Quantitative Easing, Round Two:
What Does It Mean to Corporate Treasurers?

Introduction:
With just two days remaining until the Federal Reserve Board's key policy meeting, it is almost impossible to avoid the term "quantitative easing round two (QE2)" in the financial press. Ever since the keynote speech by Fed Chairman Ben Bernanke last August[1], rumors have been rampant that the Fed will implement a daring strategy to ease unemployment and tamper deflation. But what exactly is QE2, and what can the Fed accomplish with this new tool? More relevant to corporate cash investors, what are the likely implications of this policy shift on yields and risks in the short-duration investment universe?

In this monthly installment of our research commentaries, we seek to summarize the general features of QE2, the issues and controversies which surround it, and what corporate treasurers should anticipate if and when the Fed embarks on this journey.

The goals behind QE1
As the nation's central bankers, the Federal Reserve Board is tasked with regulating the supply of money in the financial system to achieve optimal levels of economic growth and employment. After exhausting the limits of its conventional form of monetary easing by lowering the Federal funds rate to a range between 0% and 0.25% in December 2008, the Fed next began a program through which it purchased U.S. government securities for its own account. In its official capacity, the Fed essentially exchanged freshly-minted paper currency for the securities it bought, thereby injecting fresh money into the financial system and lowering lending rates in hopes of encouraging lending, consumption, and capital investments – hence the term "quantitative easing".

Since first announcing the $100 billion purchase of government sponsored enterprise (GSE) debt and $500 billion in GSE mortgage-backed securities (MBS) on November 28, 2008[2], the Fed's balance sheet has nearly tripled to $2.3 trillion as of October 10, 2010. Its securities portfolio ballooned from $790 billion to $2.0 trillion during the same period (See Figure 1 on page 2).

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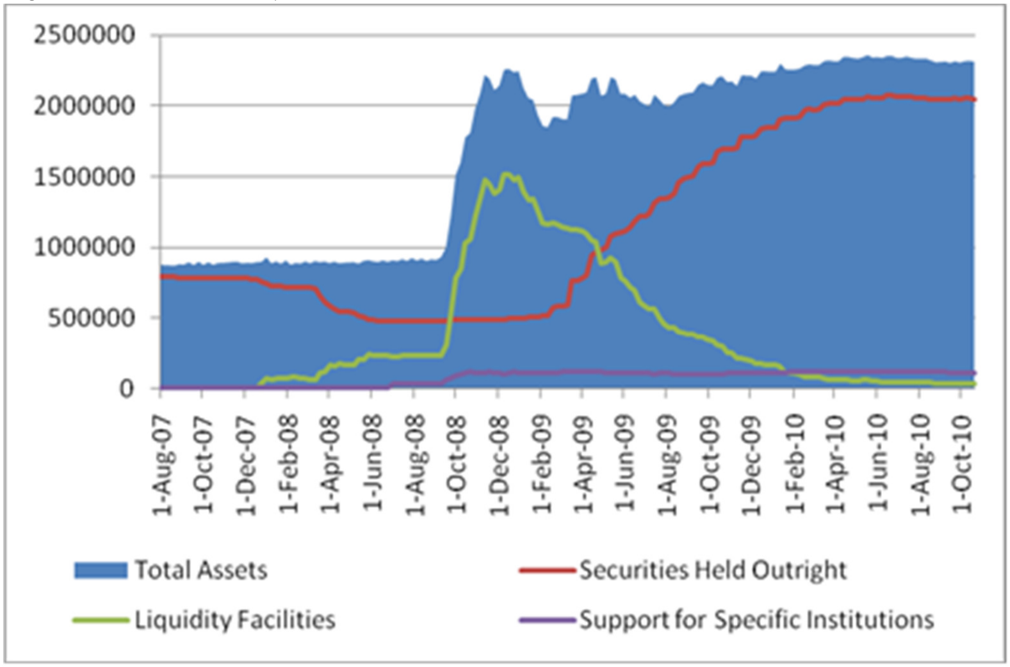
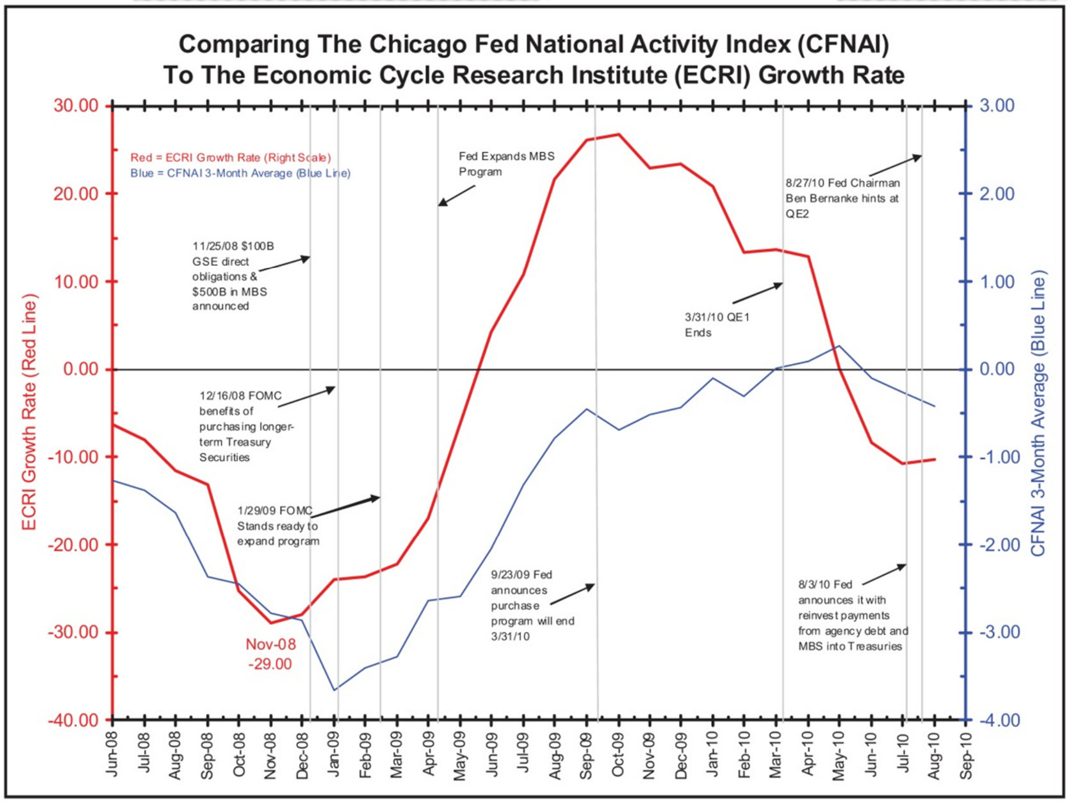
Figure 1: Assets Held by the Federal Reserve



Source: Federal Reserve

In hand with other recession-fighting measures, the strategy appears to have achieved its intended goal of stimulating growth. Figure 2 on page 3 shows the levels of economic activity between December 2008 and September 2009, when the Fed declared the end of new purchases. The National Bureau of Economic Research later would announce that U.S. recession officially had ended sometime in the second quarter of 2009[3].

Figure 2: Quantitative Easing and Economic Growth



Source: Bianco Research in "Charts of the Week 10/14/2010"

Why QE2 may be necessary

In early 2010, government tax credits for home buyers expired and growth slowed markedly. Unemployment remained high throughout the summer and foreclosures continued to plague the housing market. Low inflation expectations and low bond yields generated concerns regarding deflation, a nastier flu than high inflation to shake off. To make matters worse, a crisis of confidence in several peripheral Eurozone countries caused further deterioration of credit issuance.

Rumors of another impending round of QE were validated by Chairman Bernanke's Jackson Hole speech in which he stated that the Fed would reinvest payments of principals of its "agency securities into longer-term Treasury securities… In particular, the Committee is prepared to provide additional monetary accommodation through unconventional measures if it proves necessary…[4]"

Potential size and scope of QE2

The Chairman's speech indicated that any re-investments would be into long-term Treasury securities, consistent with the Fed's objective to own only Treasury securities.

As an outcome, the market intervention is likely to bring down the yields on long-term Treasury securities, from which mortgage and other credit assets are priced.

In an October poll by CNBC of 70 economists, fund managers and traders, 93% of the respondents expect that the Fed will boost the size of its portfolio, and of those, 86% anticipate an announcement in November[5]. These poll participants also forecast that the Fed will purchase $500 billion in assets at the conclusion of the FOMC meeting on November 3. The estimate of the amount of total security purchases varies between $100 billion to $1.5 trillion. A recent report from Goldman Sachs forecast that, based on its calculation of the gap between the current effect Fed funds rate of 0.2% and a -6.8% desired rate based on the so-called "Taylor Rule[6]", $4 trillion in purchases may be needed.

New York Fed President Bill Dudley was the first Fed official to publicly hint at the potential size of QE2. In an October 1st speech, he posited that "$500 billion of purchases would provide about as much stimulus as a reduction in the federal funds rate of between half a point and three quarters of a point[7]."

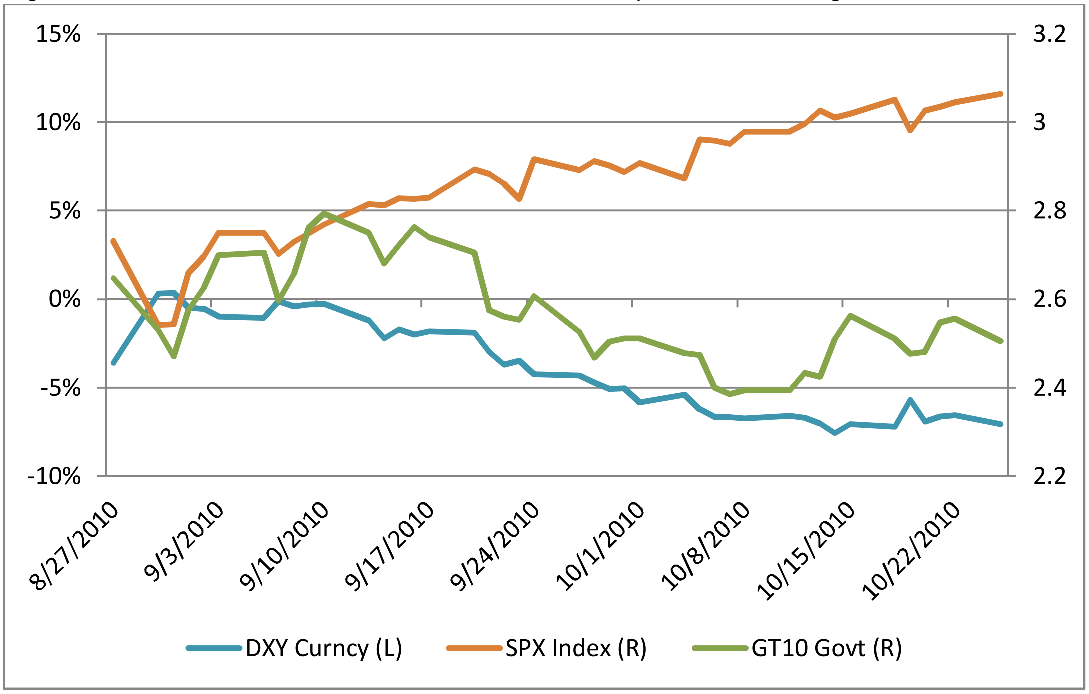
However, it should be noted that even though the market perceives an announcement on QE2 to be a done deal at the FOMC meeting in two days, Fed officials including St. Louis Fed President James Bullard have hinted that the issue is unresolved at the moment. Bullard recently hosted CNBC's Squawk Box and he suggested that QE2 is very much up in the air and that any announcement may not come until the December meeting[8]. He suggested the purchases, when initiated, may be made in "small increments," perhaps starting with $100 billion, with further Treasury purchases contingent upon the evaluation of economy at future FOMC meetings[9].

Additionally, Philadelphia Fed President Charles Plosser has said one of the aims of QE2 would be to ward off price deflation. Although not in wholesale objection to the merits of QE2, he said, "I don't see deflation as a significant risk right now.[10]" Kansas City President Thomas Hoenig remains steadfast in his insistence that additional easing could pose a threat the U.S. recovery[11].

QE2's possible impact and risks

In a way, the Fed may have already achieved some of its monetary goals without having to institute actual purchases. In anticipation of the Fed move, bond yields and equity indices began rising upon Bernanke's speech in August.

Figure 3: S&P 500, U.S. Dollar, and 10-Year Treasury Yield since August 2010



Source: Bloomberg

Interestingly, Figure 3 shows that although the 10-year U.S. Treasury note (GT10) yield dropped slightly since the Chairman Bernanke's speech on August 27, the 12% gain in the S&P 500 Index (SPX) was even more pronounced. The same could be said about the 7% decline in the U.S. Dollar index (DXY), which was almost a mirror image of the gains in the S&P.

Our first observation is that financial markets may have already discounted a large portion of the anticipated Fed move. With a balance sheet already triple the size of its pre-credit crisis level and with interest rates at exceptionally low levels, it is widely agreed that the size and impact of QE2 may be more limited than the first round. And if QE2 fails to revive the economy and to bring down the unemployment rate, the Fed's credibility may be in jeopardy and its future policy effectiveness may be questioned.

As figure 3 also illustrates, the movement of the U.S. dollar since the Jackson Hole speech leaves the impression that an implicit goal of QE2 may be to lower the value of the U.S. currency in order to improve exports. In other words, QE2 may be interpreted by overseas authorities and investors as the Fed's entry into a destabilizing currency war between worldwide central banks. As Germany's finance minister put it at the G-20 summit last week, "An excessive, permanent increase in money (supply) is, in my view, an indirect manipulation of the (foreign exchange) rate.[12]"

Thirdly, the policy encourages more borrowing at near zero levels and lending on risky assets. If poorly managed, such moves could have negative credit implications for a variety of asset classes and could result in speculative bubbles.

Lastly, the larger the Fed balance sheet, the more difficult and complex it may become for policy makers to mop up excess liquidity in the banking and finance system when inflation inevitably starts to rear its head. Although this may appear to be a remote probability today, the size and composition of an inflated Fed balance sheet may prove error-prone and ineffective in taming future inflation issues.

What QE2 may mean to short-term debt investors

Even though QE2 appears on its face to be a subject of macroeconomics, its impact on the yield, supply and credit quality of short-term investments may be quite profound. Here we list just a sample of the possible implications.

The low-yield environment may be more prolonged than forecast: With the Fed likely embarking on further easing of monetary policy, it is unlikely that officials will reverse course and raise interest rates in the short-term. When they do, a logical first step would be to let bond investments mature naturally instead of outright sales of assets. This could mean that short-term rates will stay near zero for much of 2011 and beyond, and corresponding yields on commercial paper, bank deposits, money market funds, and other cash vehicles could rest at even lower levels for the duration of QE2. Accordingly, a moderately longer portfolio duration may be warranted, especially if the amount of QE2 purchases is noticeably larger than the $500 billion to $1 trillion markets have been expecting.

We may see near-term whiplash of high bond yields: Given the recent market euphoria seen in higher equity prices and lower bond yields, any decisions by the Fed to delay QE2 to future FOMC meetings or to shrink the program size may cause a reversal in bond yields which would inevitably catch some investors off-guard. Even without such a surprise, the market adage of “buying on the rumor, selling on the news” could still cause some yield backups due to profit taking. Thus, when implementing an extended-duration portfolio strategy, investors should be cognizant of this risk and should consider using a laddered strategy to minimize a possible whiplash effect.

QE2 may create opportunities for total return investors: Based on speeches by Fed officials and ensuing market expectations, large scale asset purchases, when implemented, will likely be concentrated in Treasuries with maturities ranging from 2- to 10-years, leading to potential appreciation in the value of these securities versus others. Total return investors may be able to shift portfolio allocations to explore these opportunities and enhance returns.

QE2 may be supportive of credit: In our opinion, a resumption of quantitative easing may strengthen credit performance, especially in financial issues troubled by recent foreclosure-related legal issues. While positive spread impact may be more limited than that found with QE1, we think credit spreads could at least hold steady in an accommodative monetary environment for quite some time, which should further support a duration-extension trade into industrial and financial issuers' debt.

Conclusion:
QE2 may be consistent with a longer-duration credit portfolio
In last month's newsletter, we reviewed the regulatory building blocks now in place to strengthen our financial system and, by extension, to improve issuer credit quality. We think QE2 will further alleviate credit pressure and reduce the risks to a portfolio strategy that shifts out of overnight liquidity vehicles such as money market funds into longer duration assets. The opportunities may be the greatest for total return investors, but other investors also may benefit. We caution all cash investors that uncertainties and risks remain as to the timing and effectiveness of QE2 and in investors' reactions to asset purchases. Politics may play a role too, especially if the security purchases result in mark-to-market losses for the Fed's investments. Given the substantial uncertainties and chances for policy errors, we advise investors to stay informed on the developments of this important monetary policy topic.

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[2] Recent Balance Sheet Trend, the Federal Reserve's Website, as of October 22, 2010. http://www.federalreserve.gov/monetarypolicy/bst_recenttrends.htm

[3] Business Cycle Dating Committee, National Bureau of Economic Research, September 20, 2010 http://www.nber.org/cycles/sept2010.html

[4] See endnote 1.

[5] Steve Liesman, Fed Certain to Act in November In a Big Way: Survey, CNBC.com, October 11, 2010. http://www.cnbc.com/id/39606951

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