

# The Fed and the Markets

By Yoni Weisberg

## THE FED AND INTEREST RATES

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On February 18<sup>th</sup>, the Federal Reserve raised the discount rate 25bps to 0.75%. Further, the Fed announced that the duration of loans from the discount window, which it had extended to 28 days, would revert back to overnight on March 18<sup>th</sup>. According to the Fed, the reason for the rate hike was to encourage private sector lending; however, they claim this policy move does *not* signal an imminent shift towards tightening. The Fed will continue its purchases of \$1.25T in mortgage-backed securities up through the end of Q1 2009.

First of all, it should be noted that the Discount Rate is not set by the Federal Open Market Committee (FOMC), but rather the Board of Governors. The Board of Governors is also responsible for setting the rate paid on required reserves, which has become a new major tool for the Fed. (The FOMC is responsible for setting the target Fed Funds Rate and – usually -- running monetary policy). And with the Fed Funds Rate pinned at 0-0.25% for the foreseeable future, the Fed Governors will be more influential in setting current monetary policy.

## DEFLATION

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So what do we have? We have a very, very cautious view from the FOMC and a more aggressive view from the Board of Governors. In essence, we are seeing diverging policies. This fact, along with the extremely enigmatic and indirect fashion of the discount rate hike, has brought about uncertainty in the markets.

Mr. Bernanke has voiced his opinion on inflation over and over: there isn't any. And his actions -- continuing to purchase MBS's and holding the fed funds rate extremely low (and pledging to do so for "an extended period") -- appears to indicate that he is telling us the truth.

But if inflation were "stable", why continue to flood the markets with cash through MBS and treasury purchases? It seems that Mr. Bernanke is actually worried about *deflation*, or at least more than he is inflation. And this appears for to be for good reason. Consumer confidence dropped to a 10-month low in February and both labor and home sale numbers disappointed last week. Even an incredible 5.9% projection for Q4 GDP could not prevent these data from affecting investor sentiment. Treasuries rallied in the subsequent flight to safety:

**WSJ:** "This year, low-risk Treasuries have returned 1.71% as of Thursday, beating the 1.21% return on high-yielding corporate debt and the 1.34% return on mortgage-backed debt—indicating the fragility of the economic mood." [http://online.wsj.com/article/SB10001424052748704625004575089853291053816.html?mod=WSJ\\_Markets\\_LEFTTopNews](http://online.wsj.com/article/SB10001424052748704625004575089853291053816.html?mod=WSJ_Markets_LEFTTopNews)

Meanwhile, wages continue to drop and record numbers are collecting unemployment benefits. Walmart Vice Chairman Eduardo Castro-Wright highlighted an apparent drop in consumer discretionary spending, and top line revenue growth has yet to firmly take hold across the economy.

And then we look at the big picture: the credit markets. Credit spreads have come back well past pre-Lehman levels and the yield curve is extremely steep. Perhaps it is that trading is back to normal and the market has returned to regular operations. But then again, let us consider a different picture:

Credit spreads are generally the difference in interest rates on treasury (relatively low risk) securities and other loans and bonds. When spreads are tight, it tends to indicate that the market is willing to take risks – investors are willing to give money to riskier ventures for a relatively low premium over “riskless” treasury securities. Conversely, when spreads are high the market is said to be risk-avoidant, pouring money into safe assets and requiring a much higher rate of return for risk.

However, it is worth noting that the convergence has much more to do with the extreme drop in corporate rates from the credit freeze in Q3 2008 than a general shift out of safe assets into risky ones. This is for two reasons. First, short-term U.S. treasury rates have been and remain at historic lows, meaning demand for short-term treasury paper – the safest of all assets - remains at historic highs. Second, a great portion of the drop in interbank and market interest rates is directly due to unprecedented amounts of government purchases and guarantees, mainly of mortgage-backed and asset-backed securities. At the same time, private lending is still at relatively low levels – so the government is truly a *huge* proportion of these markets. And investors still assume that the ABSs guaranteed by Fannie, Freddie, and Ginnie (the GSEs) are essentially guaranteed by the treasury itself (an assumption that could prove fatal), driving them towards the higher returns for practically the same insurance. We will come back to this point in just a moment.

On to the second point of attention: the very steep yield curve. Generally, a steep yield curve is related to future growth in the economy. If buyers demand a higher interest rate in the future than today, they must see inflation down the road. And inflation generally means asset prices are rising (stocks, commodities, etc). But the latter assumption is nothing more than that: an assumption.

All we really know for sure is that investors are much more inclined to buy short-term US paper than long-term US paper. Perhaps this could have to do with the following story, provided by our friend Jordan:

**Washington Times:** [Berkowitz delivers blunt warning on U.S. debt](http://www.washingtontimes.com/news/2010/feb/25/bernanke-delivers-warning-on-us-debt/) “With uncharacteristic bluntness, Federal Reserve Chairman Ben S. Bernanke warned Congress on Wednesday that the United States could soon face a debt crisis like the one in Greece, and declared that the central bank will not help legislators by printing money to pay for the ballooning federal debt.” <http://www.washingtontimes.com/news/2010/feb/25/bernanke-delivers-warning-on-us-debt/>

Perhaps rather than general inflation, and ergo growth, investors are picking up on the long-term viability of US debt (or better yet, the lack thereof). So while investors are happy to accept next to nothing for 30-day investments in the U.S. government, 10 to 30 years out they see a lot of *risk*.

Basically, while the yield curve generally represents the entire system due to their “riskless nature”, perhaps investors are actually seeing substantially more risk in long-term TREASURIES specifically. And this trend isn’t set to change any time soon. According to Deutsche Bank, major dumping of treasuries on the market will drive long-term yields higher while short-term yields remain extremely low:

**Bloomberg:** “For the first time since at least 1980, a change in monetary policy may mean the difference between short- and long-term Treasury yields will widen rather than narrow. The threat of the Fed selling the \$2.29 trillion in securities on its balance sheet, combined with record Treasury auctions, will keep

longer-term yields higher, according to Deutsche Bank AG, one of 18 primary dealers that trade directly with the central bank.” <http://www.bloomberg.com/apps/news?pid=20601087&sid=aXm7hJJo448M&pos=6>

One last point. Remember that 5.9% GDP number for Q4 2009? That was revised up from an advance estimate of 5.7%. What provided that boost?

The price deflator was REDUCED by 0.2%. Deflation added to GDP.

#### FANNIE, FREDDIE, AND MORTGAGE BACKED SECURITIES

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Just recently, FNM and FRE have announced plans to increase prepayments on their securities – effectively flooding the fixed-income market with cash. This will occur just around the same time the Fed finishes its purchases of MBSs.

The government hopes that investors put this flood of cash into the mortgage market, helping to alleviate the negative implications of the end of Fed purchases. But in truth, all we can know for sure is that fixed income investors will have to reallocate their money; will they put that money into riskless securities, or will they begin once again to invest in the housing market yet to be seen.

However, if you were an investor who just received prepayment from FNM, would you want to go out and buy mortgage-backed securities – knowing that the Federal Reserve just *completed* its purchase of \$1.25T of those same assets? When will the Fed *unload* these assets? What will the implications of this liquidation be on price? Do you really want to be buying these assets just after the huge program has ended??

Not unless these securities are backed by the GSEs. Why? As we mentioned before, investors are assuming that the U.S. government will back the debt and guarantees provided by the government-sponsored entities. If the U.S. government is behind these assets, then it may be worth considering buying them for that extra return. Nevertheless, the huge level of MBSs sitting on the Fed balance sheet will deter buyers.

#### GREECE AND THE EUROZONE

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**WSJ: Greece Bailout Plan Takes Shape** “Greek officials said they expected to seal a deal by Friday, when Greek Prime Minister George Papandreou meets in Berlin with German Chancellor Angela Merkel...

“There is definitely no such plan,” said Ulrich Wilhelm, spokesman for German Chancellor Angela Merkel.”

This snippet from the Wall Street Journal explains the problems in Europe in a nutshell. Greece needs to be bailed out, but who is supposed to fork over the money? Germany is the most creditworthy nation in the Eurozone and will likely have to play a major role in any sort of bailout. (Of course, this would not technically be a “bailout” – as member states of the EU are forbidden of such acts. However, there is no rule against giving a member state a large loan, effectively allowing said state to pay off its notes coming due.) And by this solution, it is clear that any bailout would provide only temporary relief. But possibly more importantly, whatever happens with Greece will set a precedent for other ailing nations – namely Spain, Ireland, and Portugal. Spain is by far the biggest worry as the 4th largest economy in the Eurozone.

In any case, we don't expect to hear that any bailout is for certain (at least if it is coming from Germany) until March 16th, when we will basically get a "Greece progress report". If Greece does not appear to be on its way to fiscal recovery by that point, the odds of a bailout by EU nations will be reduced dramatically.

#### AND FINALLY, THE TECHNICALS

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We have certainly seen a shift in sentiment in the equity markets over these last couple months. After 3 quarters of acceleration, stocks have finally halted their advance, testing its downside support. Volume has been higher on those days of decline than on subsequent recoveries. ESHs (S&P 500 futures) have found themselves stuck just under 1110, closing the last two weeks just below that level.

The immediate future is still uncertain, although our intermediate term trend remains bearish as it has since January 25<sup>th</sup>. A close on ESHs substantially above 1110 could allow stocks to test their yearly highs. A break of these highs would indicate the uptrend still has some legs. And let me be clear – there is no point shorting a rising market.

On the other hand, a failure at the 1110 level would indicate a move further down. We would get this signal with a close on ESHs substantially below 1080, which should send the futures down to as low as 1055. A close below 1055 would mark the lowest close of the year and a continuation of the downtrend that has begun. Ergo, a break below 1055 on ESHs would make our short-term trend in line with our intermediate term trend.

#### SOME FINAL INTERESTING STORIES

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**Bloomberg:** [Greece Now, U.K. Next as Scots Investors Ready for Pound Plunge](http://www.bloomberg.com/apps/news?pid=20601110&sid=aVDvzOH9wSks)

<http://www.bloomberg.com/apps/news?pid=20601110&sid=aVDvzOH9wSks>

**WSJ:** [Japan Looks Hard at Trimming Huge Debt](http://online.wsj.com/article/SB10001424052748703940704575089952215368646.html?mod=WSJ_Markets_LEFTTopNews)

[http://online.wsj.com/article/SB10001424052748703940704575089952215368646.html?mod=WSJ\\_Markets\\_LEFTTopNews](http://online.wsj.com/article/SB10001424052748703940704575089952215368646.html?mod=WSJ_Markets_LEFTTopNews)

**FT:** [AIG and Pru close to \\$35bn Asian deal](http://www.ft.com/cms/s/0/bcf45824-23cd-11df-8b20-00144feab49a.html?nclink_check=1)



## Discount Rate Analysis

By Alex Pachman

### What's a discount rate?

On February 18, the Federal Reserve raised the discount rate 25 bps to .75%. The discount rate, the rate which depository institutions can borrow short-term funds from the Fed, is not to be confused with the Federal Funds target interest rate. According to the Fed, raising the discount rate simply depicts a "normalization" of policy, not an indication that the target rate (the rate at which banks can lend to each other) will be on the rise soon. This is an essential distinction, as the target rate drives the country's interest rate.

## Why was this discount rate raised?

This was the first increase of the discount rate since 2006. However, the Fed has made it clear this rise should be viewed as a “normalization” of the Fed’s role in the financial markets. The Federal Reserve is trying to decrease the private sectors reliance on public funds. Prior to August of 2007, the discount rate was set at 100 bps above the Federal Funds target rate. As it stands now, the spread is a mere 50 bps. In other words, the Fed is trying to get financial institutions to borrow from each other, not the government.

The level of borrowing from the Fed window has drastically come down from the \$65.1 billion that was lent out a year ago. As of February 17 financial institutions were borrowing \$14.1 billion. In addition to raising the discount rate, the Fed will shorten maturity on discount-window loans to overnight effective March 18. During the subprime mess in '07, this maturity was extended to 30 days from overnight. An additional increase followed the rescue of Bear Stearns, extending the maturity even further to 90 days. The maturity was later reduced to 28 days. Again, the Fed is trying to return to a historically “normal” policy.

It was no surprise when Ben Bernanke reiterated his stance that our nation needs “exceptionally low levels of the federal funds rate for an extended period.”, in today’s semi-annual report to Congress. Why would he shock the world with an unexpected rise in interest rates? After all, the Fed was clear to warn the world that the discount rate would be raised “before long” earlier this month. The Fed would gain nothing by raising the target rate with out preparing the markets. Though they have warned investors to be wary of future interest rate policy, I would be surprised if the Fed does not make their intentions more clear before raising interest rates.

The economy is certainly not out of the woods yet. Consumer confidence numbers came in this week below expectations, at a 10 month low of 46. According to Steven Ricchiuto, chief economist at Mizuho Securities, “Consumer spending is going to disappoint throughout most of the year”. Compared to recent years, Americans are beginning to save and many still do not have jobs. William Dudley, New York Fed President, has made it clear that it will take growth, job creation and inflationary pressure to spark a rise in interest rates. And with many, including the Fed, predicting 2010 unemployment to come in above 9 % it is unlikely we will see a raising of rates in the near future.

Anyway, why would the Fed raise the federal funds rate after just increasing the spread between the target rate and discount rate to 50 bps? If pre-crisis levels were 100 bps, and the Fed is trying to “normalize” policy, one would think the Fed would try to regain that spread, not simply widen it one day to reign it in another.

While is unlikely the Fed will raise their target rate in the immediate future, it will have to happen eventually. With the 10 to 2 year yield curve steepening to extremely high levels, investors are factoring in a future raise in interest rates (Investors will demand a higher yield on a long term bond if economic growth and inflation are on the horizon). Having said that, CPI continues to show no sign of immediate inflation.

When the time does come for the Fed to raise interest rates we need to be ready, thus it may be useful to examine industry reactions to previous hawkish interest rate programs. The Fed has instituted a tightening program 13 times since 1946. These increases took place over an average of a 25-month period, with two raises only occurring once, and 10 of 13 extending over a period of at least 11 months. While in most cases this did not lead to a collapse of equity prices, it did not lead to boom either. Over the past 60 years, the S&P 500 has gained roughly 8.1% per year. This compares to the 6.2% gain in the twelve month period following the start of a rate-hiking cycle. The markets have performed better in the second 6-month period

compared to the first. The S&P 500 has declined less than a third of the time both 6 and 12 months after the Fed started raising rates.

### **Historically, which sectors have outperformed?**

Surprisingly, Information Technology has outperformed following initial rate increases. One possible explanation being, most tech companies carry little debt on their balance sheets. Since these companies aren't dependant upon debt to finance daily operations, their interest expense will not rise with interest rates. Conversely, Utilities carry a lot of debt, causing a rise in rates to adversely affect their bottom line.

The US dollar index (DX) appreciated directly following the announcement of the new discount rate however has come back down following Bernanke's statements. Forex traders are much more concerned with the federal funds rate than the discount rate.

Invest well.

Alex Pachman

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## **More on Deflation and Debt (The Fed)**

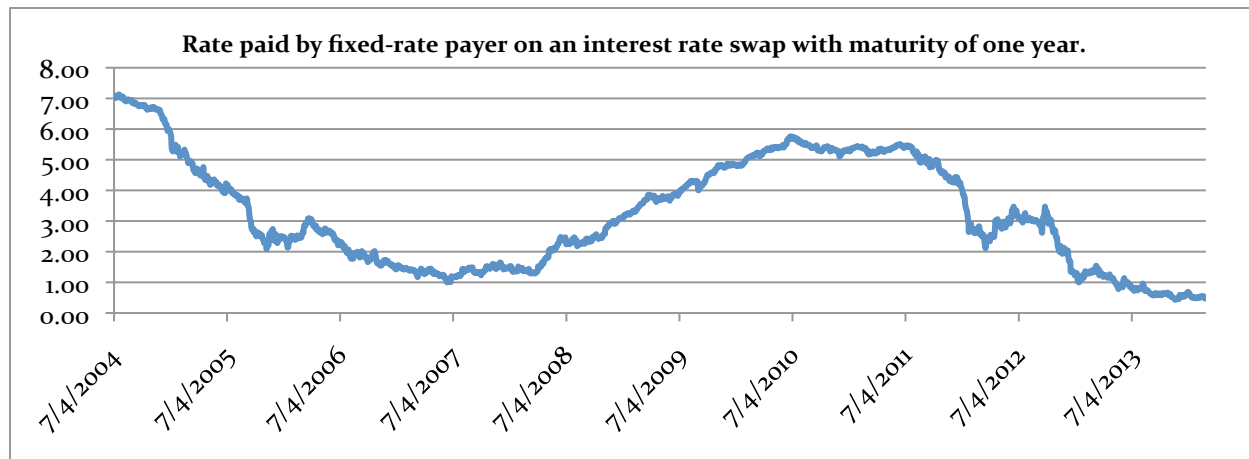
By Yoni Weisberg

Yesterday, we made the point that monetary control at the Federal Reserve is beginning to shift away from the FOMC and towards the Board of Governors. The reason for this is that the Board of Governors has proven to be more aggressive in their policy than the FOMC, who is likely to keep the Federal Funds Rate on hold for the foreseeable future, and the Governors set the Discount Rate and the Interest Paid on Reserves. According the Federal Reserve, interest paid on reserves was originally intended to return the "implicit taxes" that is inherent in making a reserve requirement. If banks are forced to park their money at the Fed, they can't make money on that money.

However, recall that the Fed has plans to make this latter component of monetary policy a more direct tool. Now, the Interest Paid on Reserves at the Fed can be used to effectively set a minimum Fed Funds Rate.

Why is this the case? Moving the Interest on Reserves to, say, 0.5% would mean that if banks were so inclined, they could park their excess cash at the Fed and earn that rate. Ergo, other banks will have to match, or more likely outdo, the Fed's rate in order to access credit.

We mentioned yesterday Mr. Bernanke has repeated over and over that inflation "appears subdued" and he does not see it in his immediate forecasts. To further illustrate the point that inflation is not imminent, take a look at swap rates for 1-year fixed-rate debt:



Data provided by the Federal Reserve ([www.federalreserve.gov](http://www.federalreserve.gov))

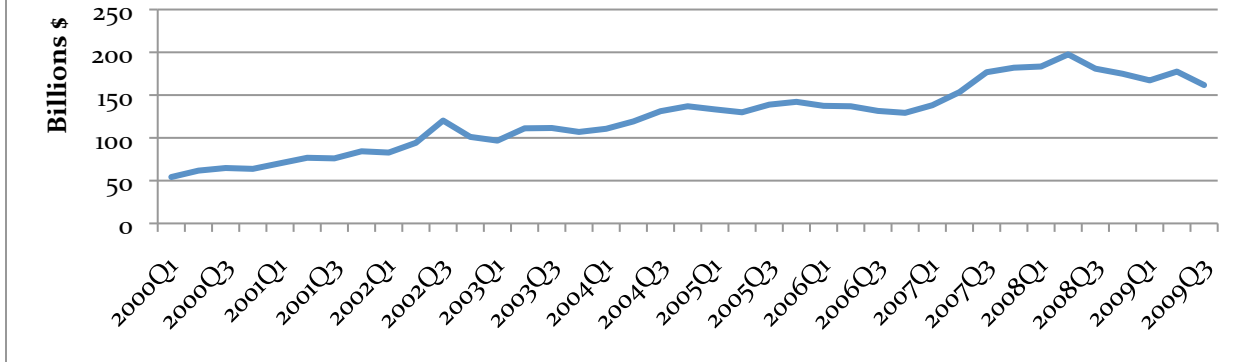
Clearly, investors expect rates to stay low for awhile. And so we determined that the more immediate threat was not inflation, but *deflation*, a point I would like to elaborate on a bit.

Deflation can be caused by a number of factors, but most directly, a contraction of credit. When credit contracts, bank deposits are reduced; this results in a contraction of the money supply. It is this contraction that causes deflation – which we can define as the rising value of the dollar relative to other assets. In turn, people are more inclined to save and wait on making investments (which is basically converting dollars into other assets). Credit spreads widen. All of this produces a downward spiraling trend, as more people hold onto their money and asset values decline and spreads to widen, causing more people to pull out their money, causing asset values to decline further, etc. It should also be noted that the effects of debt-deflation will cause the multiplier effect to work in *reverse*, pulling money out of multiple people's hands at once.

Today, spreads are at very low levels. Yesterday, we relented that a major reason for the drop in spreads across different quality bonds could be due to government purchases and guarantees of MBSs and the like.

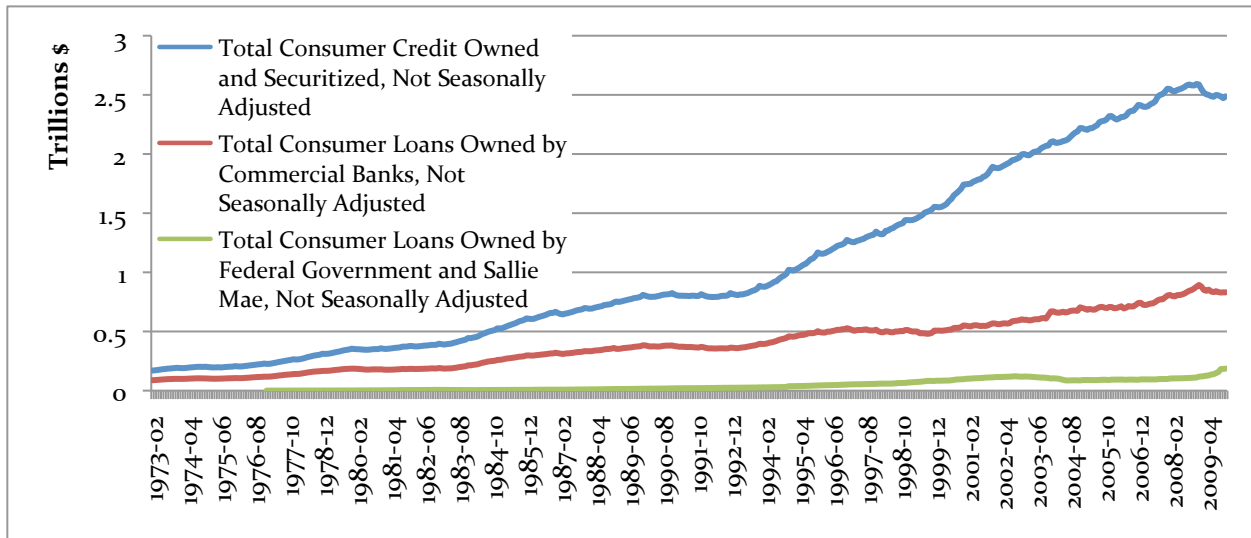
And even with the drop in spreads, we lamented that treasuries still have record demand – which has kept pace with the ballooning supply of these assets. On the other hand, bank lending – and in turn, private sector credit – has continued to fall:

## DOMESTIC FINANCE COMPANIES, BANK LOANS, Not Seasonally Adjusted



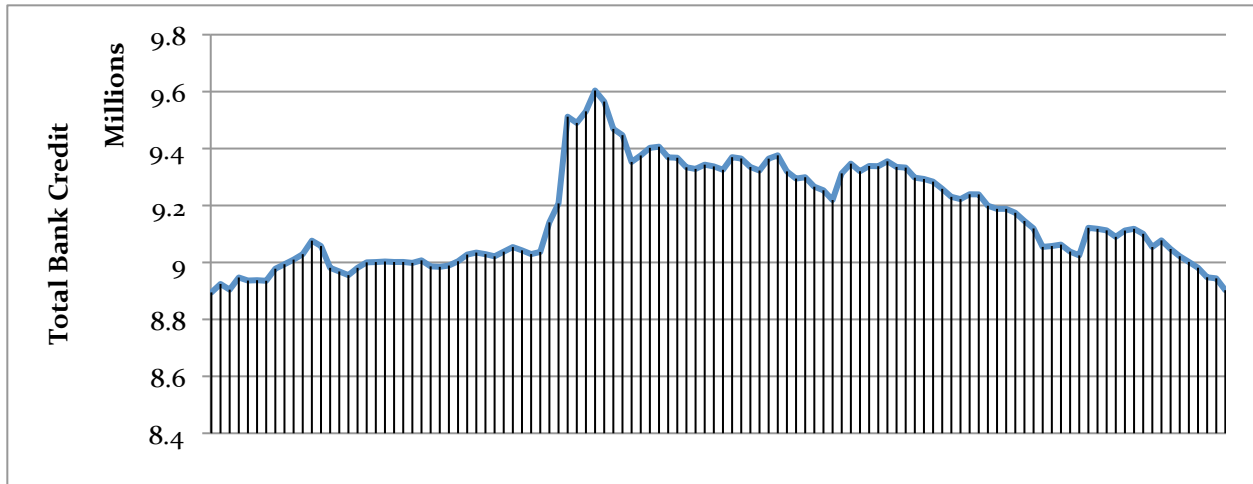
Data provided by the Federal Reserve ([www.federalreserve.gov](http://www.federalreserve.gov))

In fact, consumer credit has only just begun to contract. The record borrowing that has occurred over the last few decades is finally hitting a wall. When viewing this graph, realize that this decrease in consumer credit is the first real decrease of any kind in at least 15 years, and the sharpest decrease on record:



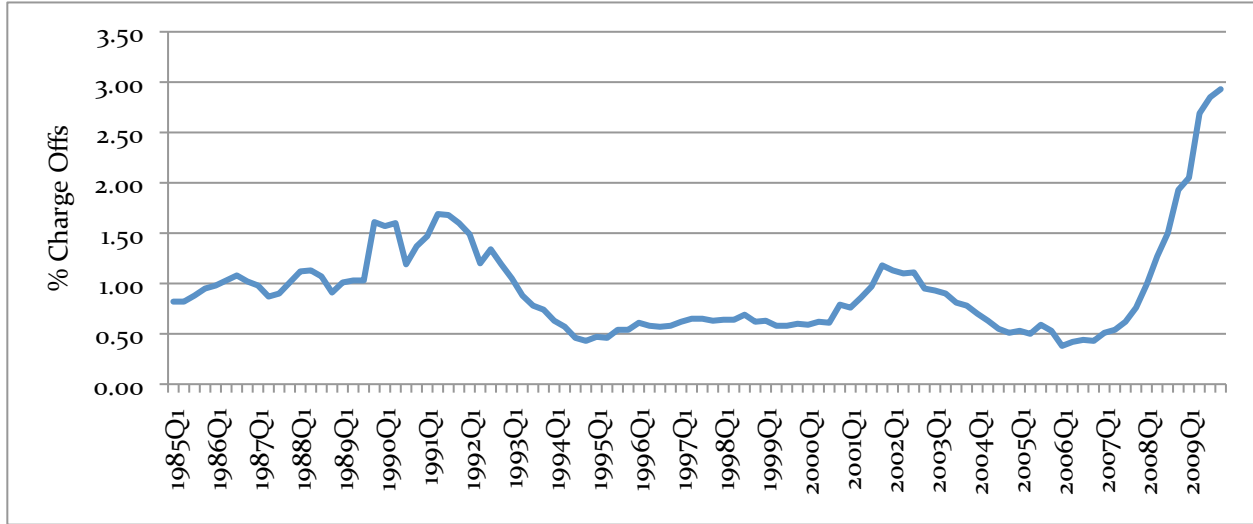
Data provided by the Federal Reserve ([www.federalreserve.gov](http://www.federalreserve.gov))

It should be noted that the green line – that comprising Federal loans – does not include guarantees nor the workings of the GSEs Fannie, Freddie, and Ginnie. But even without these pieces (which assuredly will have taken up a huge chunk of space now between the red line – commercial bank loans – and the blue line – total loans), the amount of Federal loans is now about 25% of all commercial bank loans. The following chart displays domestic bank credit since 2006. After a surge in credit during Q3 2008, these levels have declined steadily and the trend has only accelerated:



Data provided by the Federal Reserve ([www.federalreserve.gov](http://www.federalreserve.gov))

So even though rates have come down, bank lending and bank credit continue to fall (a deflationary force) – the market is holding up thanks to government intervention. We will not know what true market rates should be until the government ends its program; as we mentioned, the first major step in unwinding is set to occur in March. (This, recall, is also around the same time we will hear the progress report out of Greece – March is shaping up to be an important month). The government *needs* the private sector to re-enter the market and begin lending at that point; whether they will do that is yet to be determined. But as long as assets continue to deteriorate (illustrated by the following chart of the percentage of bank charge-offs), it will be difficult to entice a bank to go lend out money:



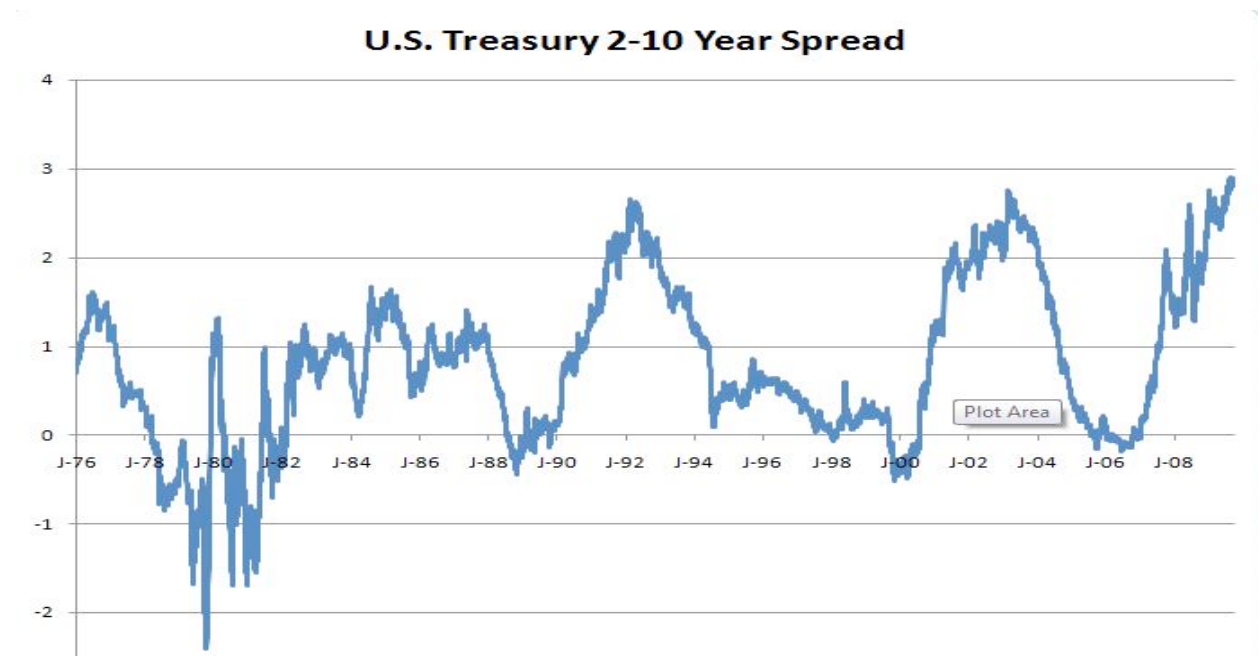
Data provided by the Federal Reserve ([www.federalreserve.gov](http://www.federalreserve.gov))

We also made the point yesterday that the steep yield curve does not necessarily indicate good times ahead. Before discussing this topic in more detail, we must realize that not only is the yield curve steep *but it is getting steeper*.

We need to understand the nature of the yield curve. The yield curve is a forward-looking indicator. When the curve goes flat or negative, many economists call for a recession – and usually, they are

right...eventually. The yield curve can *stay flat or negative*, even making its shape more pronounced, for years before the onset of the recession. Applying this same rule to the reverse, the steep yield curve can continue to get steeper and steeper before a change in trend– and that is just what is happening now.

The following chart is the spread between the 2- and 10-year treasury notes, a common proxy for the steepness of the yield curve. Note that while the spread has grown steadily since the first quarter of 2007, it has shown *no sign of turning around* – *the trend has yet to change*.



Data provided by the Federal Reserve ([www.federalreserve.gov](http://www.federalreserve.gov))

We further remarked that part of this steepness could be attributed to the risk inherent in the government bonds themselves (usually a nonfactor). While this quote was in yesterday's missive, I feel it is worth rereading:

**Washington Times: [Berkowitz delivers blunt warning on U.S. debt](http://www.washingtontimes.com/news/2010/feb/25/bernanke-delivers-warning-on-us-debt/)** "With uncharacteristic bluntness, Federal Reserve Chairman Ben S. Bernanke warned Congress on Wednesday that the United States could soon face a debt crisis like the one in Greece, and **declared that the central bank will not help legislators by printing money to pay for the ballooning federal debt.**"

<http://www.washingtontimes.com/news/2010/feb/25/bernanke-delivers-warning-on-us-debt/>

Mr. Bernanke says he will not bailout the U.S. government. Do you believe him? No way. If the U.S. government has no choice but to default or monetize debt, make no mistake – they will print money like there is no tomorrow. It is this uncertainty that is spooking markets and confounding the possibility of deflation with massive inflation.

The sheer fact that Mr. Bernanke recognizes a crisis of this sort is a scary thought, and this is why we came to the conclusion that treasury rates must inherently hold the risk of a U.S. default. Will that default happen in the next 30 days? No. The next two years? Not likely. But the next ten years? Possibly. Hence, steepness.

If this were the case, wouldn't only treasuries show a steep yield curve? Considering every other asset class is tied to treasuries, since it is the "risk-free rate" (or at least the least risky bond of its duration), no. Other asset classes could either be linked to treasury rates directly or have their own inherent risk built in based on a *government* default – either way, the steepness would bleed through to the other fixed-income assets.

And the only real proxy to determine this information (the difference in treasury and corporate rates) is completely confounded given 1) massive government intervention/guarantees in the private sector and 2) the fact that these spreads are used to determine *market risk* – when they decline, *market risk is thought to decline*. Most people do not actually consider the riskiness inherent in the "risk-free rate"; if they did, it would be much more difficult to gauge true market risk.