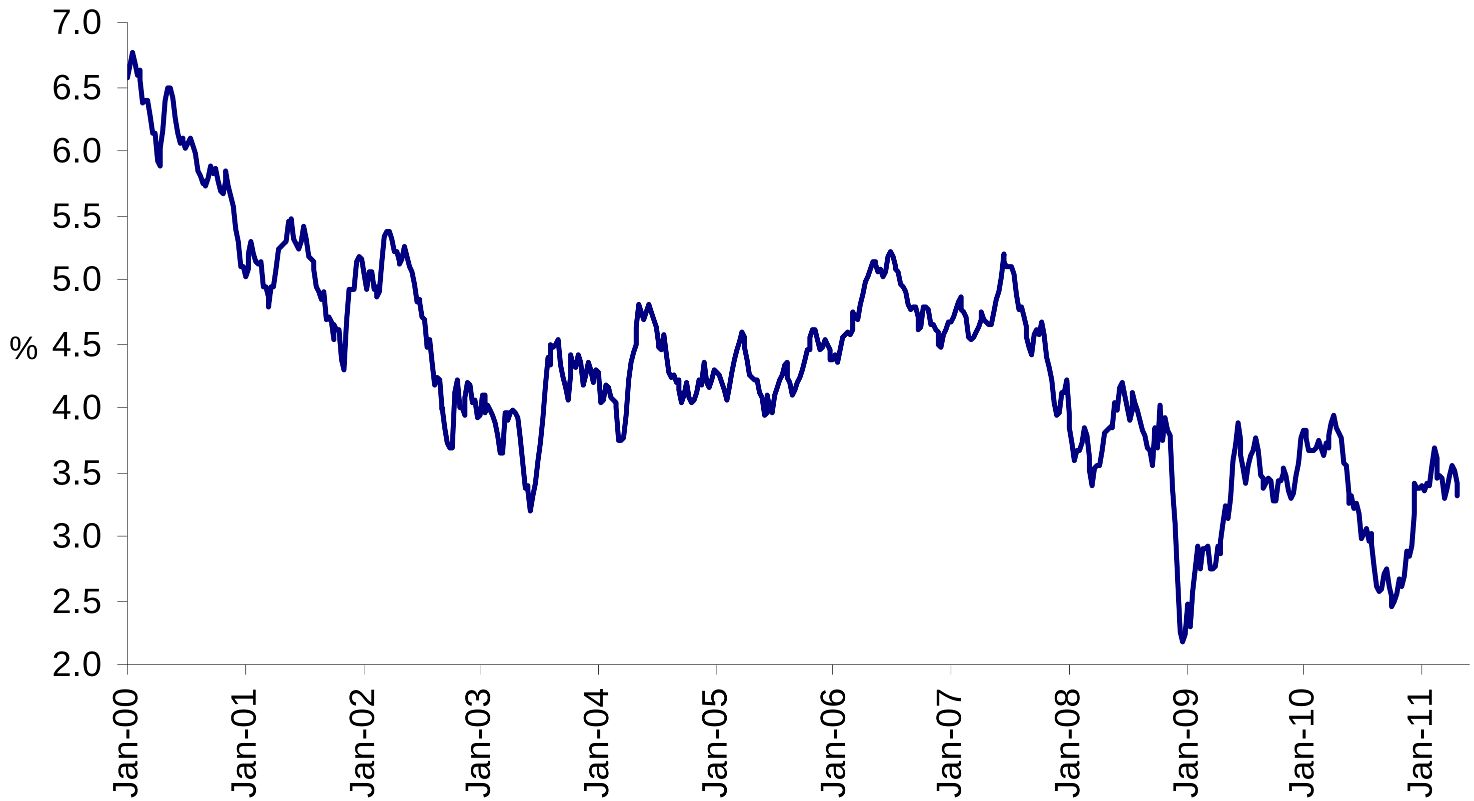
(last obs. Q4 2010)



Source: Federal Reserve; Encima Global

10 Year Treasury Yield To Rise In Second Half; Demographic Demand to Strengthen

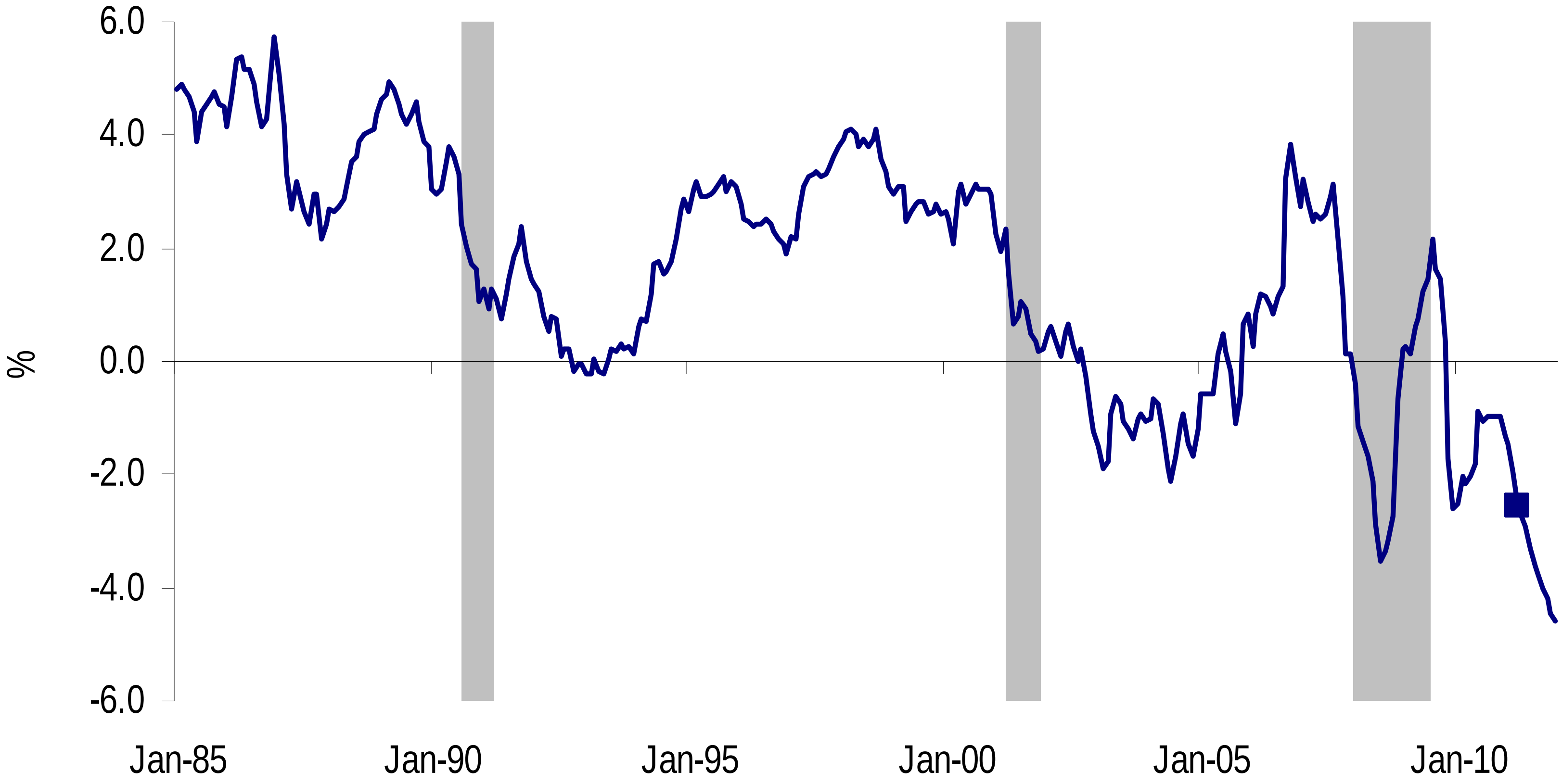
(last obs. April 26, 2011)



Source: Federal Reserve; Encima Global

Real Fed Funds Rate

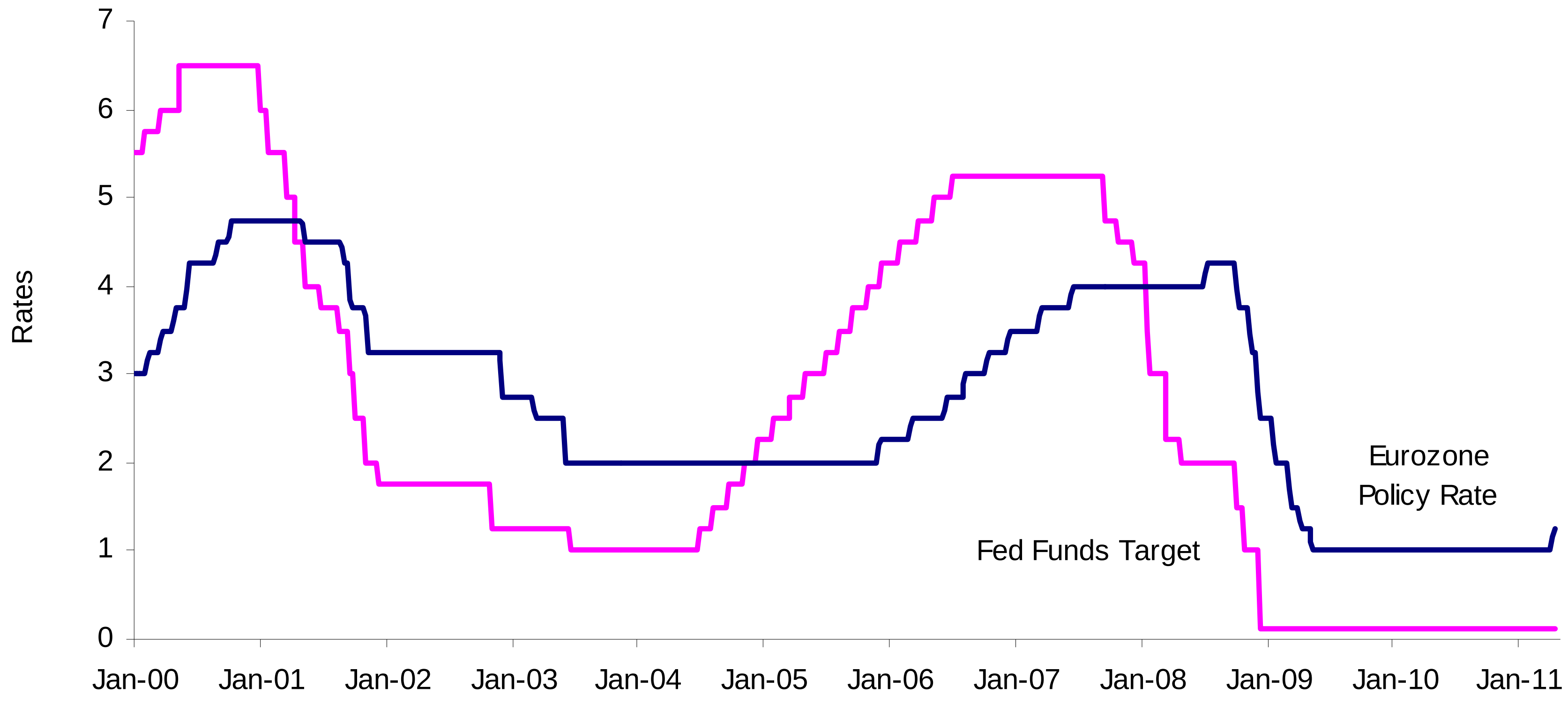
(using headline CPI; last obs. March 2011, estimated to December 2011 using 0.3% per mo)



Source: Federal Reserve; Bureau of Labor Statistics; Encima Global

Fed Funds and Eurozone Policy Rate

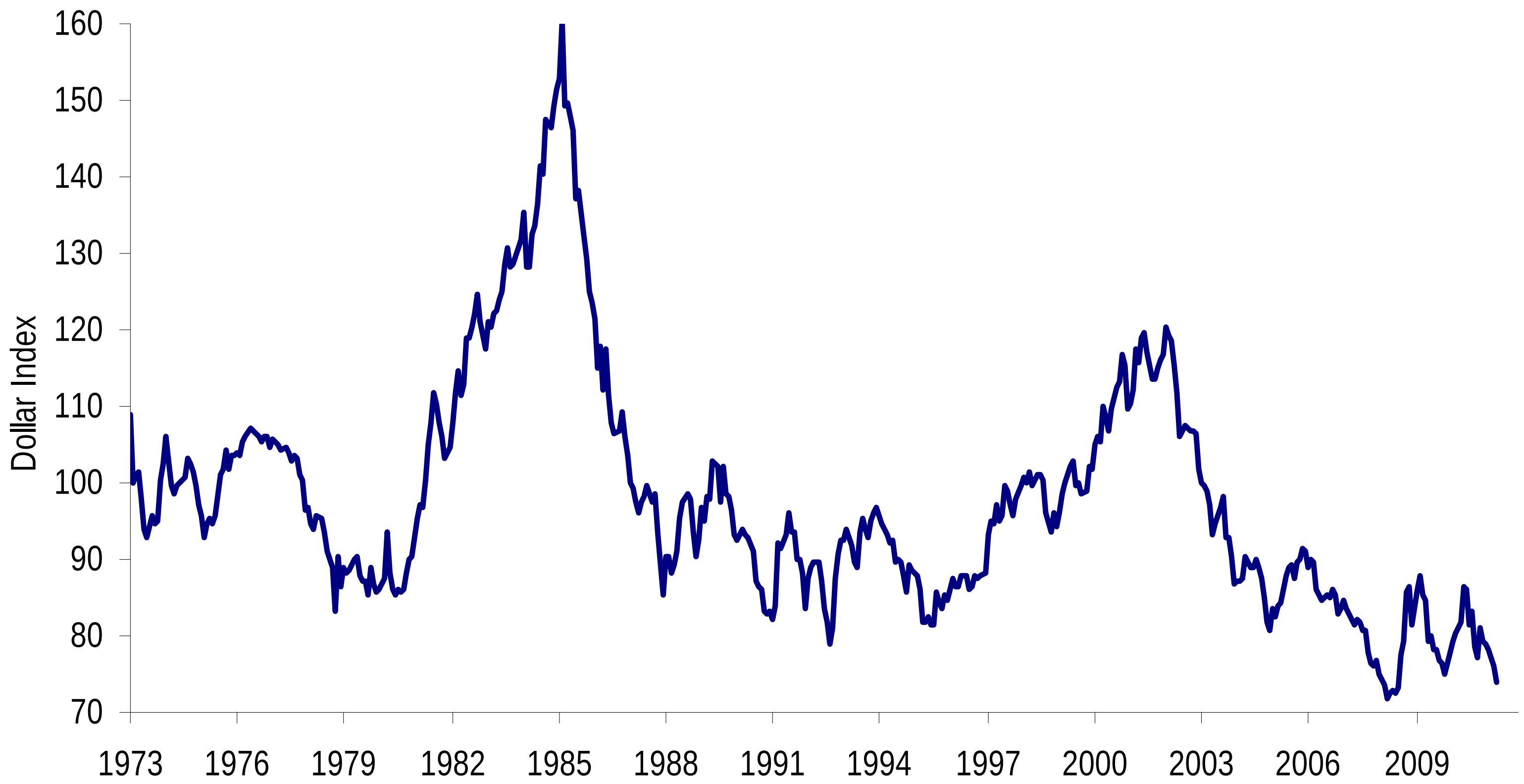
(last obs. April 26, 2011)



Source: Federal Reserve; European Central Bank; Encima Global

DXY – Dollar Index

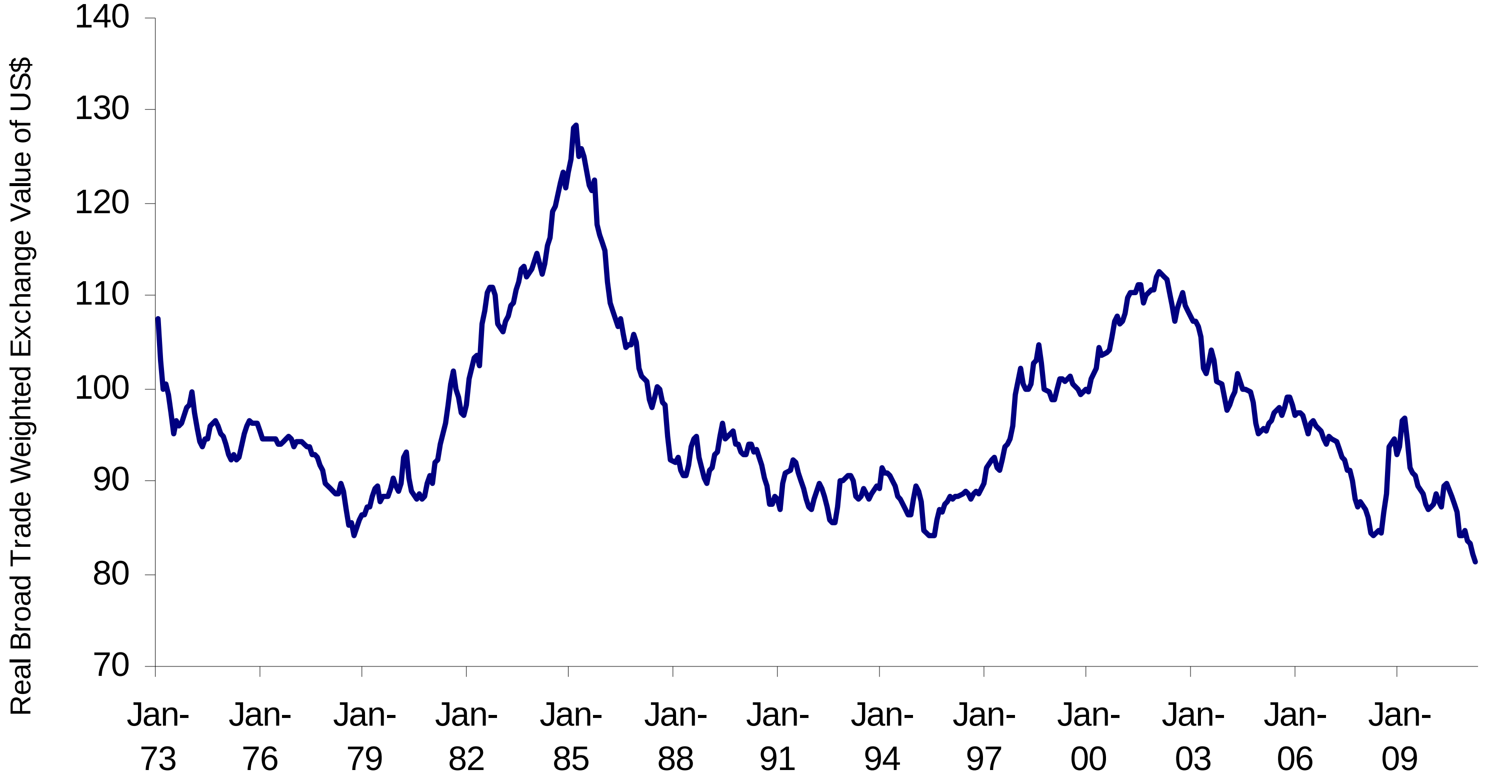
(last obs. April 26, 2011)



Source: Bloomberg; Encima Global

Record Low for 'Real' Value of $

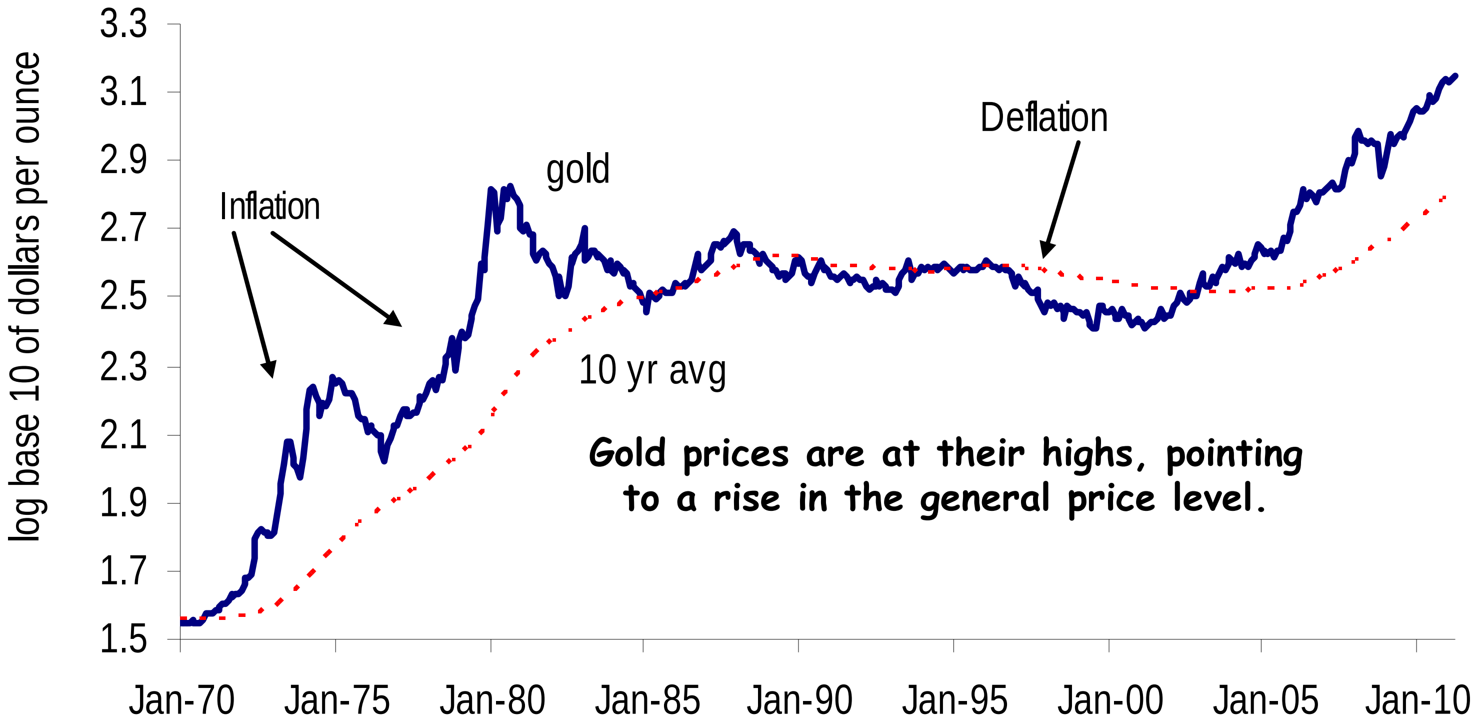
(last obs. March 2011, estimated for April 2011)



Source: Federal Reserve; Encima Global

Gold high, dollar low, pointing to rise in other prices

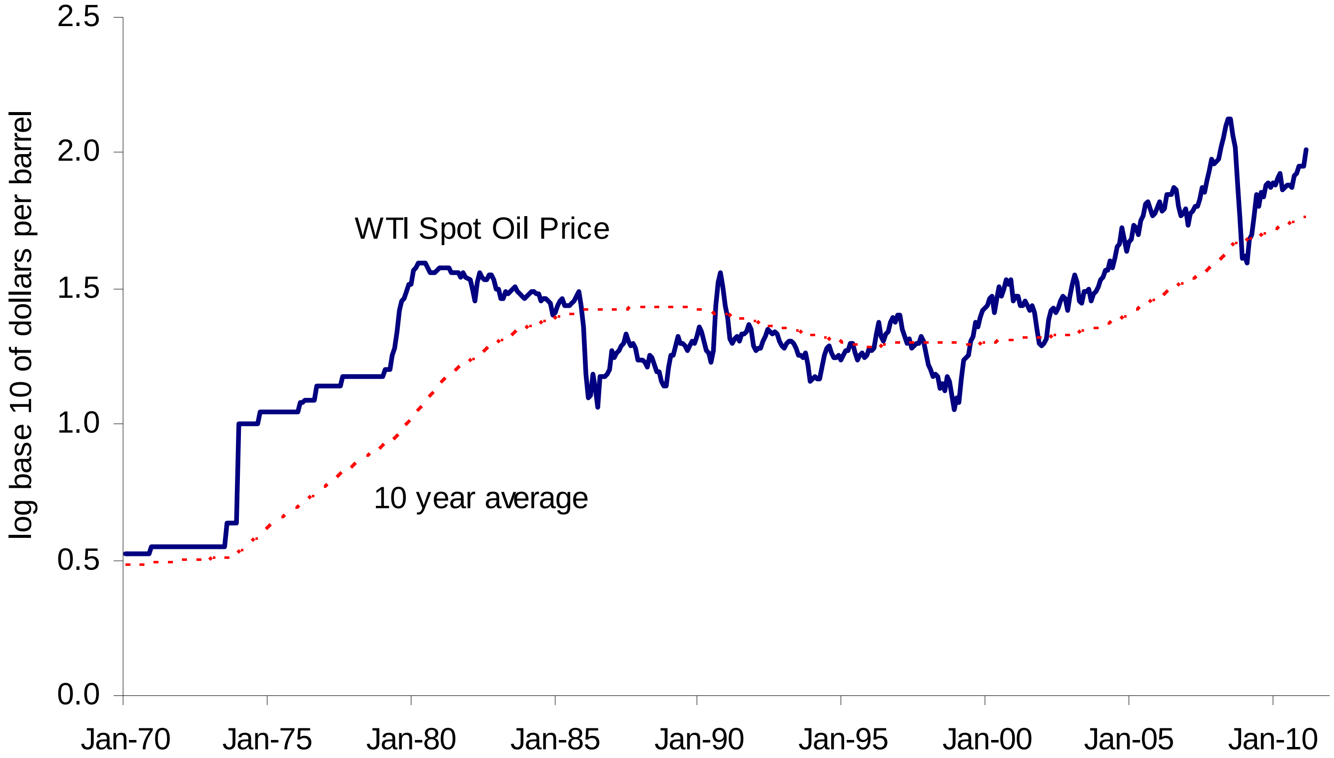
(last obs. April 26, 2011)



Source: Wall Street Journal; Encima Global

High oil prices reflect dollar's weak value

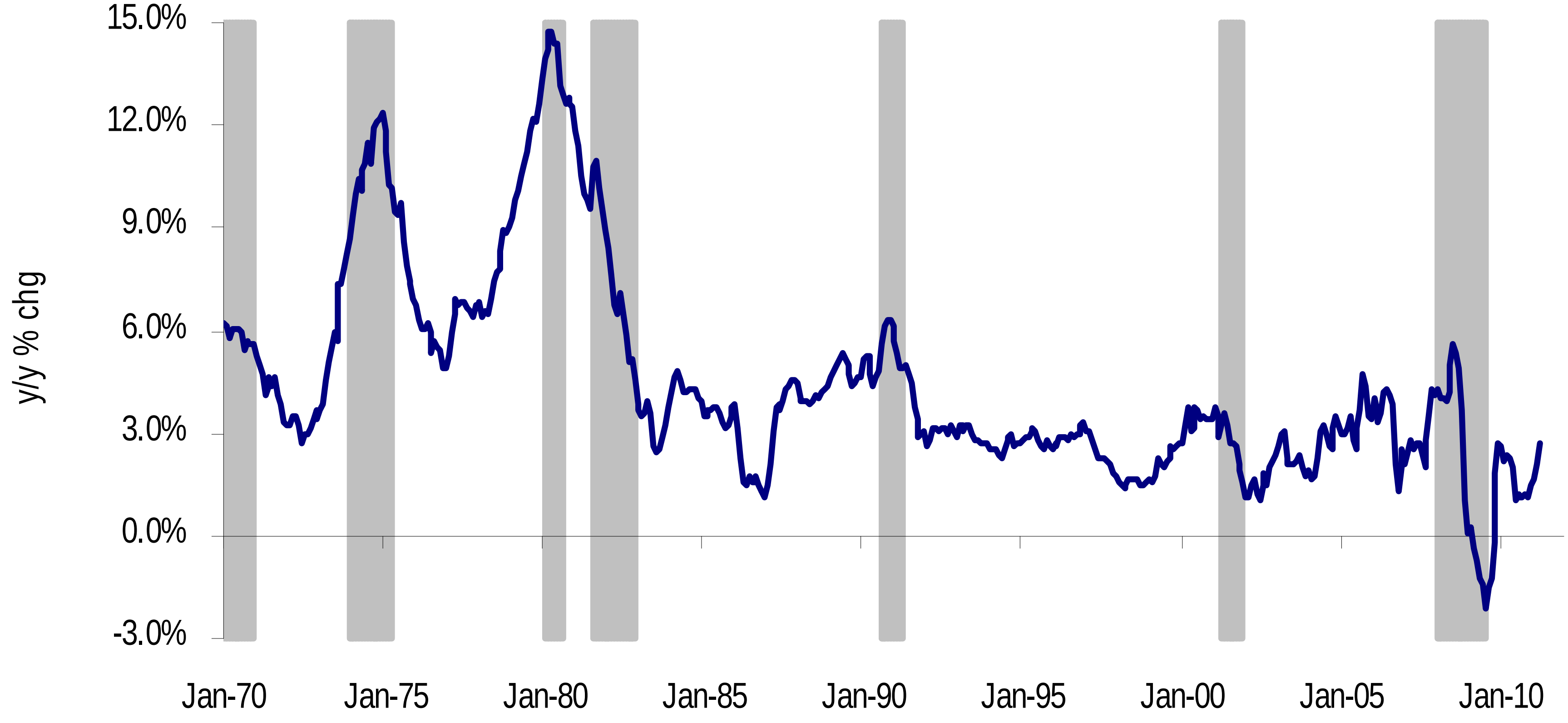
(last obs. April 26, 2011)



Source: Wall Street Journal; Encima Global

Headline CPI Rising Above 3%, but Core CPI Low

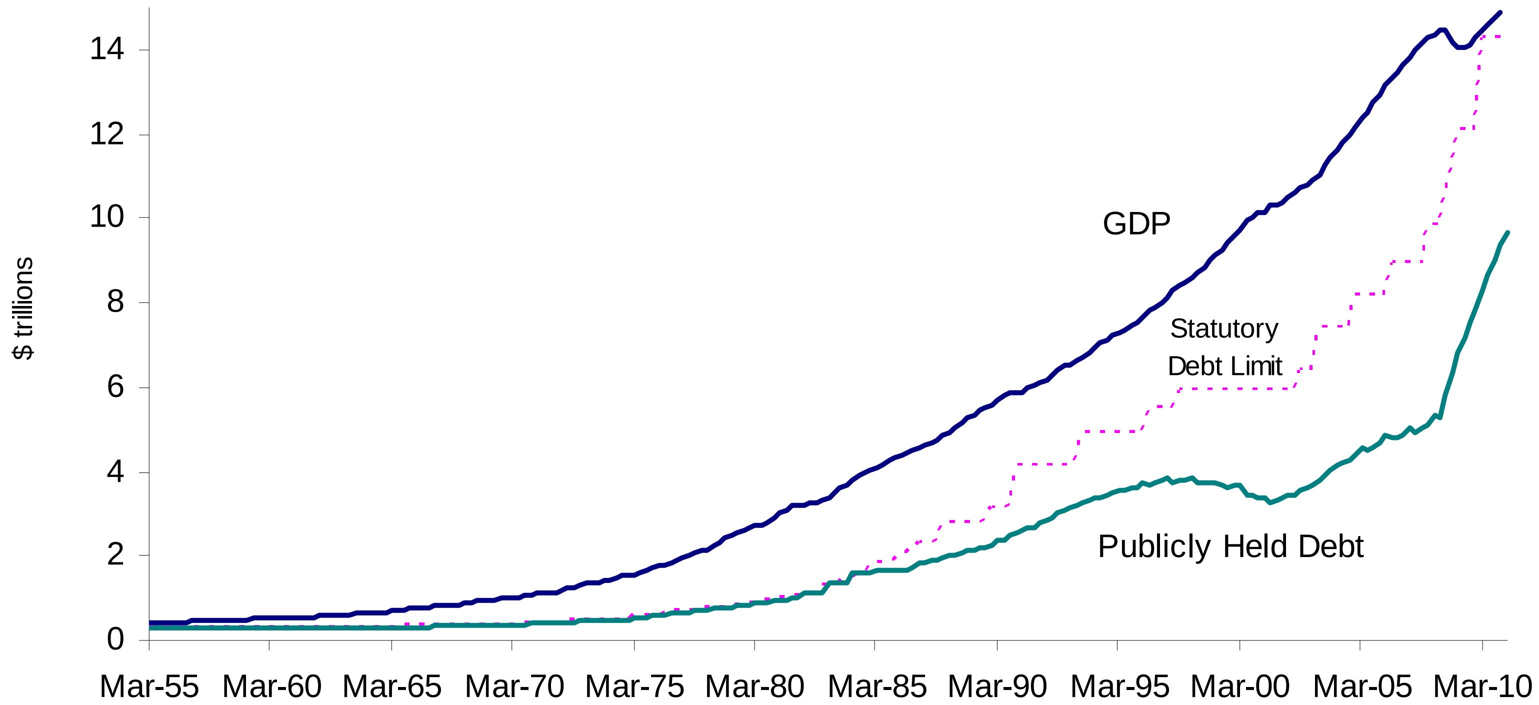
(last obs. March 2011)



Source: Bureau of Labor Statistics; Encima Global

Marketable Debt Reaching 70% of GDP

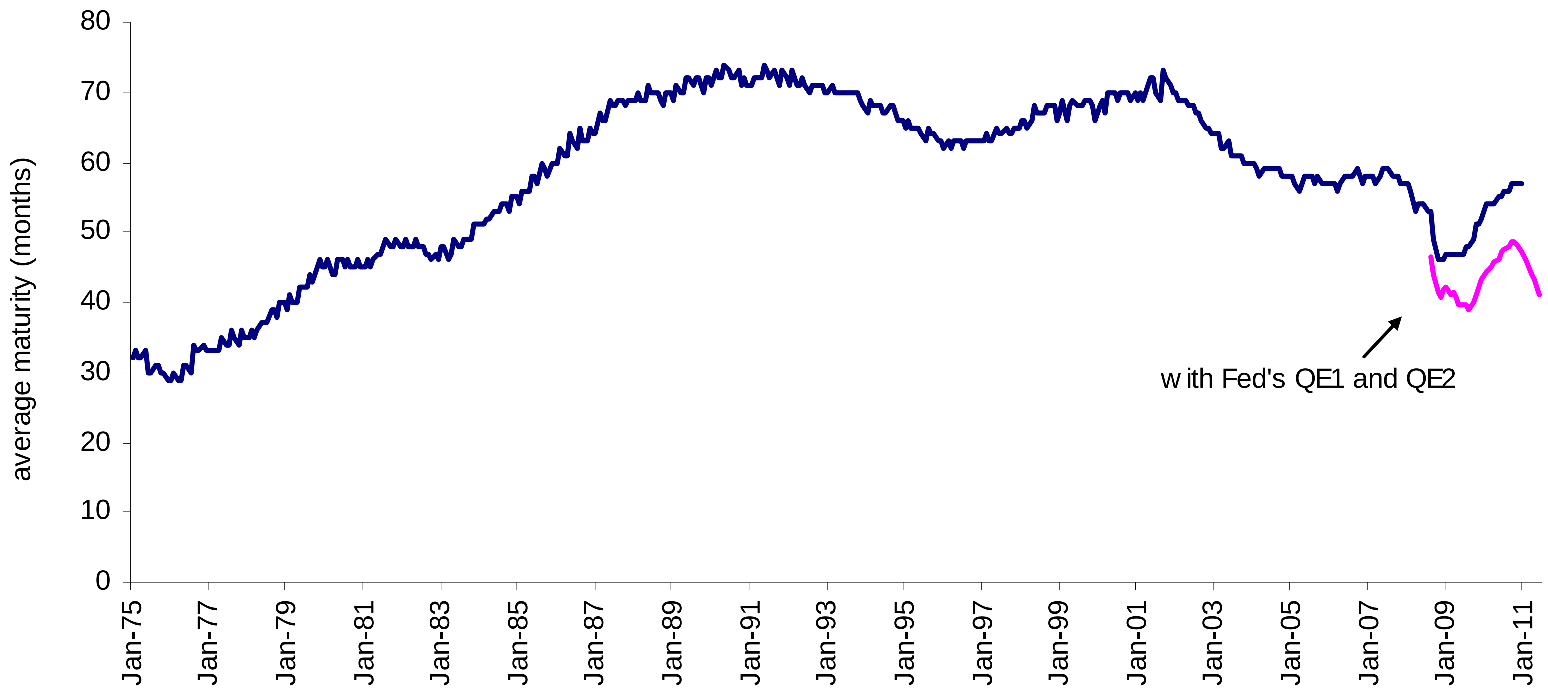
(last obs. Q1 2011)



Source: Bureau of Economic Analysis; U.S. Treasury; Encima Global

Maturity of Publicly Held Debt

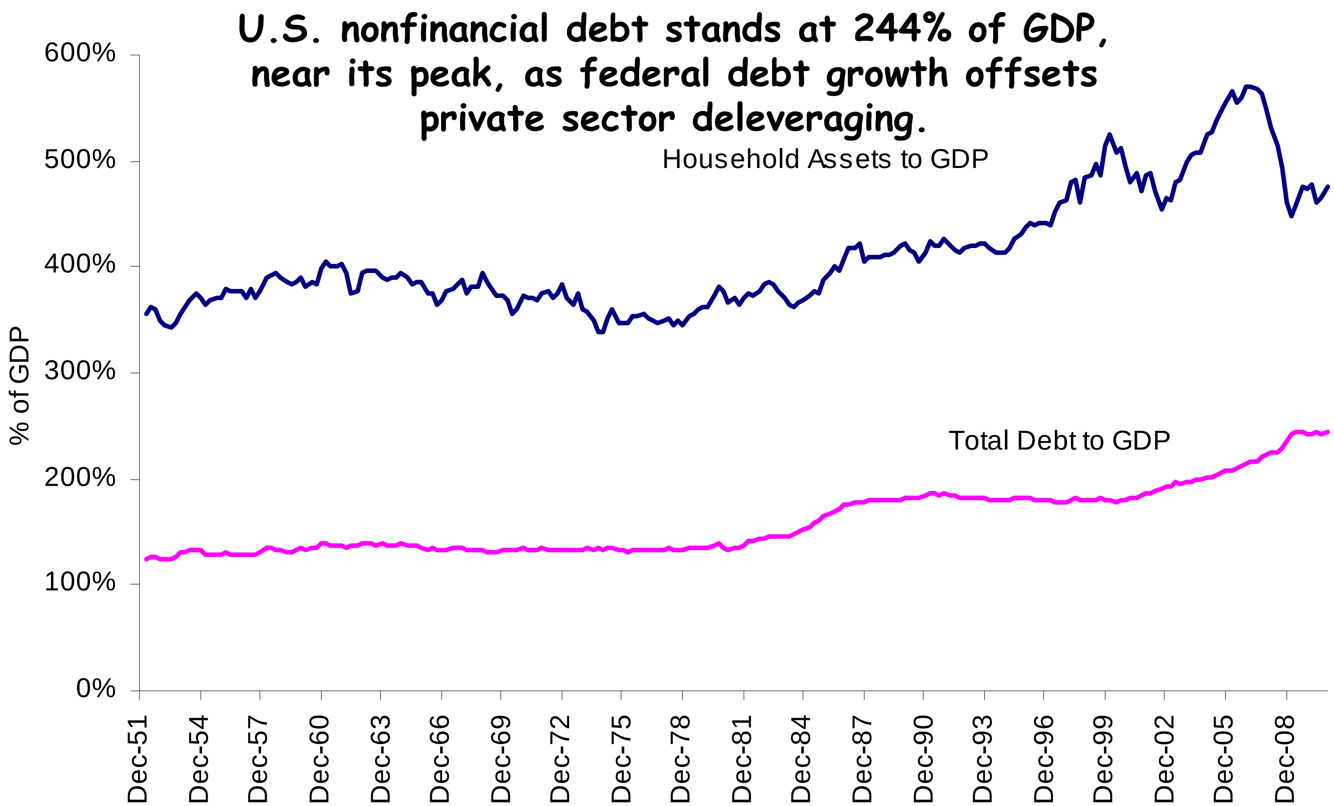
(months, last obs. December 2010, estimated to June 2011)



Source: U.S. Treasury; Encima Global

Household Assets $71 Trillion; Total Debt $36T

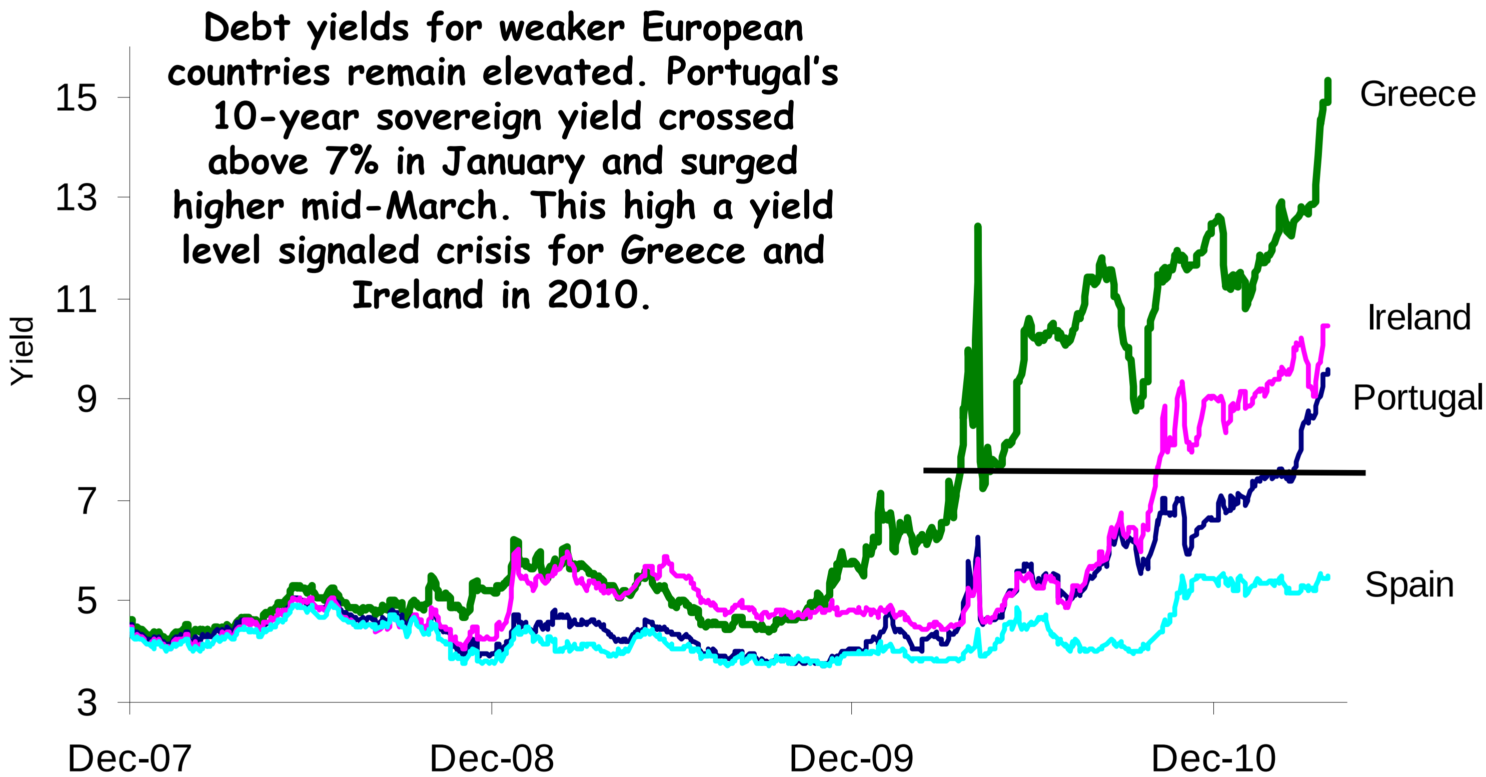
(last obs. Q4 2010)



Source: Federal Reserve: BEA; Encima Global

Select European 10 Yr Yields

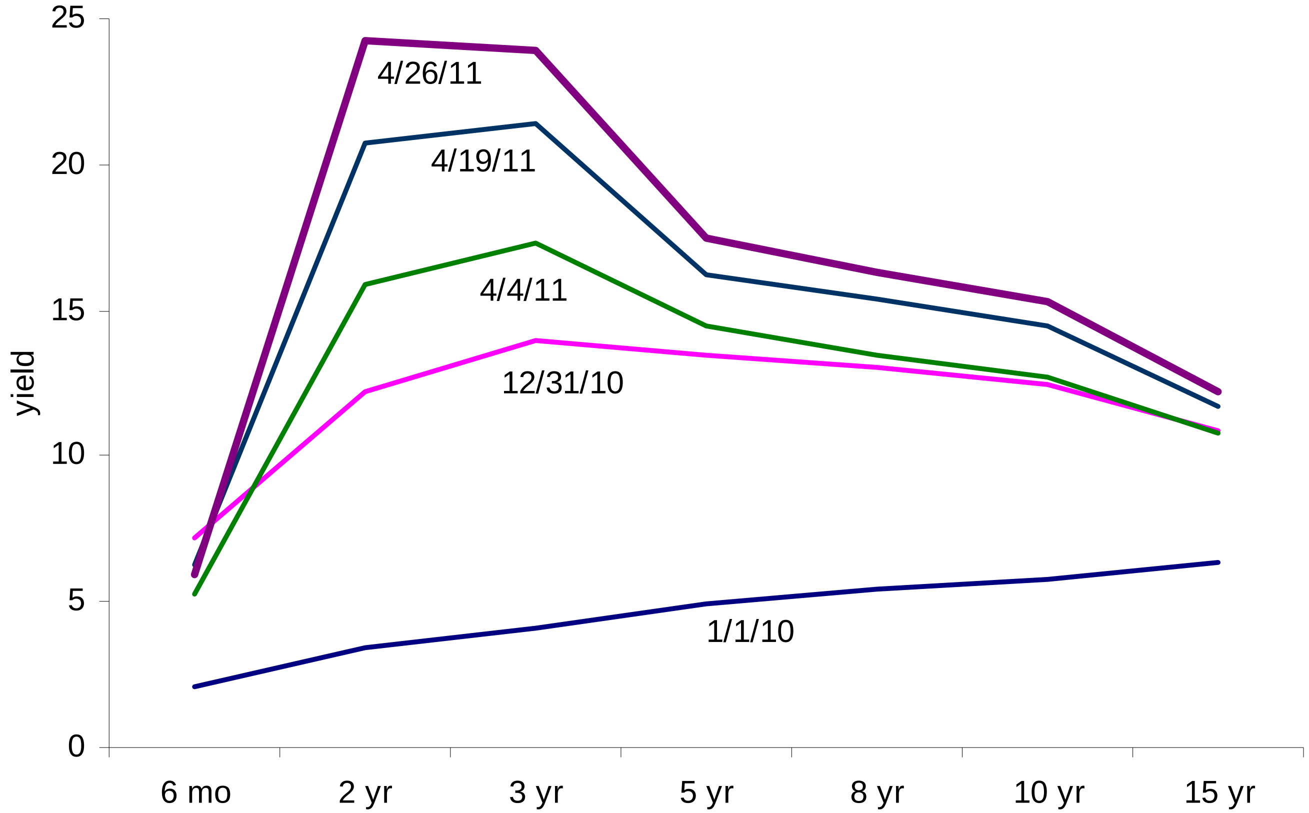
(last obs. April 26, 2011)



Source: Bloomberg; Encima Global

Greek Yield Curves

(last obs. April 26, 2011)



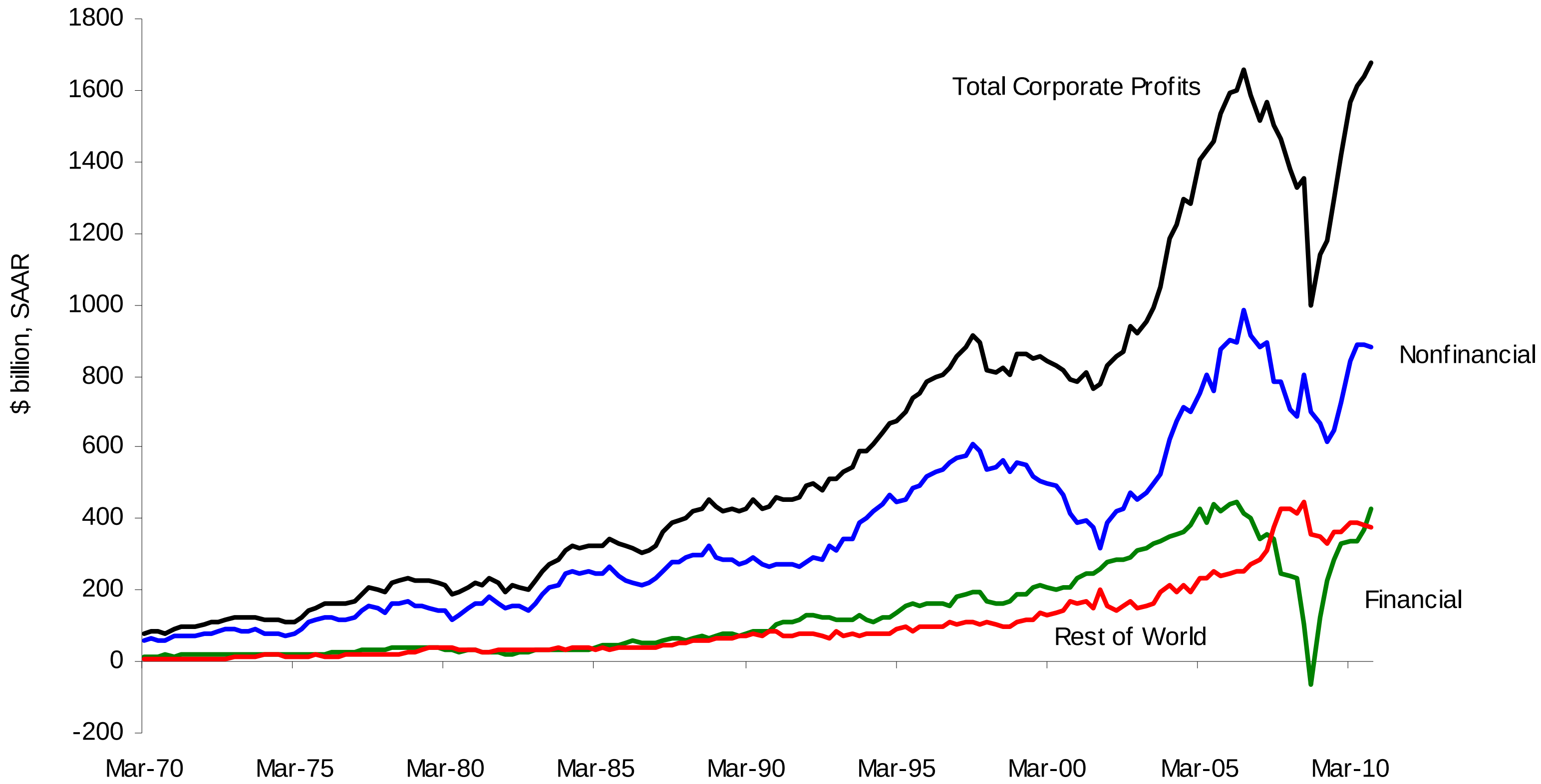
Source: Bloomberg; Encima Global

U.S. Economic Outlook

- The basic U.S. policy has been to kick the can hard down the road. Contrasting with most of the rest of the world, the U.S. government has been practicing belt-loosening (increased federal deficits and mandates) rather than belt-tightening. This has been supported by the Federal Reserve's massive debt buy-backs and the maintenance of near-zero interest rates, which hold down government and corporate borrowing costs. It's not an optimal policy, but can-kicking will probably leave economic and market trends intact, allowing an expansion past the 2012 presidential election.
- We think loose fiscal and monetary policy have been harmful but will continue. There are also worries about inflation, high oil, a U.S. double dip, the dollar, the debt limit increase, European debt and China's slowdown. We think these won't stop the expansion, leaving room for a solid improvement in expectations.
- In March, we lowered our first quarter GDP forecast to 2.2%. We look for 3%-3.5% GDP growth in subsequent quarters (a moderate expansion.) job growth and business investment will be key signposts. Despite the first quarter letdown in GDP, the household survey found over one million jobs in the first quarter, while ADP also began to show job growth for small and medium-sized businesses.
- We're constructive on profits and equities in the second half of 2011. Overall corporate profits rose to a new peak at $1.68 trillion annualized in the fourth quarter of 2010. We expect strong increases in 2011, helped by growth abroad, productivity gains and stronger capital spending in the U.S. Bond yields have fallen, but we expect an uptrend in the second half.

Corporate Profits before Taxes with IVA & CCAdj

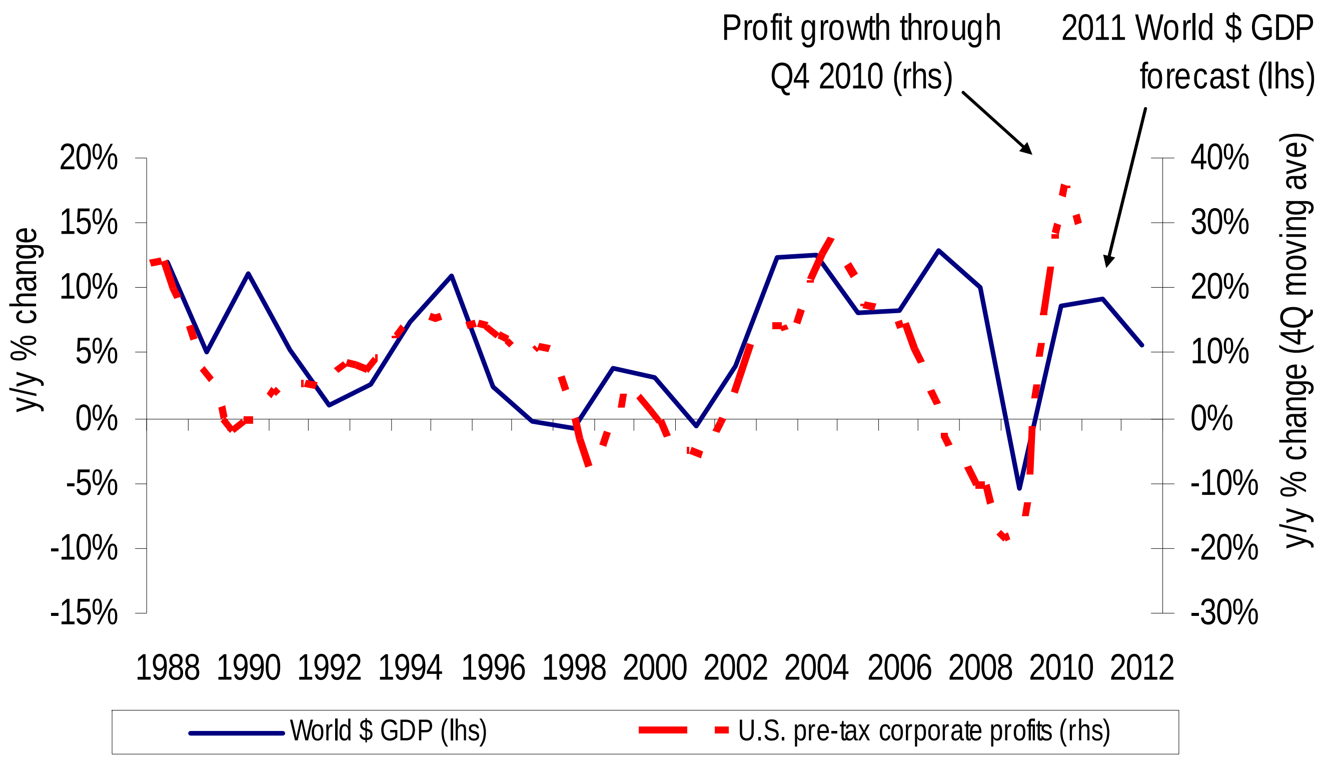
(last obs. Q4 2010)



Source: Bureau of Economic Analysis; Encima Global

Corporate Profits Growth and World $ GDP

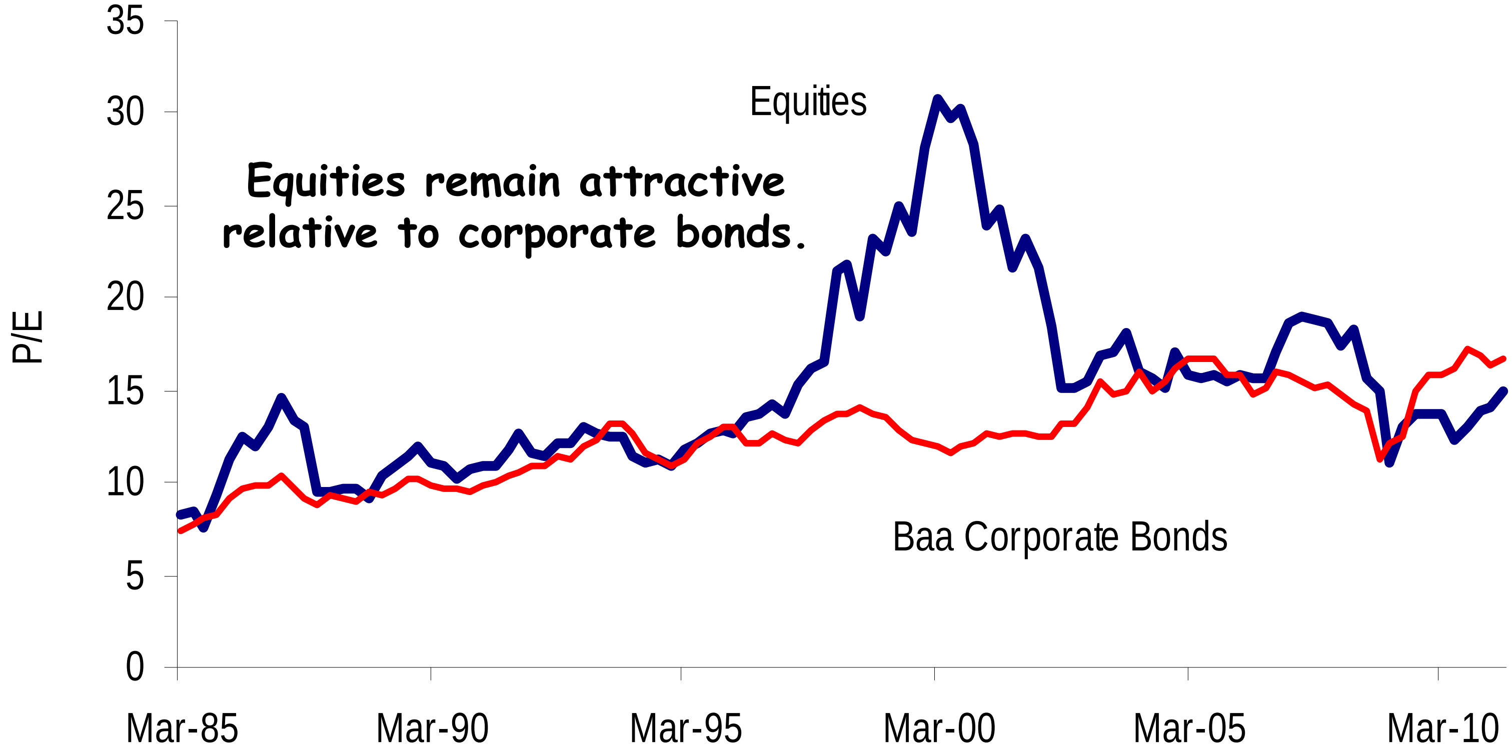
(last obs. Q4 2010, world GDP forecast to 2012)



Source: Bureau of Economic Analysis; IMF; Encima Global

Based on P/E, Equities Attractive Relative to Bonds

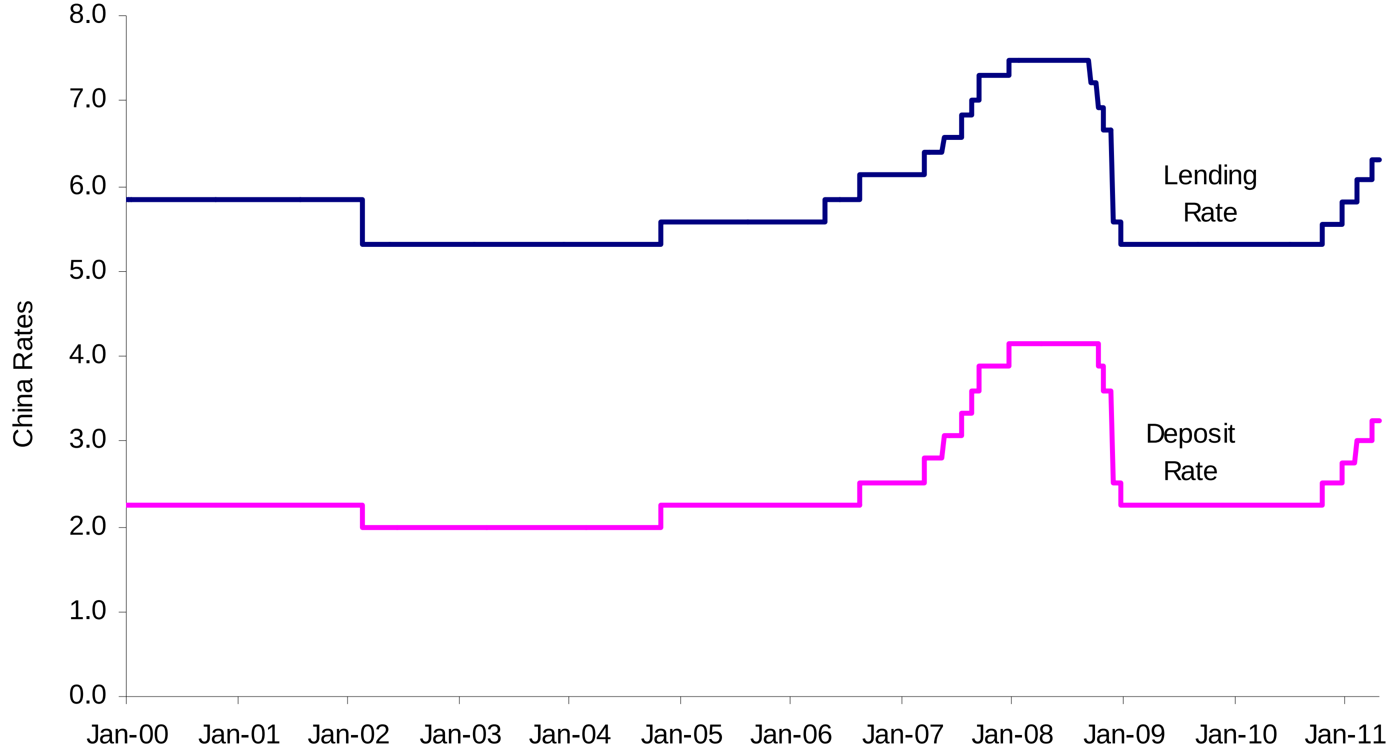
(last obs. Q4 2010, estimated Q2 2011)



Source: Haver; Bureau of Economic Analysis; Federal Reserve; Encima Global

China Tightening Monetary Policy

(last obs. April 26, 2011)



Source: Bloomberg; Encima Global