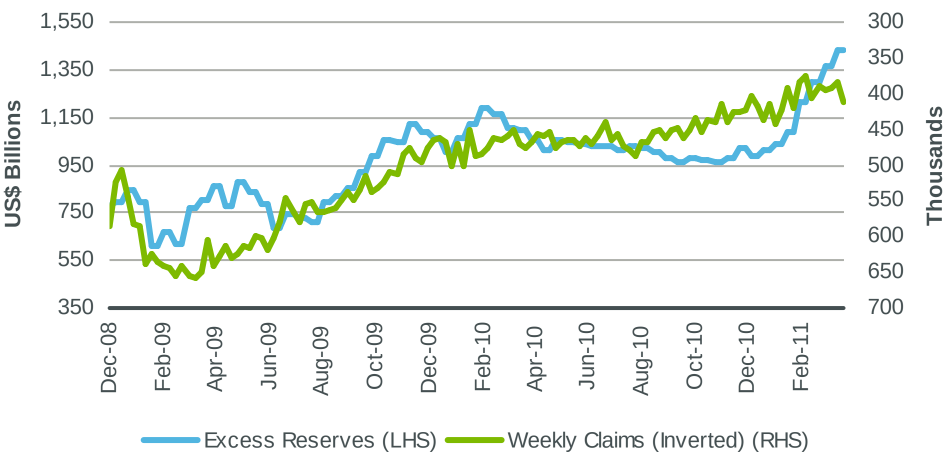
BLACKROCK

May 2011

Where Will Rates Go? Implications of the End of Large-Scale Asset Purchases

The second round of Quantitative Easing in the US is ending in June and questions about its impact on both risk assets and risk-free rates are coming to dominate debate in financial market circles. In the January edition of this publication, we gave high marks to the Federal Reserve for the success of the Quantitative Easing II (QE2) program in meeting the central bank's ostensible goals. Like the first iteration of the QE program, this most recent round of large-scale asset purchases (LSAPs) coincided with better performance in the US economy. Irrespective of whether the relationship is causal or coincident, Figure 1, which plots initial jobless claims against the size of excess reserves on the Fed's balance sheet (excess reserves are the money that the Fed "prints" to fund large-scale asset purchases) is impressive.

Figure 1: QE and the US job market



Source: Bloomberg; data as of 8 April 2011

Sami Mesrour, CFA, Director, is a member of BlackRock's Fixed Income Asset Allocation Model-Based Fixed Income Portfolio Management Team. Mr. Mesrour holds a bachelor's degree in history from Columbia University and a Masters degree in global history, with merit, *from the London School of Economics.*

Having recognized the salutary effects of QE2, the market is now focused on a different set of questions, including: Are the economic strides made since October 2010 real or illusory? What might be the inflationary impact of QE2 in the future?

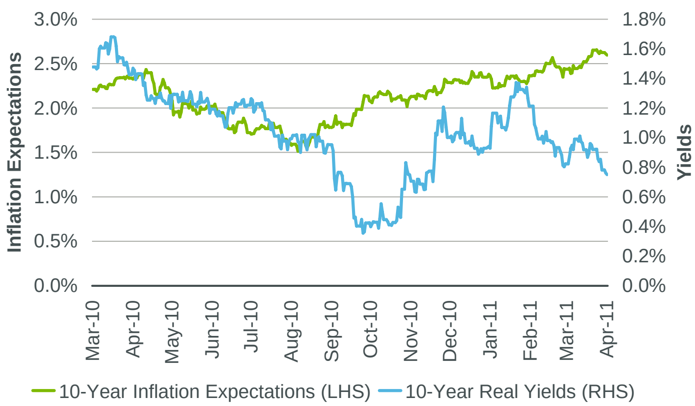
One further question which is particularly important for fixed income investors is the extent to which Treasury yields might move in response to the Fed's ending of the program, or in other words, how much of the ending of QE2 is already priced into the market? The argument from the Fed is that the LSAPs ratchet down yields by permanently removing a certain stock of issuance from the market[1]. In a liquid market, the Fed's purchases should be priced in when the LSAP quantity is known (or comfortably estimated). As the theory goes, the stock effect is far more important than the "flow" effect from purchases. As long as the stock is not unexpectedly increased (for example by the announcement of asset sales), yields going forward should start from the

1 For the importance of the "stock" versus "flow" effects of the Fed's program, see Stefania D'Amico and Thomas B. King, "Flow and Stock Effects of Large-Scale Treasury Purchases", Federal Reserve Board, September 2010. http://www.federalreserve.gov/pubs/feds/2010/201052/201052pap.pdf

new baseline and move up or down from that point based on the behavior of other bond valuation components (such as growth and inflation expectations). Put differently, we believe the one-time impact of QE2 is largely behind us and, although yields will vary, the level where they move from has been permanently reset downwards to a new range.

If this hypothesis is true, we should be able to see a drop in yields as the Fed's intent to purchase became priced in the market after Ben Bernanke's speech at Jackson Hole, on 27 August 2010. Indeed, in Figure 2, we do observe a drop in yields through early November. This drop in Treasury yields happened despite a rise in inflation expectations. Rising nominal rates accompanied by rising inflation expectations implies that real yields went down. A drop in real yields is consistent with the idea that as the stock of Fed's purchases began to be priced in, the level of the real cost of capital was reset downwards.

Figure 2: Inflation expectations and real yields diverged sharply after Bernanke's 27 August 2010 speech at Jackson Hole



Source: Bloomberg; data as of 19 April 2011

As it turns out, however, this drop in real yields might well be explained by a drop in growth expectations that occurred at the same time. In other words, the effect from the Fed's purchases on yields is not entirely clear. It is possible that the drop in real yields was not driven by the portfolio balance effects of the Fed's purchases on the stock of Treasuries, but by a drop in expectations of economic activity. It is also possible that the upturn in economic performance that we observed in the last quarter of 2010 was driven not by lower rates, but by increased inflation expectations pulling consumption forward, or general confidence from the Fed's actions filtering through to more hiring. Figure 3 again shows the ten-year real rate from the Treasury Inflation-Protected Securities (TIPS) market, this time plotted against fourth quarter 2010 real GDP expectations.

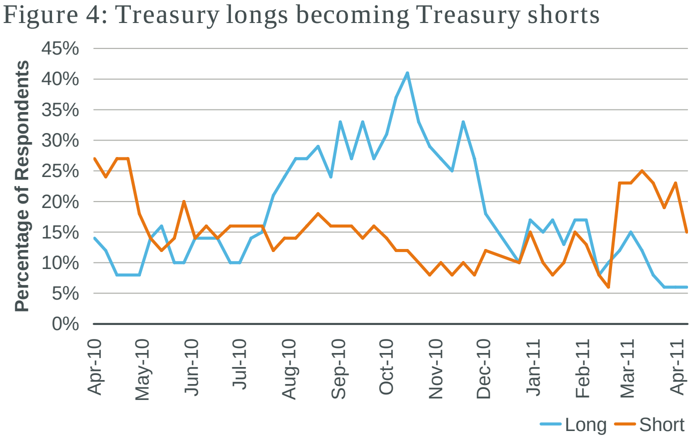
Figure 3: Forecasted GDP and ten-year real yields moved in tandem

Source: Bloomberg; data as of 19 April 2011

Given the ambiguous nature of the effect of Fed LSAPs, it is very possible to see yields rise modestly as we near the end of QE2 and newly-issued government debt looks for a home. Net monthly Treasury supply (Treasury issuance less Fed purchases), which has been running close to zero since December 2010, is set to rise above $75 billion for the next few months. Funding those purchases out of private sector savings or foreign dollar recycling may well require an increase in the premium of Treasuries relative to other asset classes. Of course, as we have argued elsewhere, a shifting regulatory landscape also suggests increased bank and insurance company purchasing is quite likely in the future as well.

Do we think it is time to short interest rates? Probably not. Given how well-publicized the end of the program is, we will likely see some run-up in Treasury yields prior to 30 June 2011, at which point we may even see yields rally slightly, courtesy of disappointed shorts. As illustrated in Figure 4, investor positioning surveys suggest the market is well on its way toward pricing in the end of the Fed program.

Figure 4: Treasury longs becoming Treasury shorts



Source: JP Morgan; data as of 18 April 2011

What happens next may also be supportive of lower-than-expected yields, since the economic growth outlook is crucial at this point. If economic prospects fall, or if yields rise far enough, risk assets sell off (rises in discount rates, which are unaccompanied by improvements in the growth outlook, serve primarily to lower the present value of risk assets). The sell-off and increased volatility of risk assets could make Treasuries look attractive, which would set a natural floor on the price of Treasuries. With the stock of savings generated at each paycheck looking for a home, it is likely that home becomes Treasuries, especially in a slowing economic environment. Unfortunately for the true bond bears, the potential "crowding-in" of private savings driven by a tremendous global search for yield suggests the era of unhinged interest rates is probably not yet upon us.

BLACKROCK