

Winding Down the Fed's QE

We've been critical of this round of Fed quantitative easing on the grounds that there's no pressing emergency, it won't help growth, jobs or small businesses, mostly benefits traders and Wall Street, and is a risky expansion of the Fed's power. As the opposition grows to the Fed's plan to buy another massive \$600 billion in Treasury debt, and the rationale for it evaporates, **the next issue is how the Fed can get out of its buying plan. We think it will be relatively easy and non-disruptive for the Fed to wind down its asset purchases early.**

Reasons to Stop QE

The Fed is shouldering responsibility for economic growth and using unprecedented balance sheet expansion and leverage to try to achieve it. This is wrong on economic and market grounds and puts Fed authority at risk.

- The mechanism the Fed cites is not the normal money multiplier from bank reserves through banks to business loans. That would "create money" and require more bank leverage. The Fed might encourage this by talking with regulators or paying lower interest rates to the banks on excess reserves so they would lend the reserves. Instead, the Fed has cited higher stock prices, higher inflation expectations and yet lower corporate bond yields. This is a very indirect (and unlikely) transmission mechanism to jobs. The clearer result is a weaker dollar, disastrously high commodity prices and even faster outflows of American risk capital abroad.
- **The Fed's plan stretches its authority and invites future constraints on the Fed's power to buy assets, which would be harmful in the event of a true emergency. By itself, this objection to Fed QE should be enough to stop it.** The Fed should be asking itself – is it worth risking the Fed's future independence to make these unprecedented purchases?
- While the Fed's QE announcement has been getting credit for the nine-week equity advance, we think the more likely causes have been signs of growth (no double dip), good corporate earnings, and market-oriented election. **We think U.S. equities would have gone up as much without QE (though emerging markets and commodities wouldn't have had their stellar gains.)**

How Might Fed Accomplish a Wind Down?

The Fed has already set up a smooth communications process to wind down QE. Last week's FOMC statement said: "The Committee will regularly review the pace of its securities

purchases and the overall size of the asset-purchase program in light of incoming information and will adjust the program as needed to best foster maximum employment and price stability.” In his op-ed in today’s Wall Street Journal, Fed Governor Kevin Warsh reinforced this, saying that the FOMC “did not make an unconditional or open-ended commitment.” Thomas Hoenig and Richard Fisher (who will take Hoenig’s spot as a voting member in January’s FOMC meeting) have already expressed clear concerns about the purchase program, so the Fed would be able to guide financial markets toward an early wind-down of QE simply by highlighting their views or expressing concern about rising inflation (even beer prices are going up!)

Mr. Warsh laid the decision-making groundwork for an early Fed wind-down in today’s WSJ op-ed, saying: “Policies should be altered if certain objectives are satisfied, purported benefits disappoint, or potential risks threaten to materialize.” All of these can arguably be met in time for the FOMC’s December 14 meeting.

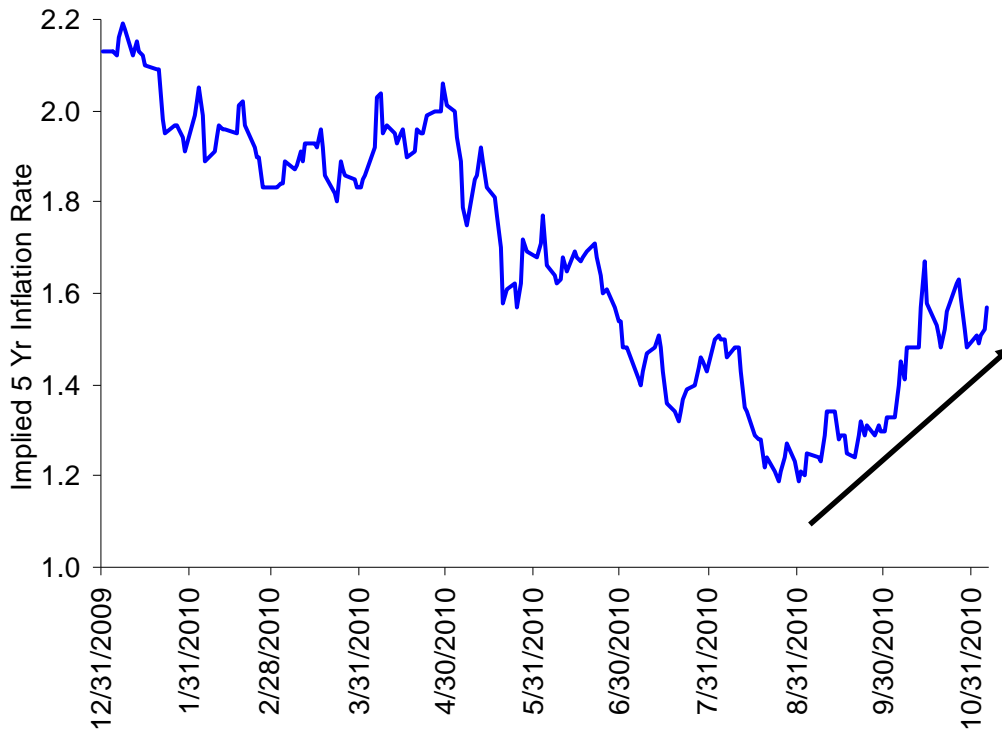
- Regarding objectives being satisfied, the FOMC statement said the Fed was expanding its holdings “to promote a stronger pace of economic recovery and to help ensure that inflation, over time, is at levels consistent with its mandate.” The economy is clearly strengthening, with consensus forecasts for fourth quarter growth above third quarter and CPI inflation, a lagging indicator, already running right in the middle of a 0%-2% price stability mandate (and implied TIPS at 1.5%). Other objectives of the QE were to satisfy market expectations (that’s been achieved, with the exception of Goldman Sachs’ suggestion of \$5 trillion in Fed buying); to push up equities (done, though we think growth, profits and the possibility of a year-end tax cut should get more of the credit); and to kick the can down the road while the President and Congress consider the tax, spending and regulatory crisis (Fed QE speculation starting in Q3 bought months of market patience on mortgages, Fannie/Freddie, Basel III, etc).
- Regarding Warsh’s checklist if “purported benefits disappoint”, Fed Chairman Bernanke, in his November 4 Washington Post article, named only one mechanism by which this type of quantitative easing would directly add to production: “Lower corporate bond rates will encourage investment.” Baa bond yields are already up 14 basis points (spread to 10-year up 20 basis points) since the Fed announced its purchases and no one’s really expecting an improvement.

Regarding “potential risks threatening to materialize”, gold jumped \$50 per ounce after the Fed’s announcement, oil by \$3 per barrel, both primary inflation hedges.

- Warsh pointed out “nontrivial risks” as Fed purchases distort spreads. “The prices assigned to Treasury securities... are the foundation from which the price of virtually every asset in the world is calculated. As the Fed’s balance sheet expands, it becomes more of a price maker than a price taker in the Treasury market.”
- Europe, Japan and China all loudly criticized the Fed, showing an increasingly polarized attitude among central bankers against the ridiculous U.S. choice of near-zero interest rates and even more asset purchases.

- Though we can't trust it due to Fed distortions, the implied TIPS inflation rate turned higher after the Fed announcement and now stands at 1.5% per year (already too high by many measures of price stability).

Implied 5 Yr Inflation Rate (last obs. November 5, 2010)



Source: Federal Reserve; Encima Global

Stopping QE Won't Reduce Monetary Stimulus

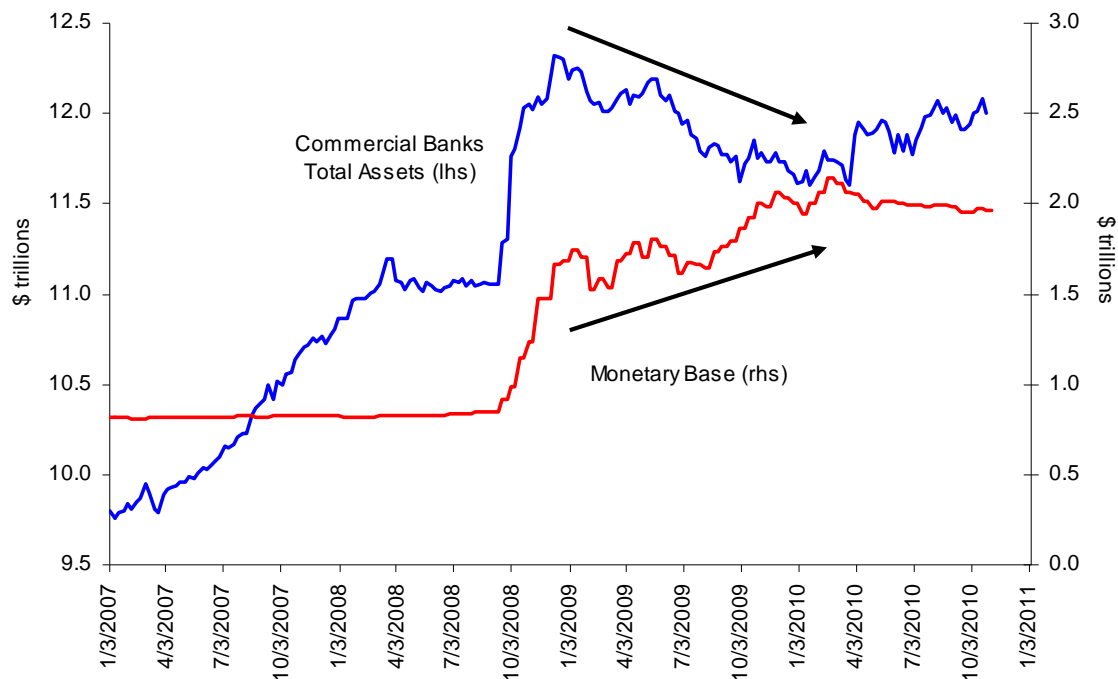
We think the Fed could wind down QE with little negative impact. Wall Street will threaten a tantrum – Goldman Sachs is championing the Fed's asset purchases, which are incredibly profitable for the Fed and for currency, commodity and bond traders. But we think the dollar would stop its slide, beginning to staunch the hemorrhage of risk capital from the U.S. and helping restart the small-business job creation process.

- We disagree with the view that the Fed's quantitative easing creates money. It does reduce global confidence in the Fed, weakening the dollar and adding to commodity inflation in a harmful way, but the Fed's not actually creating money or adding anything to private sector credit.
- Fed QE would be stimulative if banks were constrained by a shortage of reserves. "Injecting reserves" would be like giving the banks new oxygen. The banks would take the new reserves and lend them multiple times, limited by reserve requirements. But **banks aren't constrained by a shortage of reserves, so additional Fed reserves**

(or discontinuance of the additions) will have no impact on the amount of their lending.

- **As the Fed buys bonds, it credits banks with excess reserves. The Fed's balance sheet is bigger, but there's no growth in the overall balance sheet of commercial banks or any more money in the private sector. When the Fed buys a bond and pays for it by crediting a bank's reserves at the Fed, the banking system has the same asset and liability totals as before, but their duration has shortened.** The Fed's idea is that the private sector will then go looking for riskier and longer duration assets to make up for the bond it sold. But the evidence is clear that the banks have been shrinking, not growing, their assets as the Fed expands. The banks either accept the shorter duration or buy safe Treasury bonds (see Bloomberg story today called Record Treasury Buying by Banks Frustrates Bernanke.)

Commercial Banks Total Assets and Monetary Base (last obs. November 3, 2010)

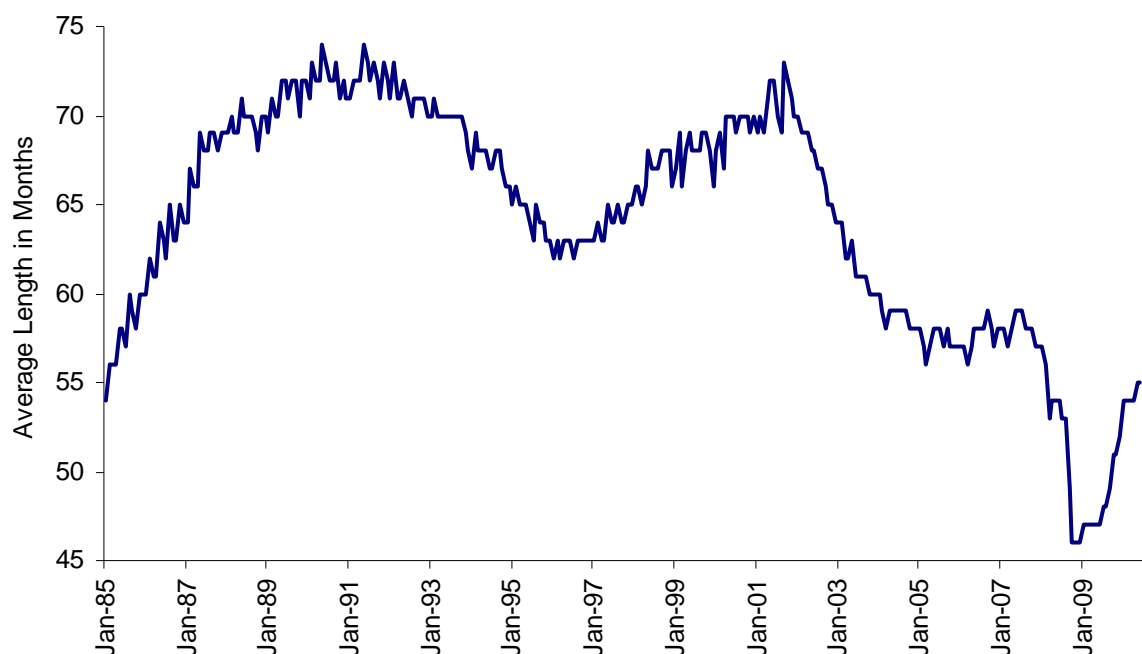


Source: Federal Reserve Board; Encima Global

Fed Can't Flatten Yield Curve

We're very skeptical of the argument that the Fed's quantitative easing should cause a flattening of the yield curve and the credit risk curve, and we don't think a winding down of QE would cause any steepening. In concept, we can consolidate the balance sheets of the Fed and Treasury and analyze the Fed's purchases as a government buy-back of Treasury bonds. The Fed's holdings of Treasury bonds offset Treasury issuance, while the Fed's liability to commercial banks (excess reserves) is parallel to Treasury's T-bill issuance. The net effect is that the same amount of U.S. government debt is outstanding, but it has an even shorter average maturity than before the Fed's QE.

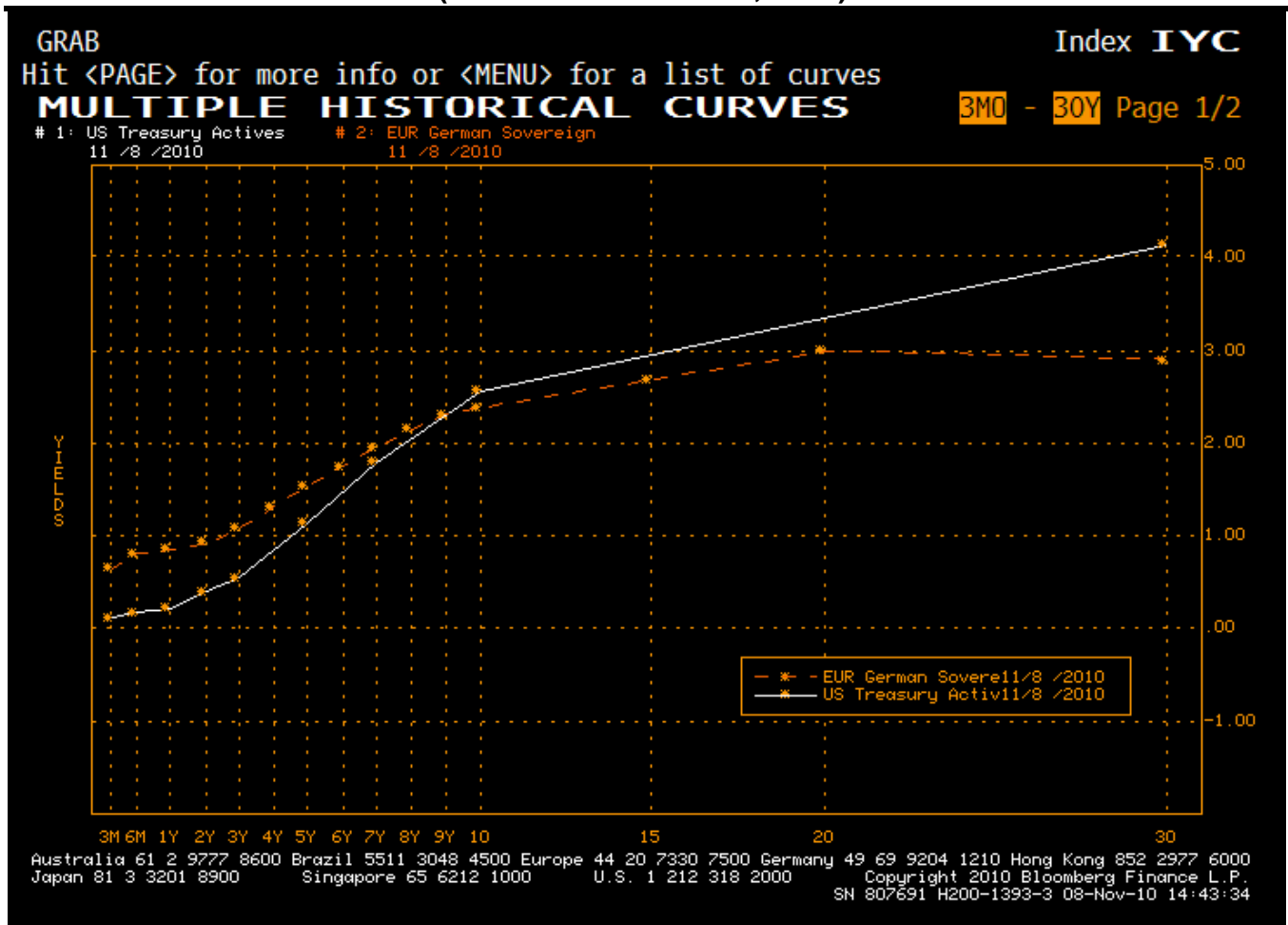
Average Maturity in Months of Public Debt (last obs. June 2010)



Source: US Treasury; Encima Global

- If we assume the Treasury lengthens its maturity issuance to meet the Fed's demand, then the Fed's QE is completely sterilized, meaning undoing the QE would be automatically offset within the Treasury Department's choice of issuance.
- If instead we assume Treasury leaves issuance unchanged, then all that's happened through Fed purchases is a shortening of the maturity of the remaining marketable debt. The government could have accomplished exactly the same result as Fed QE by having Treasury shorten the maturity of its issuance. Through arbitrage, the shape of the yield curve is not dependent on the points of issuance, so it's questionable whether a shortening of the average maturity of debt issuance can have a lasting flattening effect.
- We note that Germany's yield curve is flatter than the U.S. yield curve even though it's not doing QE. Germany's 10-year yield, at 2.39%, is materially lower than the U.S. 10-year yield at 2.57% despite the Fed purchases.

US and German Yield Curves (last obs. November 8, 2010)



Source: Bloomberg; Encima Global

- We think a Fed wind down of QE would bring a small flattening of the U.S. yield curve in a healthy way, allowing more long term capital formation (rather than the short-term financing encouraged by current policies.)

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