

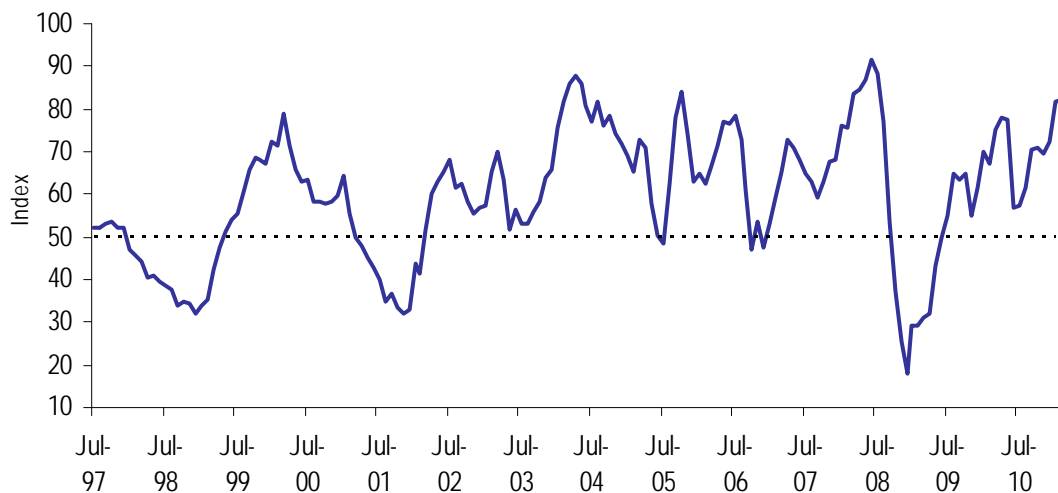
April 1, 2011

Fed Exit Strategies – Too Slow

One of Bloomberg's top headlines today is how Australian men without college degrees are, on average, earning more than Ben Bernanke. We can chuckle, but it means they have more actual purchasing power than Americans.

- Underscoring this impact of dollar weakness, today's ISM prices-paid indicator jumped to 85 for only the fourth time since the 1970s. This supports Walmart's warning yesterday about coming price increases.

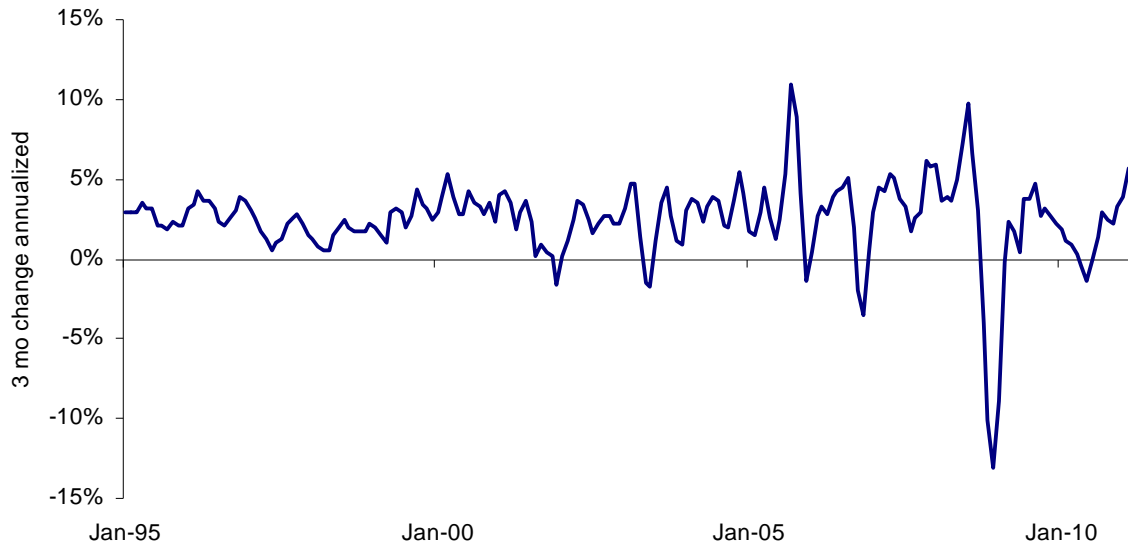
ISM Manufacturing Prices Paid (last obs. March 2011)



Source: ISM; Encima Global

- We expect year-over-year CPI inflation, now 2.1%, to rise above 3% in coming months. It is running at a 5% plus annualized rate in December through February, with the latest oil spike still to take effect. Aside from Katrina and the 2008 oil bubble, this is already the highest three-month inflation rate since the first Iraq war in 1990.

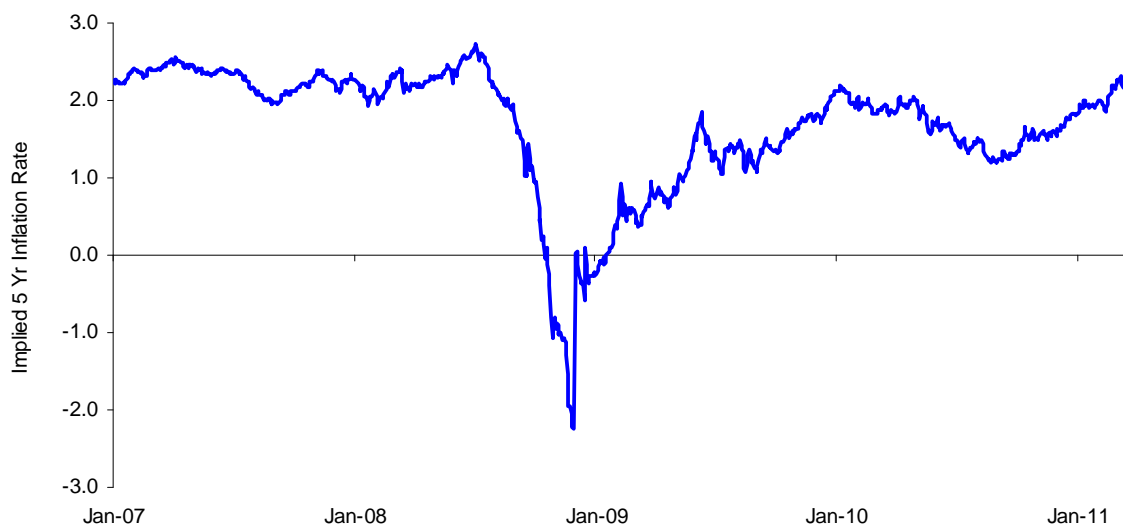
CPI 3-mo change annualized (last obs. February 2011)



Source: Bureau of Labor Statistics; Encima Global

- Inflation expectations are also rising materially, as reflected in the TIPS spread and the one-year University of Michigan inflation outlook (now at 4.6%, up from 2.2% in September 2010 before the Fed launched QE2.) Per New York Fed President Bill Dudley on February 28: “If inflation expectations were to become unanchored because Federal Reserve policy makers failed to communicate clearly, this would be a self-inflicted wound that would make our pursuit of the dual mandate of full employment and price stability more difficult.”

TIPS implied 5 year inflation rate (last obs. March 30, 2011)



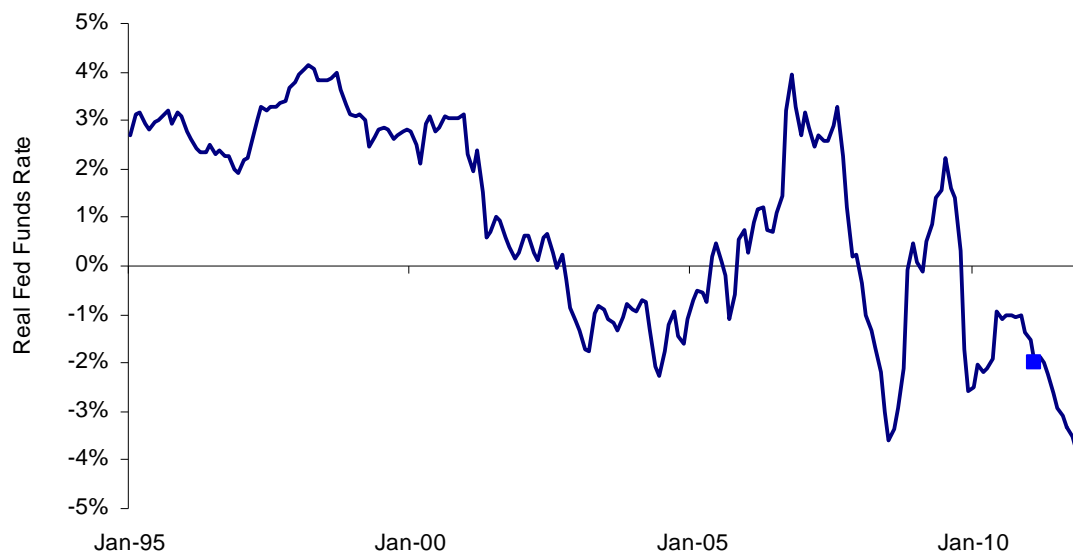
Source: Federal Reserve; Encima Global

Fed Exit Strategies – Fed Funds Rate the Key Variable

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 too late and too gradually as in 2004-2006. 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.

- We don't think the exit from QE2 is as important as the near-zero Fed funds rate itself. As discussed in our previous pieces, QE2 through Treasury bond purchases is the equivalent of Treasury shortening the maturity of its issuance (less bonds, more bills). This 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, which borrows short and lends long, 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. We were also critical of negative real interest rates in the "overflowing punch bowl" period from 2003-2005, which we think was a substantial contributor to the 2007 bubbles in housing and bank leverage. In the graph 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. February 2011, projected to December 2011)

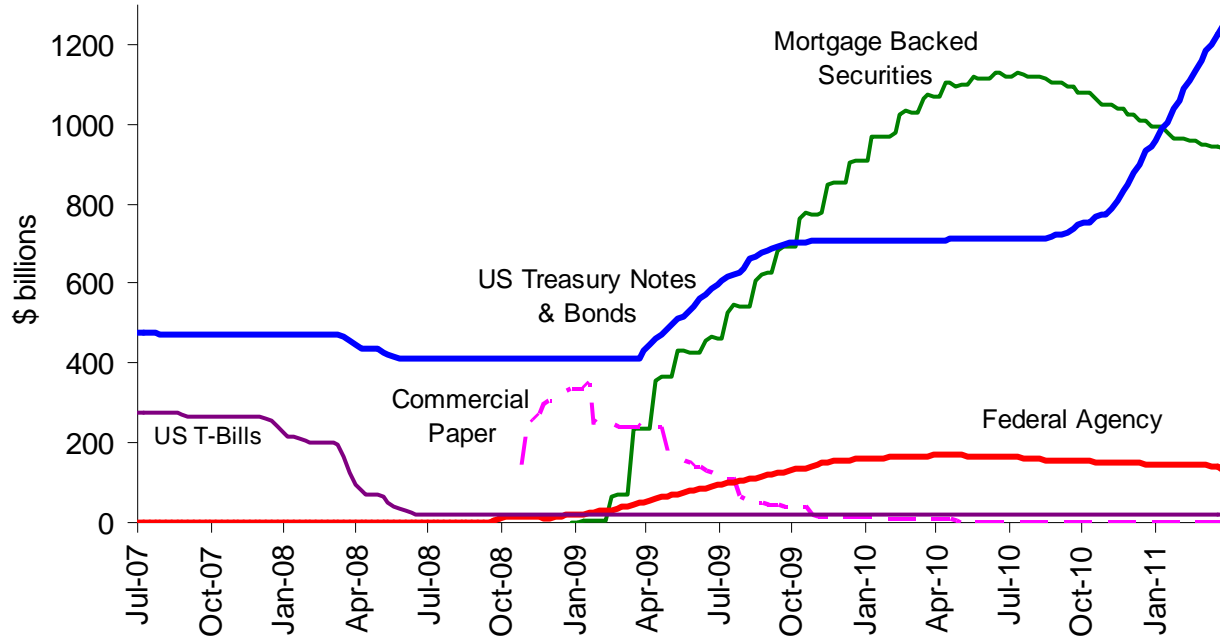


Source: Federal Reserve; Bureau of Labor Statistics; Encima Global

We think the Fed will **complete its \$600 billion QE2 purchases in June**. In recent weeks, there's been a slight tilt away from the Fed's ultra-dovish analysis, including more inflation-aware comments from FOMC members.

- **The Fed will probably continue buying enough new Treasury bonds after June to offset maturing MBS and Treasuries.**

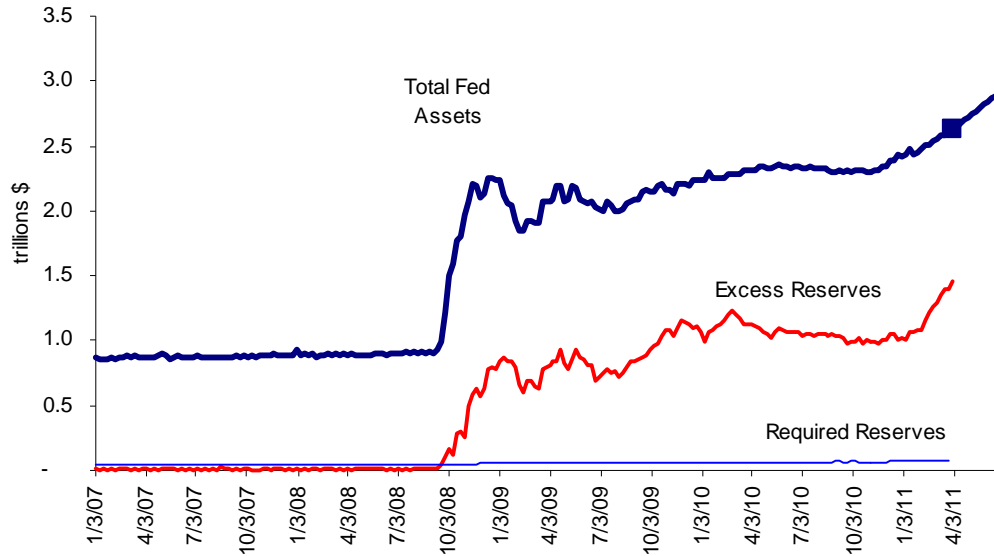
Fed Assets (last obs. March 30, 2011)



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 are rising faster than total Fed liabilities and assets because the Fed is using bank debt to pay Treasury back for a supplementary loan made by Treasury to the Fed in September 2008. The February and March Fed repayments to Treasury have helped Treasury stay under the statutory debt ceiling by allowing Treasury to pay off Treasury bills, which are counted in the debt ceiling, using extra bank borrowing by the Fed, which aren't counted in the debt ceiling.)

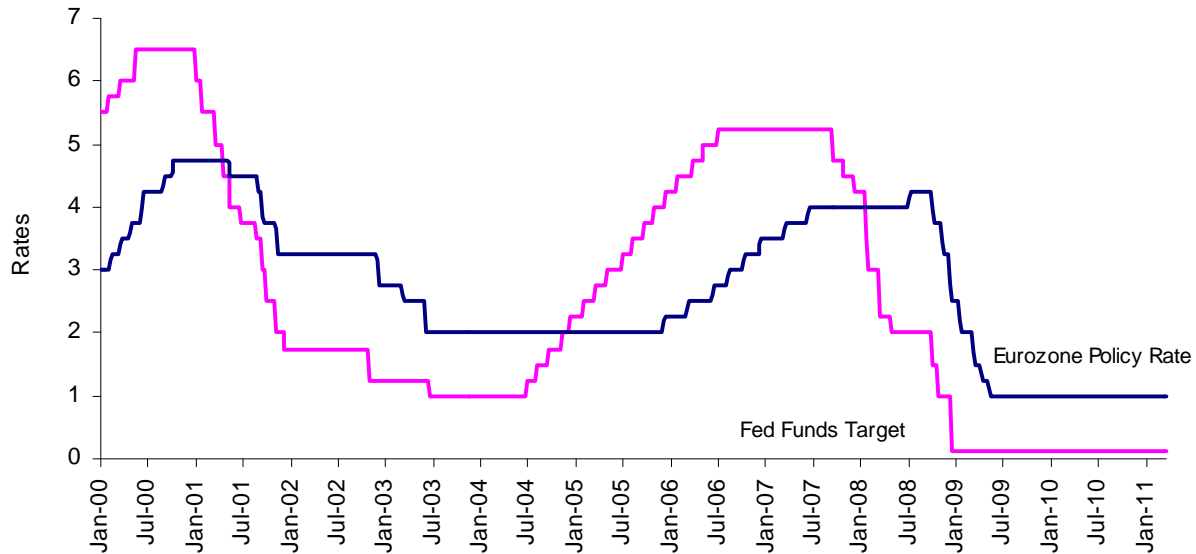
Fed Assets and Excess Reserve (last obs. March 30, 2011)



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 1, 2011)



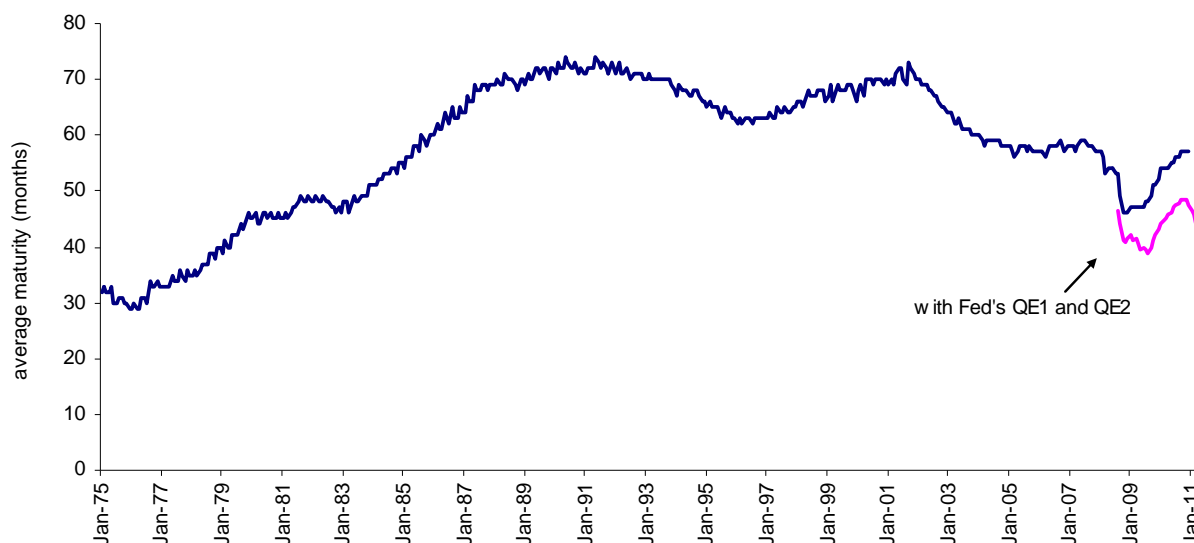
Source: Federal Reserve; Encima Global

Longer-Term Exit

The combination of very low interest rates, a weak dollar and higher effective tax rates from inflation leaves a moderate (i.e. disappointing) U.S. GDP growth outlook, though still-fast growth in emerging markets as U.S. capital flows there. We think the U.S. unemployment rate will decline slowly and the U.S. economy will underperform U.S. potential growth. This gives the Fed the rationale it needs for a slow exit.

- 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 will remain short for several years as the Fed's holdings gradually unwind.

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



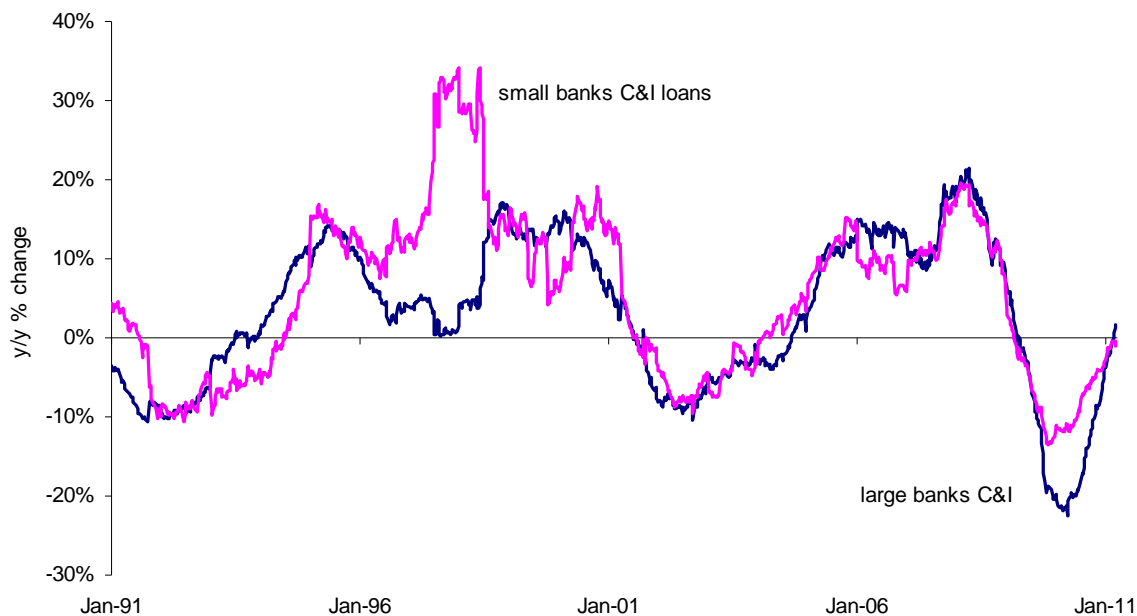
Source: U.S. Treasury; Encima Global

- At the same time, 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 0.10% above the effective Fed funds rate the banks would otherwise earn. Since the Fed's excess profits were \$80 billion in 2010, there's no real limit on the amount the Fed can choose to pay banks to, in effect, not lend.
- 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 its experimentation with reverse repos, creating a robust system to manage its enlarged bond portfolio.

- In addition, regulators are restrictive and loan demand is still sluggish. Loan officer surveys show a gradual loosening quarter to quarter, but still not enough loosening to cause loans. Commercial and Industrial loans outstanding for large banks were \$624.5 billion on March 16, up only 1.7% year-over-year, while small-bank C&I loans were at \$377.2 billion, down 1% year-over-year.

Growth in C&I Loans (last obs. March 9, 2011)



Source: Federal Reserve; Encima Global

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;

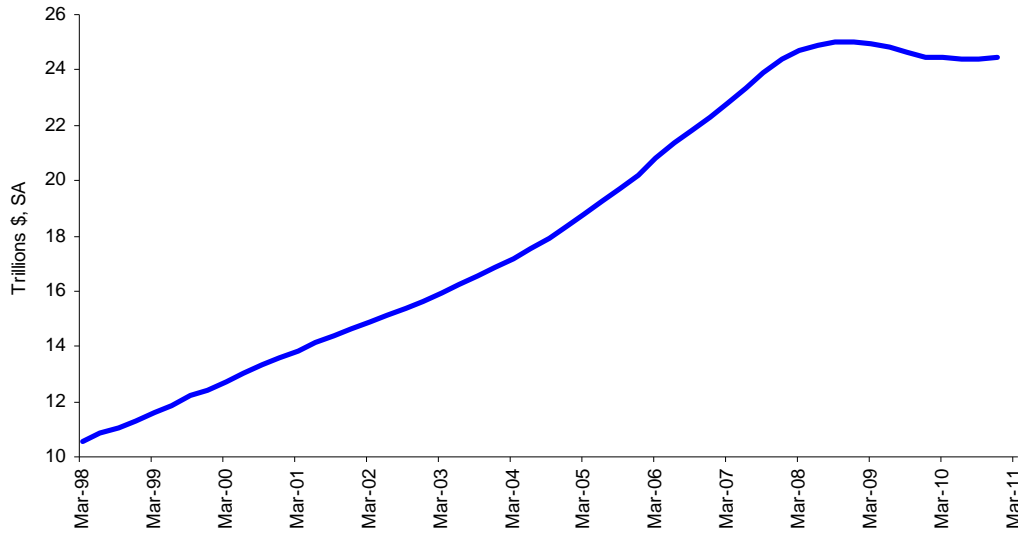
Record Low for Real Broad Trade-Weighted Dollar (last obs. Feb 2011)



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).

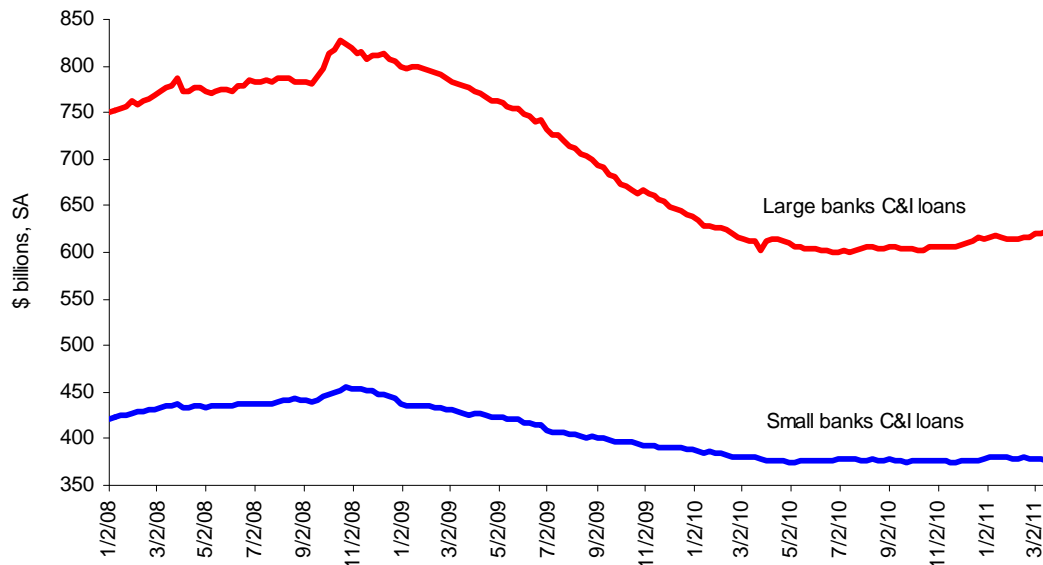
Private Sector Credit (\$ trillions, last obs. Q4 2011)



Source: Federal Reserve; Encima Global

- Because the Fed is financing its expansion with excess reserves, there is little traditional monetary stimulus being applied. In a normal monetary policy based on the Fed “printing money”, the Fed injects liquidity by buying Treasury bills using ‘excess reserves’. Banks then add to their lending multiple times, converting the excess reserves into ‘required reserves’. With the Fed forcing excess reserves, bank lending has been sluggish.

Commercial and Industrial Loans (last obs. March 16, 2011)



Source: Federal Reserve; Encima Global

- M2 has grown 4.6% year over year, a signal that monetary policy is being conducted through credit rationing rather than market-based pricing (see Near-Zero Rates Are Hurting the Economy, WSJ December 4, 2009.) Note the contrast with the monetary stimulus in the 2002-2003 recovery.

M2 Y/Y (last obs. March 26, 2011)



Source: Federal Reserve; Encima Global

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