The Economic "Soft Patch" at the End of QE2

How Will It Impact Corporate Treasury Investors?

Introduction

How long does it take for "green shoots" to grow into a "soft patch"? For the U.S. economy, it has taken a little more than two years.

In his famous *60 Minutes* interview on March 15, 2009, Federal Reserve Chairman Ben Bernanke popularized the phrase "green shoots" to describe the growing confidence in the post-crisis U.S. economy[1]. As the Fed's second round of asset purchases of $600 billion (dubbed QE2) came to an end last week, "soft patch" became the new phrase du jour, describing the recent slowdown in economic activities. Even the June 22nd Federal Open Market Committee (FOMC) statement acknowledges that the recovery is progressing "more slowly than the Committee had expected." For investors, this likely means that the Fed will be on hold longer than previously anticipated and interest rates may remain low for the foreseeable future.

Growth Hindered by Slow Jobs Creation and Housing Slowdowns

For the last two months, we have seen signs of deceleration in the economic recovery. The 1.8% estimated growth rate for the first quarter GDP, first released on April 28th, marked the start of this soft patch. Other unimpressive economic data soon followed, with double-dip home prices and disappointing jobs numbers leading the pack.

The S&P/Case-Shiller Home Price Index fell to 138.16 in March 2011, representing a drop of 33% in national home prices from the index's peak in July 2006. This new cyclical low point edged out the index's previous trough in April 2009 and put national home prices in a double-dip recession, erasing modest gains from the government housing tax credits. Existing home sales of 4.8 million units in May, a peak month, were lower than sales figures in April and the winter months. The online real estate listings company, Zillow, found that more than 28% of U.S. homeowners have mortgages that are now underwater[2]. The lost wealth effect and the lingering threat of foreclosures no doubt present great challenges to consumer spending and economic growth.

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Initial jobless claims surprised the market on the high side in seven of the last nine weeks, at an average rate of 429,000 per week. After scoring big with 244,000 new jobs in April, nonfarm payrolls increased by a mere 54,000 in May, which shocked the market and pointed to a long road ahead for a labor market recovery. The unemployment rate also inched up to 9.1% from 9.0% in April, a far cry from the full employment level of 5%. A recent study by the McKinsey Global Institute estimates a total of 21 million new jobs are needed to return the economy back to full employment before 2020. This equates to roughly 175,000 new jobs per month before the decade's end[3]. The slow recovery in job creation puts more breaks on spending, housing prices and economic growth.

Other indicators of the soft patch include the slowdown in manufacturing activities, sharp declines in commodity prices and, of course, the reversal of stock market gains. The S&P 500 Index and the Dow Jones Industrial Average each declined 6% since April, falling in seven of the last eight weeks.

Divided Outlook for the Economy after QE2

Economists generally agree that temporary external factors may partially explain the soft patch. The supply chain disruptions resulting from the Japanese earthquake and tsunami may have had a direct effect on manufacturing activities. The recent surge in oil and gasoline prices also may have played a big part in consumer and business spending habits. As suppliers come back online and oil prices fall from peak levels, some economists believe strong growth will return in the second half of 2011 and in 2012[4]. However, waning government fiscal stimulus, an ongoing European sovereign debt crisis, and reduced demand from China may dampen some of these growth projections. In particular, the absence of future monetary stimulus after QE2 may further prolong the subpar pace of job growth and GDP.

Fed Chairman Bernanke made it clear in his post-meeting conference on June 22nd that the market should not expect a third round of quantitative easing (QE3) even as the central bank reduced its forecast for domestic growth[5]. Economists remain divided on the economic impact of the Fed's QE2 program of government bond purchases. Some argue that the measure neither raised home prices nor lowered the unemployment rate, but did create inflationary pressures and asset bubbles in the stock market[6]. Given that QE2 proved less impactful on the recovery than the first round of quantitative easing and inflation worries are on the rise, it is fitting that Fed officials are more cautious on the possibility of implementing a new round of stimulus.

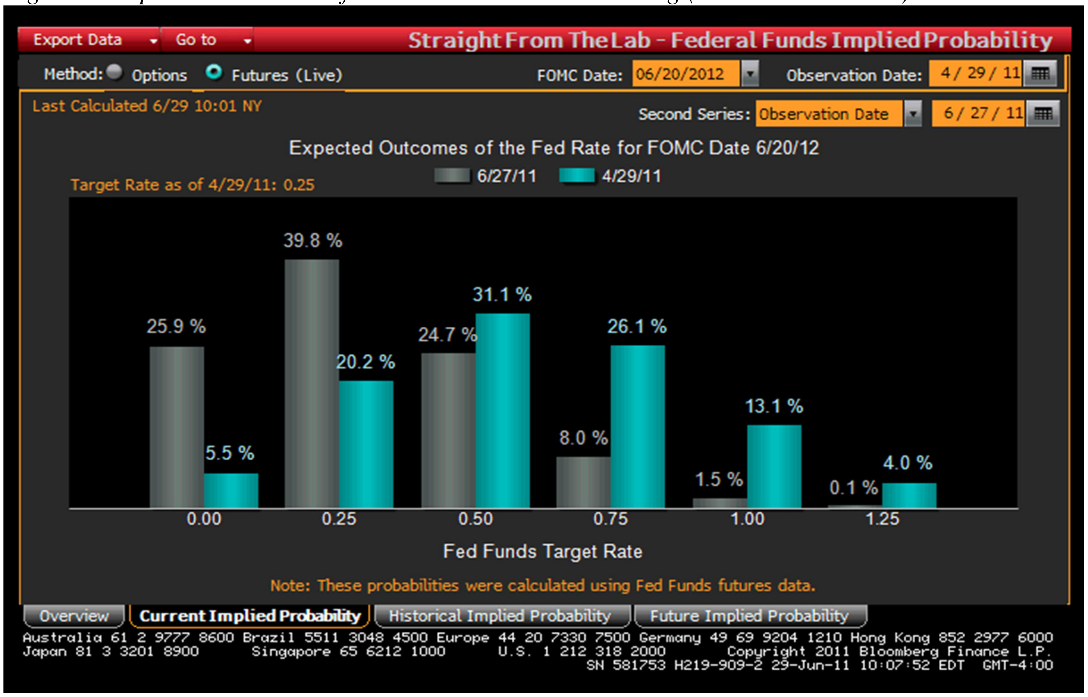
The possibility for other additional fiscal stimulus may be equally slim. With the White House and Congressional Republicans engaged in the battle of cutting federal deficits before raising our national debt ceiling, it is doubtful the economy will receive substantial new fiscal help while the old programs run out.

Recent economic data releases, while soft, remain in positive territories and do not seem to point to an impending recession. Still, a disappointing housing market, lackluster jobs numbers, and the lack of fiscal and monetary policy support may mean a prolonged period of sub-par growth. In fact, the Fed has revised its 2011 GDP projection to a rate between 2.7% and 2.9%, down from the 3.1 to 3.3% range projected in April.

Low Interest Rate Environment Lingers Longer

All of these conditions point to one certainty – we will be in the near-zero interest rate environment for the foreseeable future. The FOMC's rock-bottom federal funds target rate may remain in a range of 0-0.25% for at least the next 12 months, if not longer. According to the fed funds futures market tracked by Bloomberg, the market currently assigns a 65% probability that the rate target may hold steady at near zero at least through the June 20, 2012, FOMC meeting (See Figure 1). This compares to just 26% two months ago, meaning that the market had expected rates to move higher at or before the June 2012 meeting.

Figure 1: Expected Outcomes of the 6/22/2012 FOMC Meeting (6/27/11 vs. 4/29/11)



Source: Bloomberg

In addition to the economic conundrum in the U.S., we think the ongoing European debt crisis will help keep short-term rates low as risk-averse investors seek safety and protection in U.S. government securities. Further declines in real estate prices, a worsening of the sovereign debt crisis, or another spike in oil prices may mean that we will remain in this environment much longer before signs of vigor return. Lest bond investors get caught off guard, the Fed has devised an early warning system to inform financial markets of impending rate hikes.

An Early Warning System for Rate Hikes

According to Chairman Bernanke's remarks at the April 27th FOMC press conference and the meeting minutes, the Fed will begin an orderly process of withdrawing its extraordinary stimulus prior to hiking interest rates[7].

First, the Committee will look for improving signs in the jobs market, resource slack, headline inflation and inflation expectations before a tightening process begins.

Then, the "extended period" phase will be removed from the FOMC statement to signal the central bank's readiness to reduce extraordinary support. The Chairman clarified "extended period" to mean "a couple of meetings" before action, or approximately 12 to 20 weeks. He stressed that "we will do our best to communicate our view."

The actual steps toward Fed policy "normalization" will begin by ceasing reinvestment of principal on agency securities and, simultaneously, or soon thereafter, the reinvestment of Treasury securities. These would be the first moves toward gradually reducing the Fed's balance sheet.

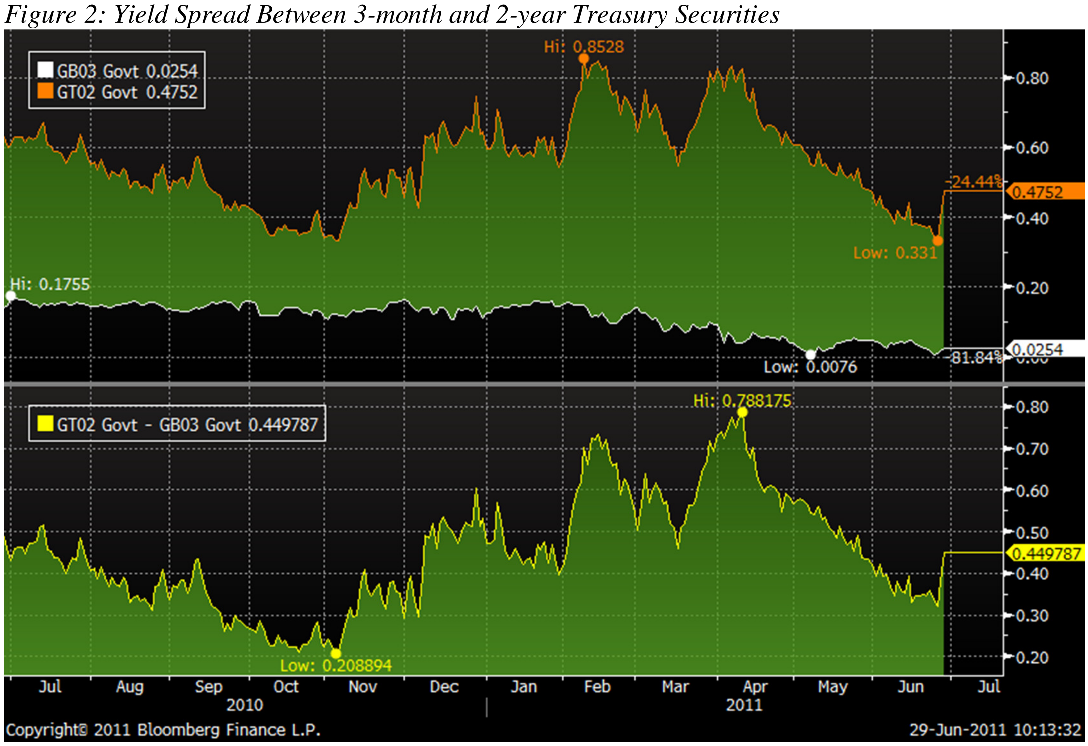
From there, large scale asset sales of agency securities and moderate increases in the fed funds target rate may commence on a predetermined and preannounced path. Most FOMC members prefer that "sales of agency securities come after the first increase in the FOMC's target for short-term interest rates." The preference for an earlier rate increase will give the Committee the option to lower rates if economic conditions later warrant. The timing and magnitude of asset sales will influence the rate hikes, all else being equal, and remain a discussion point with Committee members. The Committee also debated the merits of using temporary reserves-draining tools before hiking the rate target, but no final decision was made.

In short, investors will likely have better visibility as to when and how the Fed removes monetary stimulus and raises rates. This also means yield opportunity for the corporate treasurer may remain limited for quite some time.

Investment implications

Beyond overall range-bound interest rates expectations, we continue to assess the impact of the European credit market deterioration and the slowdown in China on U.S. financial conditions. Of course, political noise surrounding the U.S. debt ceiling will be with us for the next month or so, although we think there is almost zero probability of a technical default of U.S. government debt. We do, however, expect short-term rates to move marginally higher, at least temporarily, reflecting the end of the Fed's QE2 purchases and the resumption of Treasury borrowing if the debt ceiling is raised in early August.

Figure 2: Yield Spread Between 3-month and 2-year Treasury Securities



Source: Bloomberg

The current investment environment actually presents a difficult trade-off for corporate treasury investors. The revised outlook for the Fed argues more favorably for a longer weighted average maturity (WAM) strategy. Meanwhile, the confluence of credit concerns limit investors' choices of investments in implementing the duration extension strategy. On balance, we continue to advocate the approach of extending duration with high-quality government and corporate names and keeping maturities short on financial and lower credit quality names. In trying periods such as this, patience is still a virtue.

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