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Fed Preview: More Talk, Less Action

The FOMC meets on the 17th and 18th of March. While there is speculation of new measures, including the outright purchases of Treasuries, the probable outcome is more subdued. More likely than buying long-dated Treasuries, the FOMC could announce increase in its size or scope of buying mortgage-backed securities.

The Fed's economic assessment is unlikely to change much. There are some positive signs emerging, but they are too preliminary for the Fed to do more than recognize in passing, but can be a source of optimism going forward. It appears, for example, that consumption may contribute positively to 2009 first quarter GDP for the first time since the second quarter of last year. The continued unwinding of the unintended build up of inventories is also a necessary precondition for increased output.

The Fed's assessment of inflation is unlikely to change significantly either. At the last FOMC meeting in late January, the FOMC said it expected inflation pressure to remain subdued in coming quarters and there is no reason to expect a change in this assessment. Although headline CPI may dip below zero in the coming months, this is mostly picking up the decline in energy and food prices. Core CPI dipped below 2% at the end of last year, but remains near that threshold. Historically speaking, headline CPI moves towards core, not the other way around.

Although the FOMC has targeted Fed funds at 0%-0.25%, the weighted average rate (effective Fed funds) has been closer to the ceiling than the floor. The Fed funds futures market appears to be pricing in some risk of tightening later this year. The October Fed funds futures, which may be a useful guide given that the last FOMC meeting in the third quarter is on September 23rd and there is no meeting in October, have about 27k open interest as of the end of last week (each contract is \$5 million notional value). This is implying a 40 basis point average Fed funds rate in October, suggesting some tightening of Fed policy. While we tend to favor the optimistic camp of a positive economic growth in the second half of 2009, we think it is premature to begin pricing in tightening for late in the third quarter. Look for the FOMC to reiterate that "The Committee continues to anticipate that economic conditions are likely to warrant exceptionally low levels of the federal funds rate for some time."

There has been some increased speculation that the FOMC may announce its intention to buy US Treasuries outright. The possibility was first raised in December 2008 and then in January, when the FOMC said that "The Committee also is prepared to purchases longer-term Treasury securities if evolving circumstances indicate that such transactions would be particularly effective in improving conditions in private credit markets."

The conditions that were outlined do not appear to have been met. Therefore, it seems unlikely that the FOMC will announce a plan to buy long-dated Treasuries. Although the Fed's Lacker dissented from the January decision, being in favor of buying Treasuries immediately, he is unlikely to have won converts over to his view in recent weeks. In fact, NY Fed President Dudley probably spoke for the majority when he played down the need to buy Treasuries, preferring instead to concentrate on specific markets.

For example, since the Fed announced it would buy mortgage-backed securities in November 2008, the 30-year year fixed mortgage rate has fallen nearly 100 basis points. It is possible that the FOMC announces an expansion of its program of buying mortgage-backed securities. Fed officials have indicated that this was a possibility and with the commercial real estate market showing increasing signs of stress, this would be a new area to move into.

There are several reasons why there may be heightened expectations that the Fed could announce intentions to buy long-dated Treasuries. First, the Bank of England has enjoyed dramatic success since it began buying UK bonds. The yield on the 10-year gilt fell nearly 70 basis points in response to the BOE's purchases. Yet given the size of the operation relative to the supply (BOE will purchases as much as 20% of the outstanding supply), the

FOMC would have to buy something on the magnitude of \$1 trillion, which would seem to be larger than FOMC could realistically contemplate.

Second, China's Premier Wen recently expressed "We have lent a huge amount of money to the US, so of course we are concerned." This rhetoric appears politically motivated and may be aimed at preempting new calls that China is manipulating its currency and ongoing trade tensions. Like a basketball game, where it is more important to watch the opposing players hips than his hands or head, it is more important to watch what China does than what it says. China increased its holdings of US Treasuries by almost 40% in the second half of last year, and the TIC data showed additional Treasury purchases in January. Direct purchases of Treasuries by the Fed to address the Chinese concerns are unlikely. The concerns are in the realm of rhetoric not practice. It is not clear that printing dollars to buy Treasuries would protect the value of the Chinese investment as what could be gained in terms of security price could be lost if the dollar were to decline as a result of the monetization of the debt.

In addition to the Bank of England going down the quantitative ease path, the BOJ is buying government bonds, corporate bonds, and equity from the banks. There is some speculation that following the meeting this week, the BOJ could announce plans to increase its quantitative ease strategy, with some talk of extending the program into subordinated debt.

It was the Swiss National Bank's decision to engage in quantitative easing that commanded the market's attention last week. The Swiss government bond market is too small for the SNB to efficiently implement a quantitative easing program. Instead, it announced a plan to buy foreign bonds, which would necessitate the selling of Swiss francs. However, the SNB has provided no details on the quality or quantity of bonds that it would purchase. This strategic ambiguity and the surprise effect of its announcement produced immediate results, with the Swiss franc weakened noticeably against its major trading partners. Given the peculiarities of the Swiss considerations, it seems unlikely that another G10 country will follow it. Specifically, intervention by the SNB does not make BOJ intervention more likely. Nor does it signal that the major industrialized countries have taken an important step down the road of beggar-thy-neighbor competitive currency devaluations.

For his part, Fed Chairman Bernanke has tried to distinguish the Federal Reserve's course of action by calling it a "credit ease" not a "quantitative ease." The goal of the Fed's policy is to lower the cost of credit-specific borrowers. This is different from the quantitative ease associated with the Japanese experience, which was aimed at boosting bank reserves. With criticism that the rules of government action are not clear and that the Treasury and Federal Reserve have sent mixed and confusing messages, the FOMC needs to be careful not to exacerbate this issue in its signals about the potential purchase of Treasuries. The conditions laid out by Bernanke and FOMC have not been met. Therefore to buy Treasuries in this environment would be counterproductive.

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