

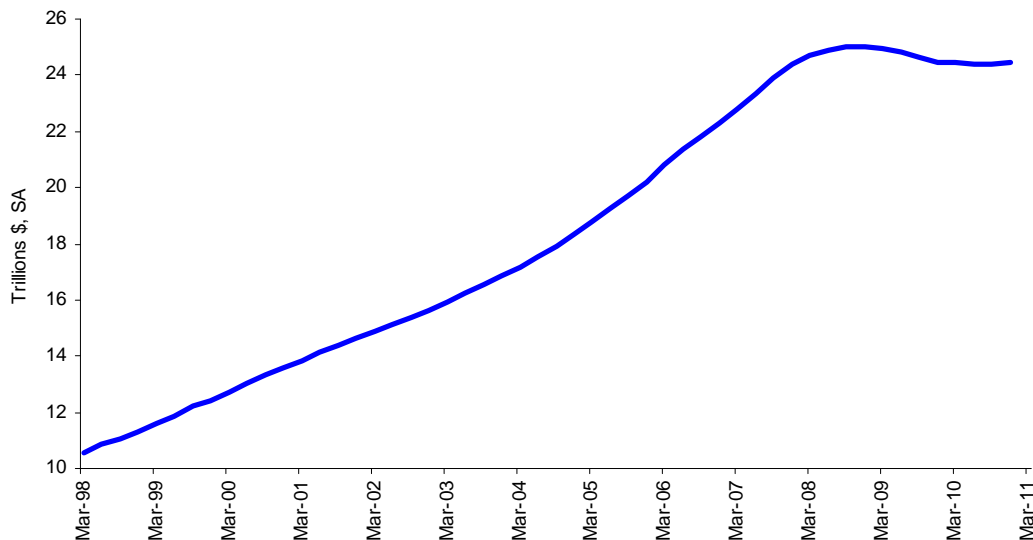
April 25, 2011

Fed Exit – Fed Funds Rate, not QE2, the Key Variable

The Federal Open Market Committee will meet Tuesday and Wednesday and issue its statement on Wednesday at an earlier-than-normal 12:30pm. Chairman Bernanke will then hold a press conference at 2:15pm.

- We don't expect the FOMC statement or the press conference to break new ground on key issues like dollar weakness and the connection to rising gold and oil prices; or the U.S. delay in hiking the Fed funds rate while other central banks tighten. We expect the Fed to complete QE2 in June and to pursue other forms of monetary accommodation after that.
- We don't think QE2 had much impact on the economy nor will its completion. The wind-down has been widely anticipated. QE2 didn't cause a material expansion of private sector credit, and its completion shouldn't cause a reduction.

Private Sector Credit (\$ trillions, last obs. Q4 2010)



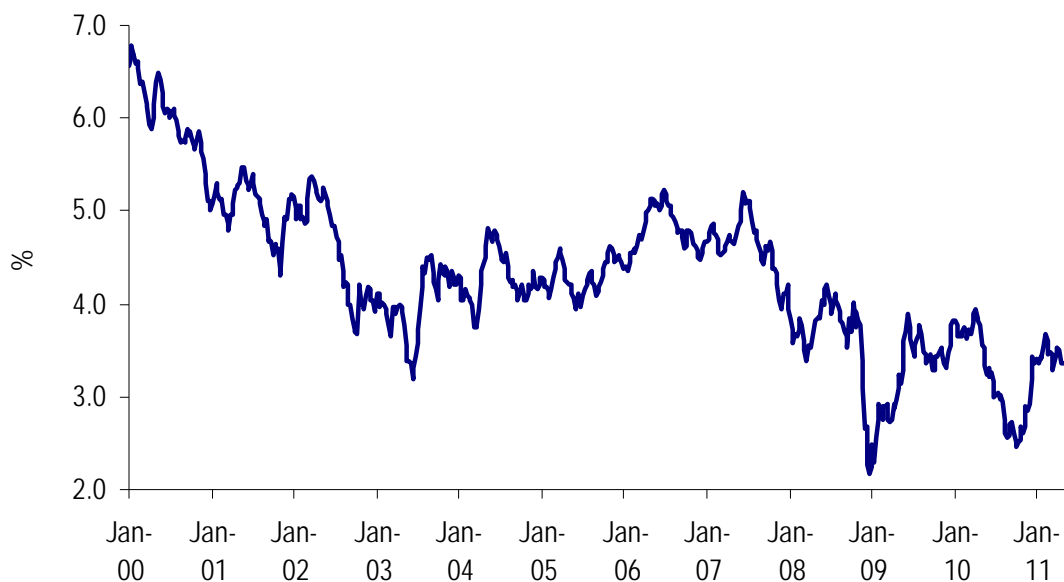
Source: Federal Reserve; Encima Global

- We disagree with the concern based on credit flows that ending Fed purchases will create a vacuum of bond buyers and tighten credit. Under QE2, the Fed has been

borrowing from banks through excess reserves to make a leveraged investment in Treasury bonds. The Fed's investment decision, while large relative to the Treasury market, is small compared to potential substitutes which include agencies, MBS, supranationals, high-grade corporates, bunds, other euro sovereigns, UK sovereigns and, for Japanese investors, JGBs. **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.**

- As it completes QE2, we expect the Fed to promise monetary policy accommodation through the Fed funds rate and maintenance of an enlarged balance sheet. **Core inflation is still low enough and unemployment high enough that Chairman Bernanke can use them as explanations for current monetary policy.** In recent months, there have been inflation-wary comments from some FOMC members, but Chairman Bernanke and Vice-Chairmen Yellen and Dudley have each explained the Fed's confidence in its inflation-fighting tools and the current inflation outlook.
- As discussed in other pieces, we think bond yields are being distorted for other reasons and are going through a whipsaw in which 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, confusion about the economic impact of ending quantitative easing and the above-market 25 basis points being paid for the excess reserves added during QE2. 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.

10 Year U.S. Treasury Yield (last obs. April 25, 2011)

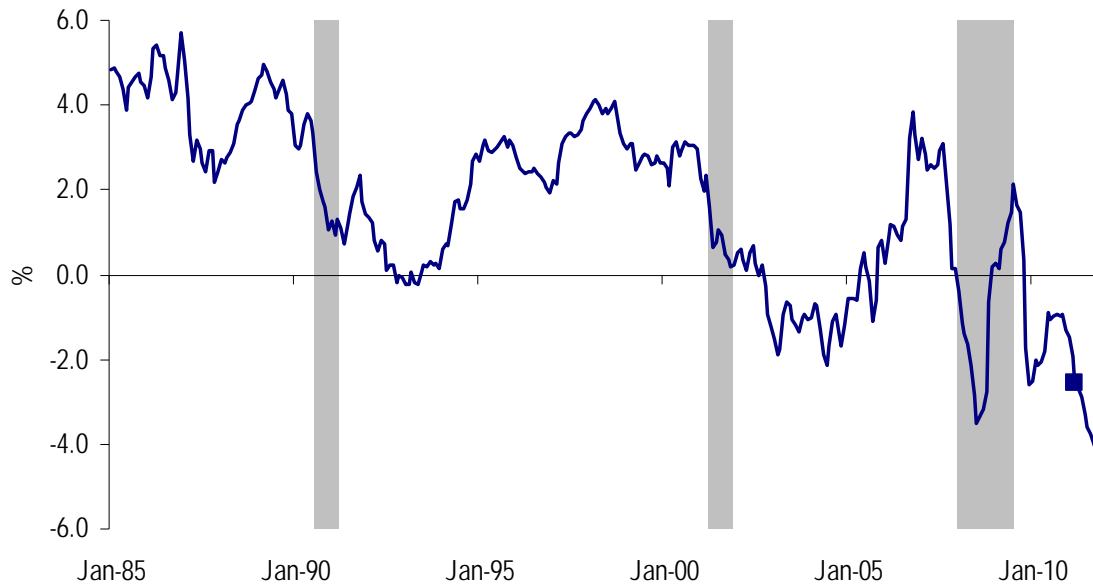


Source: Federal Reserve; Encima Global

We think the Fed has ample tools to transition monetary policy from ultra loose toward neutral in coming years. The question is when it will use these tools -- probably later and more gradually than it should, a repeat of the 2004-2006 pattern. Another important issue in the Fed's exit is whether the Fed puts boundaries on the future use of quantitative easing or leaves that power unlimited. (This piece is drawn from our similar discussion of these issues in Fed Exit Strategies on April 1.)

- We don't think the exit from QE2 is as important as the near-zero Fed funds rate itself. QE2 through Treasury bond purchases didn't have much impact on the economy, house prices or equity markets -- which rebounded off the 2010 soft-patch lows and probably would have gone up even without QE2 given strong corporate profits, the strengthening economy and the December tax deal. 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 Federal Reserves.
- 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. In the graph below, we assume no Fed rate hikes in 2011 and inflation running 0.3% per month from March through December.

Real Fed Funds Rate (last obs. March 2011, projected to December 2011)

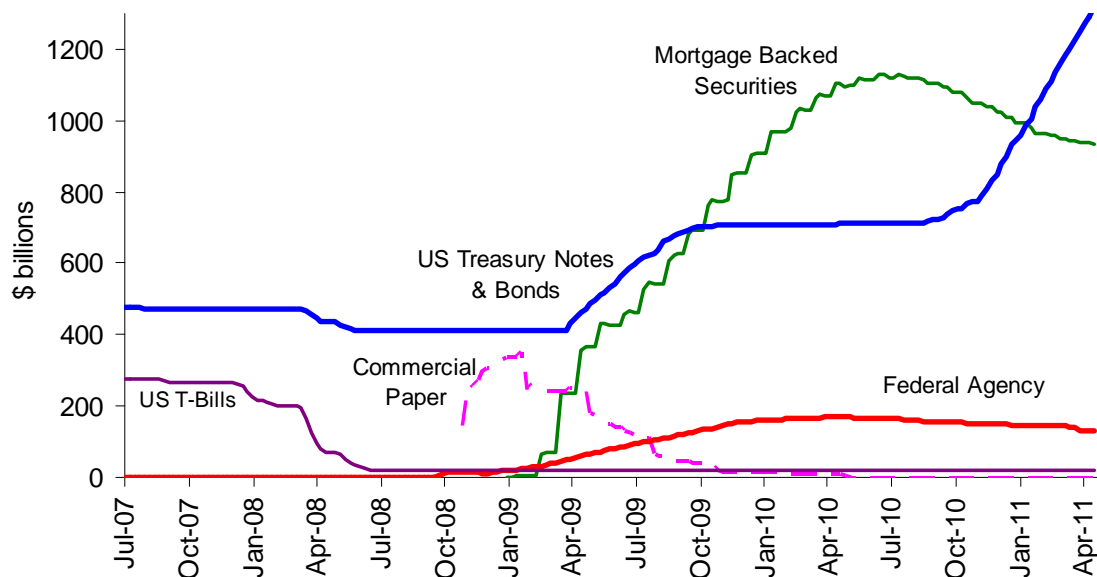


Source: Federal Reserve; Bureau of Labor Statistics; Encima Global

The Fed's Gradual Exit

We think the Fed will **complete its \$600 billion QE2 purchases in June**. The Fed will **probably continue buying enough new Treasury bonds after June to offset maturing MBS and Treasuries**.

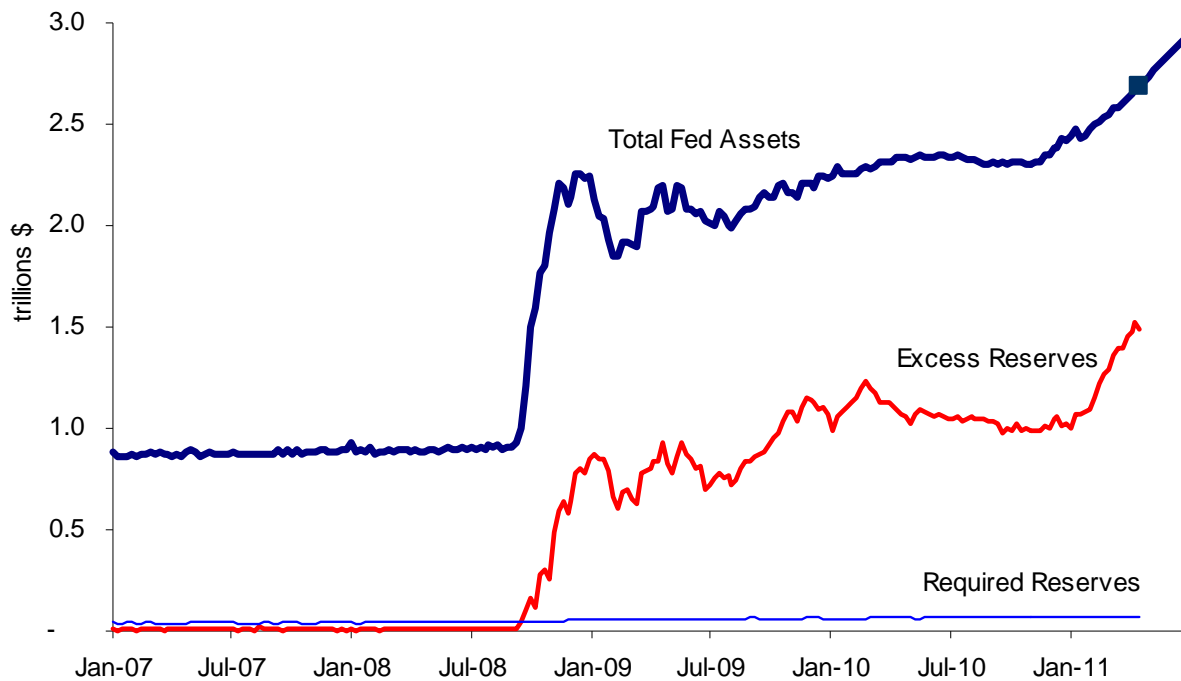
Fed Assets (last obs. April 20, 2011)



Source: Federal Reserve; Encima Global

- This would **maintain the size of the Fed's balance sheet** at its projected peak of \$2.9 trillion, probably for a few months with the idea of weaning markets. The Fed has been buying longer-term Treasuries financed by short-term commercial bank loans. By the June completion of QE2, these excess reserves – the idle funds deposited at the Fed by commercial banks -- will have grown to about \$1.8 trillion from \$1.0 trillion at the end of 2010. (Excess reserves rose faster than total Fed liabilities and assets in February and March because the Fed borrowed from banks to pay Treasury back for a supplementary loan made by Treasury to the Fed in September 2008. The Fed repayments to Treasury helped Treasury stay under the statutory debt ceiling by allowing Treasury to reduce issuance of Treasury bills. Bills are counted in the debt ceiling. The extra bank borrowing by the Fed (of excess reserves) isn't counted in the debt ceiling.

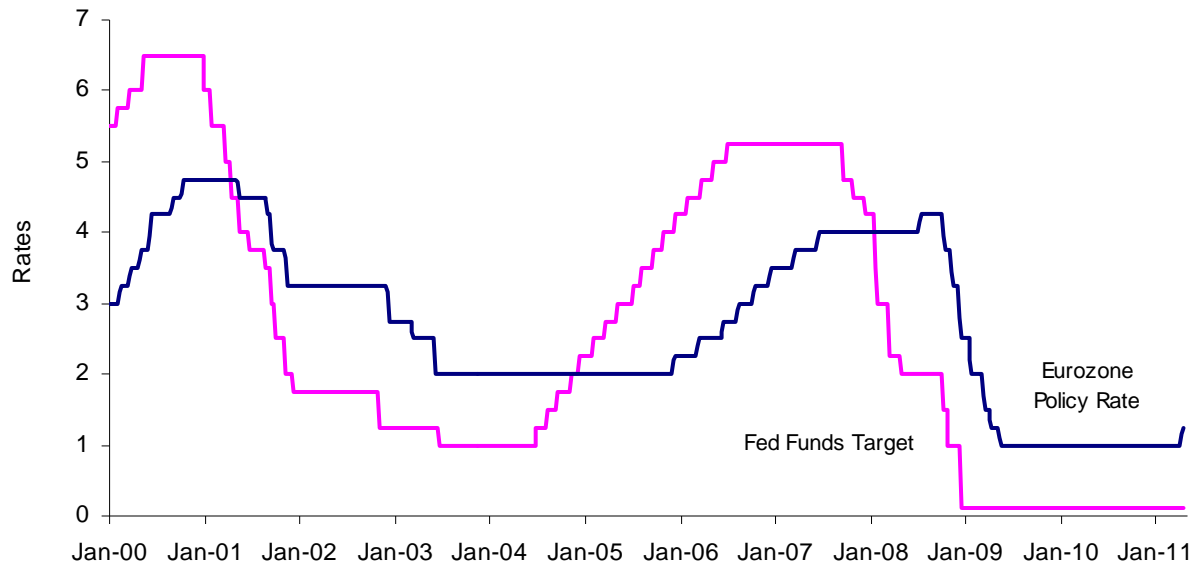
Fed Assets and Excess Reserve (last obs. April 20, 2011)



Source: Federal Reserve; Encima Global

- 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.

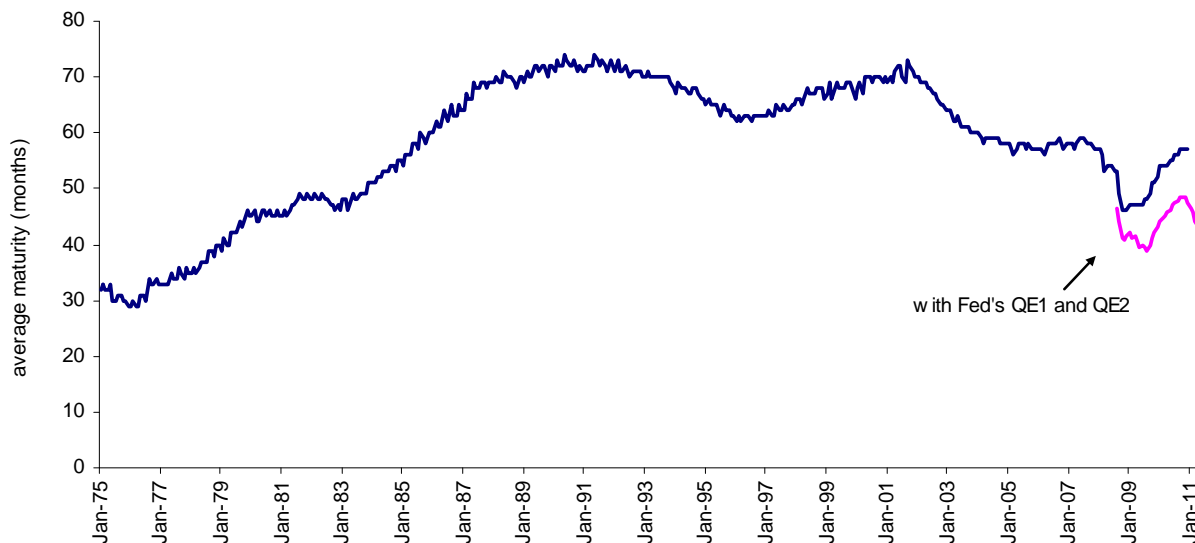
Fed Funds Rates and ECB Policy Rate (last obs. April 25, 2011)



Source: Federal Reserve; Encima Global

- In 2012 and beyond, we think the Fed will follow Treasury's recent precedent on the proposed sale of its MBS holdings. The Fed will pre-announce a **gradual reduction in its Treasury holdings, mostly by attrition** (which Chairman Bernanke mentioned in his March 1 remarks). We think the Treasury will continue its debt issuance program without regard to Fed holdings, meaning the effective maturity of the national debt would revert gradually over several years as the Fed's holdings unwind.

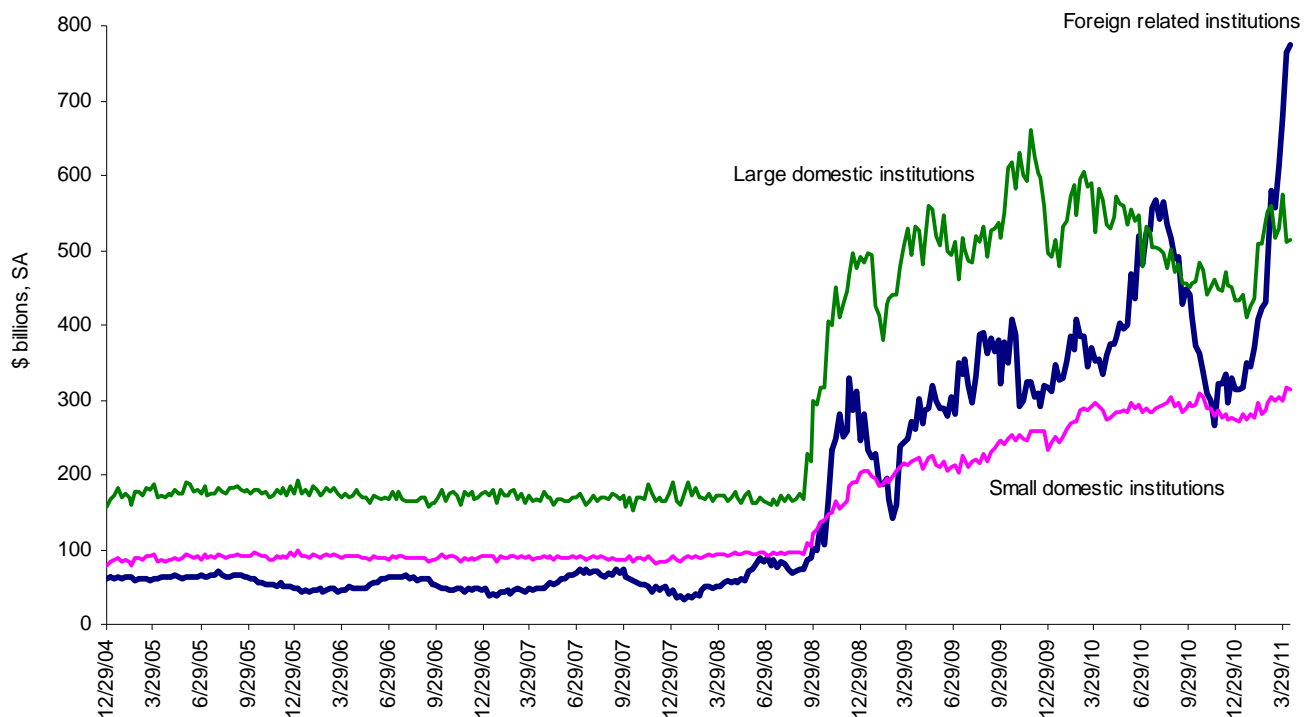
Average Maturity of Publicly Held Debt (last obs. Dec 2010, est. June 2011)



Source: U.S. Treasury; Encima Global

- At the same time, perhaps during 2012 and 2013, the Fed will gradually raise the Fed funds rate and, in conjunction, the interest rate paid on excess reserves. A key issue is whether the Fed can hold onto excess bank reserves to finance its long-term asset portfolio. For now, the Fed is paying banks a 0.25% interest rate on excess reserves, about 0.15% above the effective Fed funds rate the banks would otherwise earn. Since the Fed's excess profits were roughly \$80 billion in 2010, there's no real limit on the amount the Fed can choose to pay banks to retain the excess reserves.
- The biggest lender to the Fed through excess reserves are foreign banks, followed by large U.S. banks and then small U.S. banks. We think the availability of above-market deposit rates at the Fed as the Fed expands QE2 has been one factor holding down bond yields (like a marketing incentive paid to the seller). It will likely give way to higher bond yields once the Fed slows its Treasury purchases (during the asset size maintenance phase) and then stops Treasury purchases (during the shrinkage-by-attrition phase.)

Cash Assets of Banks (last obs. April 13, 2011)



Source: Federal Reserve; Encima Global

- We think the Fed can maintain sufficient liabilities without too much added expense. The Fed is expected to expand the new Term-Deposit Facility. There are now 500 depository institutions registered for the program, earning slightly above the normal rate

on excess reserves in return for extending the maturity of their deposit at the Fed. The Fed will also continue building its reverse repo process, creating a robust system to manage its enlarged bond portfolio.

What's Wrong With QE?

We think a better policy approach would be for the Fed to wind down QE2 now and begin small hikes in the Fed funds rate. As in 2004 when the Fed started rate hikes, markets adjusted. We've been critical of QE2 on multiple concerns:

- The Federal Reserve should not be expanding its already-too-large role in the economy and markets (except perhaps in a dire emergency like 2008);
- QE2 weakens the dollar and drives capital away from the U.S. Fed ownership of bonds creates a conflict of interest for the Fed in setting the Fed funds rate, undermining confidence in the Fed and the dollar, which has hit a new record low (below 2008) in the broad trade-weighted inflation-adjusted dollar index;

Record Low for Real Broad Trade-Weighted Dollar (last obs. March 2011)



Source: Federal Reserve; Encima Global

- Fed asset purchases create a deeply harmful precedent by establishing the Fed's authority and responsibility for buying assets to speed up economic growth and for controlling bond market yields (the Fed's explicit goal in QE2);

- Fed buybacks of Treasury bonds shorten the effective maturity of the national debt at a time when maturities should be extended;
- QE2 hasn't added much to private sector credit or created a lasting change in the shape of the yield curve or the credit curve (see Winding Down the Fed's QE on November 8, 2010);
- Despite the rapid expansion of the Fed's balance sheet and M0, M2 has only grown 4.8% year over year. We think monetary policy is being conducted more through credit rationing and regulatory policy than price mechanisms (see Near-Zero Rates Are Hurting the Economy, WSJ December 4, 2009.)

M2 Y/Y (last obs. April 11, 2011)



Source: Federal Reserve; Encima Global

Notes: This email and attachment are confidential and intended solely for the use of the individual to whom they are addressed. Encima Global LLC does not accept liability for the content, or for the consequences of any actions taken on the basis of the information provided. The information is not necessarily complete, and we make no warranty as to its accuracy.