

December 15, 2008

Key Variable: What the Fed Is Willing to Buy, and When

The Fed is expected to announce a cut in the 1% Fed funds rate target on Tuesday at 2:15pm. Whether to 0.5% (our guess) or lower, we don't think the rate cut itself will have much impact on the outlook.

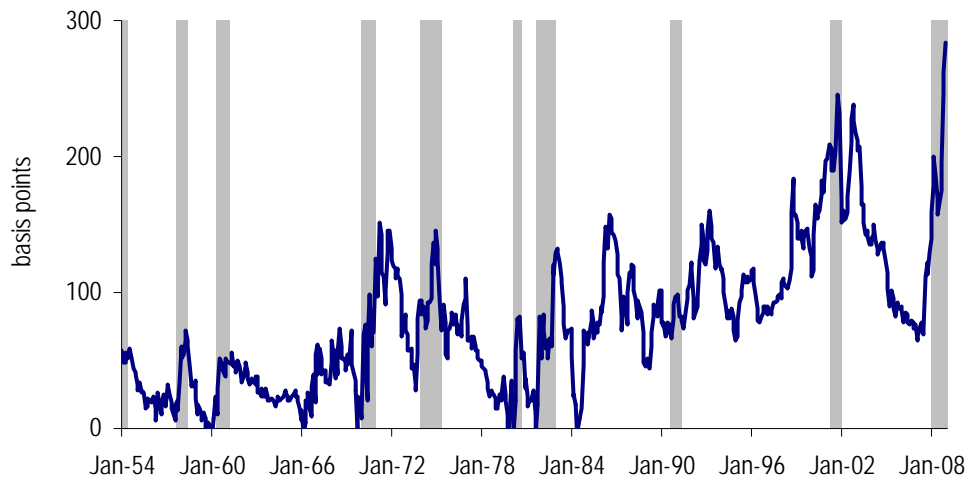
- Since the Lehman bankruptcy, the Fed's bigger impact has been through the expansion of its balance sheet. Assets have grown to \$2.2 trillion as of December 11 from \$900 billion pre-Lehman.
- **The key variable in the outlook is the Fed's announcements regarding its future balance sheet expansion plans. If it plans to buy Treasuries, that will be a market dead end. If it plans to identify higher-yielding instruments that it would consider purchasing, that points to a sustainable process and an end to the credit freeze.**

In a quantitative easing, the central bank buys government bonds (or other assets) from banks, crediting the banks' reserve accounts held at the central bank.

- The theory is that the banks will increase their lending by a multiple of the extra reserves. In current circumstances, banks are reluctant to increase their lending while deflation risks persist.
- Another part of the theory is that an increase in central bank purchases of government bonds (like Treasuries) will lower their yields, which in turn would lower yields in the private sector. In current circumstances, however, low Treasury yields have been taken as a signal of deflation – as Treasury yields have fallen, credit spreads have widened, negating any positive impact on credit markets.

- Even AAA bonds have been getting “riskier” as Treasury yields have declined in recent weeks.

Moody’s Aaa minus 10 Yr US Treasury (last obs. December 12, 2008)



Source: Haver; Encima Global

- Japan used a form of quantitative easing beginning in March 2001 when it raised the target for commercial bank reserves held at the BOJ to 5 trillion yen from 4T yen and began buying government bonds. Over the next two years, it raised the reserve target to 20T yen (\$190 billion), with no positive impact on the economy. There were several flaws in Japan’s approach. 1) It was gradualist. 2) The yen remained super-strong, causing deflation (not an issue for the U.S.) 3) Most of the expansion in BOJ assets was in the form of repos. 4) While JGB yields declined slightly, there was no throughput to the private sector. We wrote extensively about these issues at the time – e.g. Japan Adopts a Quantitative Target 3/19/01 and Japan’s Deflation: What Can Be Done? on 10/14/03. These are available for clients on the Encima Global website.

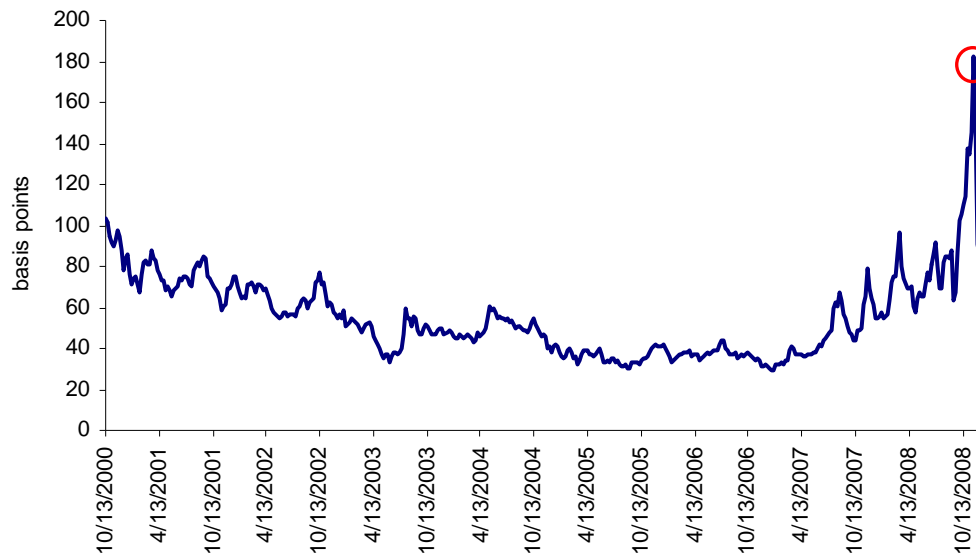
Rather than focusing on the liability side of the Fed’s balance sheet (monetary base, targets for the increase in bank reserves, the role of commercial banks as a conduit for monetary policy), **we think the more powerful aspect of quantitative easing during a credit freeze is from the asset side – from the Fed’s choice of purchases.**

- By purchasing credit instruments, the Fed lowers yields on those and similar instruments. Through arbitrage, this lowers yields on slightly riskier and longer duration instruments. The Fed should be able to use this technique to gradually reopen credit markets.
- On November 25, the Fed announced that it would buy mortgage-related securities. It didn’t actually buy any until a small \$5 billion purchase of agency paper on December 5 (\$3B more on December 12). Yet the November 25 announcement caused an

immediate decline in MBS yields and agency yields and, within days, mortgage rates themselves.

- The Fed's November 25 announcement (red circle on graph) caused a big decline in yields in huge, deep markets – yields fell by a percent on trillions of dollars of credits, no small feat. In this way, the Fed purchase announcement had a much bigger impact on markets and yields than their size would suggest.

Fannie Mae 10 yr yields minus 10 Yr US Treasury (last obs. December 12, 2008)



Source: Haver; Bloomberg; Encima Global

In the mortgage experience, the Fed ended up pointing out to the private sector a group of undervalued credit instruments that it was willing to buy for its own account. In effect, it gave the profit to the private sector, letting it trade first.

- **We think the Fed can expand on this concept and already has. In his December 1 speech, Fed Chairman Bernanke pointed out another profitable trade in which banks could borrow at the effective Fed funds rate (roughly 0.25%) and earn 1% on Fed reserves.**
- **If the Fed points out more undervalued credits (through an announcement that it may buy them), it should be able to lower yields on an expanding group of high-quality assets.**

Notes

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