“Should the Fed Tighten – Part II”

Veritas White Papers No. 16

August 24, 2009

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At its most recent meeting, the Federal Open Market Committee (FOMC) reiterated its plan to leave the fed-funds rate unchanged and to purchase $1.75 trillion of U.S. Treasury and Agency debt. However, the Fed announced that it will gradually slow the purchases of Treasury securities, as it anticipates that the full amount of the $300 billion commitment will be completed by the end of October. This decision is neither a prelude to a tightening of policy nor a tightening of policy. Current monetary policy is even more accommodative than the policy that caused depreciation in the dollar and pushed crude-oil prices well-above $100/bbl. As a result, the Fed should begin to tighten monetary policy by reducing the size of its balance sheet, in an attempt to lower the potential risk to the economy from a weaker dollar, which will cause an increase in inflation, a slowdown in global economic activity and capital-losses on financial assets.

The Fed's balance sheet peaked at $2.25 trillion during the week ended 17-Dec-08 and has remained around $2 trillion since the March meeting of the FOMC. Current monetary policy remains overly accommodative, despite its announcement at the conclusion of the meeting of its expectation to fill the $300 billion commitment to purchase secondary U.S. Treasury securities by the end of October. The lack of an announcement to extend the program, which is the effective discontinuation of the program, is being interpreted by the market as a modest display of monetary restraint, as the dollar strengthened modestly versus other major currencies. However, the Fed ended these purchases because the program was ineffective at lowering interest-rates. As a matter of fact, the yield on the 10-year Treasury security, which reached 2.51% after the March 18th announcement of the policy, closed at 3.98% on June 10th and currently yields 3.52%. At the same time, the steepness of the yield curve, as measured by the spread between the on-the-run 10-year and 2-year Treasury notes, which widened from 1.69 basis points on the day of the meeting, reached 271 basis points on 5/27/09 and currently sits at 250 basis points. Higher yields and a steeper yield curve signal not only firmer economic activity but also increased expectations for inflation.

The Fed created several emergency lending facilities, in an attempt to facilitate the extension of credit to bank and non-bank financial institutions. At the height of the financial meltdown, the total amount outstanding under the facilities reached $1.62 trillion. As the financial system has improved, the total amount outstanding has declined to $511 billion, which is the lowest total since the week-ended 17-Sept-08. In order to replace the loss of reserves from the drawdown of the emergency facilities, the Fed committed to purchase up to $1.75 trillion of U.S. Agency and Treasury debt, in order…"to provide greater support to mortgage lending and housing markets and to improve conditions in private credit markets".

As we wrote in White Paper No. 15, "The Lack of a Fed Exit Strategy", we expect the size of the Fed's portfolio of Treasury and Agency mortgage-backed securities to continue to expand and remain unusually large, as a result of the expected difficulty in unloading such a large amount of securities. The Fed has purchased $650 billion of U.S. Agency securities, which leaves $798 billion remaining on the $1.45 trillion commitment. Assuming the eventual redemption of the entire $511 billion outstanding on the emergency lending facilities, the Fed's balance sheet will be expected to reach $2.28 trillion by the end of the year, which will eclipse the high-water mark set at the end of the week of 17-Dec-08. In light of the improvement in the economy, the Fed needs to curtail this aggressive monetary expansion.

The Fed also agreed to extend the Term Asset-Backed Securities Loan Facility (TALF) for all consumer loans through the first-quarter of 2010, while the program is extended through the first-half of 2010 for commercial mortgage-backed securities. The Fed has acknowledged the persistently tight credit conditions in the markets for consumer finance and commercial real estate, as impediments to a sustainable and durable recovery. While the amount of outstanding TALF-loans totals only $36.2 billion, the program has capacity of $1 trillion. As the economy and credit-markets continue to improve, demand for TALF-loans would be expected to increase. While it is unlikely that outstanding loans would reach $1 trillion by 2010, any incremental demand in the program would add to an already large Federal Reserve balance sheet. Moreover, the Fed also left the open the possibility that they will consider extending the program, as they "will consider in the future whether unusual and exigent circumstances warrant an extension".

The Public-Private Investment Partnership (PPIP) was created to facilitate the sale of legacy assets by the banks to investment partnerships. The program has capacity of $1 trillion. Although the program has yet to commence operations, we expect that the improvement in the markets will contribute to increased demand for PPIP-loans. In addition, as improvements in the markets push asset prices higher and rising credit-costs push carrying prices lower and encourage banks to jettison troubled assets, we expect an increase in demand for PPIP-loans.

The amount of fiscal stimulus in the system continues to grow. This spending, which includes the $787 billion stimulus package, the proposed new health-care spending, the proposed $3.55 trillion fiscal-year 2010 budget, "cash for clunkers" and a possible second stimulus, shows no signs of abating, despite warnings from Chairman Bernanke. The amount of fiscal stimulus in the system dwarfs the amount of Fed-provided bank reserves.

These factors suggest an asymmetric risk toward a weaker dollar, as a result of continued growth in monetary and fiscal reserves and an indefinite period of extreme monetary accommodation. In the Veritas White Paper No. 3 entitled, "Should the Fed Tighten" and published on August 4, 2008, we argued for a combination of a more restrictive monetary policy and across-the-board cuts in personal, corporate and capital-gains tax-rates, in an attempt to encourage economic activity, as opposed to the series of Fed rate-cuts and the Economic Stimulus Act of 2008, the Bush tax-rebate package. A more restrictive monetary policy would have prevented the dramatic decline in the value of the dollar and the precipitous rise in crude-oil and inflation, which were the main factors in the financial meltdown in the fourth quarter of 2008 and the global and domestic economic contraction, which contributed to the failure of AIG, Fannie Mae, Freddie Mac, Bear Stearns, Merrill Lynch and Lehman Brothers; the severe decline in the U.S. auto sector and other energy-dependent industries, and the large loss of consumer wealth caused by severe weakness in housing prices. Across-the-board tax-cuts would have generated substantial recurring benefits to economic growth, instead of providing temporary benefits. Consumers would have received more recurring after-tax income that would have provided many benefits to the economy, which would have included paying-down outstanding credit-card debt, financing expenditures, affording higher mortgage-interest payments and saving for down-payments on home purchases. Lower corporate taxes would have provided new incentives to invest in new businesses and new business opportunities that would have contributed to job creation and income growth. Lower capital-gains taxes would have increased the after-tax return on financial assets, which would have helped to raise demand for financial assets and enhanced access to capital.

Given the sizeable amount of excess central-bank reserves, it suggests that the monetary accommodation has played only a limited role in the current economic recovery. With the banks still exposed to rising credit costs and greater capital needs, the supply of credit continues to contract and underwriting standards continue to tighten. In addition, demand for credit continues to fall. There are signs that the monetary accommodation is fueling the rise in commodities prices, in addition to debt and equity prices. The amount of monetary stimulus in the system is generating an increase in inflation. The July ‘core’ producer-price inflation, which excludes food and energy, is running at an annualized rate of 2.6%, while the reading for July 2008 was 3.5%, while the ‘core’ consumer-price inflation has recorded increases of 1.7% and 2.5%, for the same period. These statistics have been observed during the worst economic decline since the Great Depression. In addition, crude-oil prices have increased 118% since March, while gold prices are only 8% below the record-level of $1,030.00/troy ounce reached in 2008. This situation will only worsen as the Fed continues to encourage such growth in reserves. With excess reserves at $708 billion and required reserves only 12% higher than the average during the first quarter of 2009, it appears that the monetary accommodation is not providing much stimulus to the economy. On the other hand, the fiscal stimulus appeared to contribute to the moderation of the economic decline in second quarter gross domestic product (GDP). With estimates of only 15% of the funds in the stimulus package having been spent, future growth should continue to benefit from the stimulus package and other fiscal spending initiatives. Also, there are signs that the “cash for clunkers” and housing tax-credit for first-time homebuyers are generating demand for cars and houses. We conclude that the benefits of a tightening of monetary policy would outweigh the potential costs.

Not only is the value of the dollar impacted by domestic monetary and fiscal policies, but it is also affected by the actions of foreign monetary and fiscal authorities. Although the risks of further domestic monetary accommodation and fiscal spending are asymmetric in favor of a weaker dollar, the monetary and fiscal decisions of other G-20 countries will also impact the future value of the dollar. Between July 2008 and March 2009, the dollar strengthened versus the currencies of the G-20 countries, which reversed the depreciation of the dollar that took place between September 2007 and July 2008. The initial fall in the dollar happened, as a result of the initiation of aggressive Fed rate-cuts that dropped the fed-funds rate to 2.00% by April 2008. The Fed was attempting to address expected economic weakness from sub-prime mortgage distress. During that period of time, the dollar/euro fell from $1.3880 on September 2007 to $1.5939 on July 2008. As global growth was still positive, foreign central-bank monetary policy was largely unchanged, with the exception of moderate rate-reductions by the Bank of England and the Bank of Canada. Positive economic activity kept global policy relatively restrictive. However, higher food and energy prices, especially crude-oil prices above $100.00/barrel, began to cause a slowing in foreign economic growth. Higher food and energy prices began to feed higher inflation. The European Central Bank raised its main lending-rate by 0.25% in July 2008, to address the worsening inflation. The dollar reached its trough in July 2008 and began to strengthen, as crude-oil prices reached $147.27/bbl and pressure increased for foreign central-bank rate-cuts. As falling crude prices translated into moderating inflation, global central banks participated in a coordinated rate-cut. Although the Fed eventually lowered its fed-funds rate to 0.00% in a two-month period, the other G-20 central banks had more room to reach sub-1.00% lending rates. The dollar reached its peak in March 2009, as the euro/dollar reached $1.2544, before the announcement of the Fed's plan to purchase $300 billion in outstanding U.S. Treasury debt. Although other central banks, which include the ECB and BOE, have also pursued quantitative easing programs, the size and scope of the Fed's plan contributed to the dollar falling to its current level of $1.4333.

The outlook for the global economies suggests that global central-bank monetary policy will remain relatively accommodative. The majority of foreign countries are facing a combination of weak aggregate demand, hobbled financial institutions, high consumer indebtedness and high levels of government debt, despite recent signs of stabilization in their economies. Also, all of the G-20 countries are hoping that exports will contribute to economic activity. With most central bankers worried about price deflation, there is little pressure to preemptively raise rates. Expectations that the Reserve Bank of Australia and the European Central Bank will be the first to raise rates will slightly benefit these currencies versus the dollar. However, these economies are showing nascent recoveries and central banks are unlikely to threaten their derailment with higher rates, absent signs of higher inflation. The Monetary Policy Committee of the Bank of England decided recently to increase its quantitative easing by 50 billion pounds, while Mervyn King, the head of the BOE advocated a 75 billion pound increase. This new, more aggressive monetary accommodation will limit gains in the pound. The dollar/pound reached $1.70 before the BOE meeting. As a major trading partner of the U.S., there is also little likelihood that the Bank of Canada will allow the Canadian dollar to strengthen versus the U.S. dollar. Although there are many similarities among the monetary policies of the G-20 countries, the Federal Reserve is expected to continue to pursue the most aggressive monetary policy. Specifically, the TALF and PPIP programs will add to the growth in the monetary reserves. As the U.S. economy and equity- and debt-prices continue to improve, these programs will expand the amount of monetary stimulus from these programs.

With the exception of Canada, the fiscal deficits of the G-20 countries are dangerously high. With the deficits of the United Kingdom and the United States each in excess of 12%, the value of the pound and dollar should trade in a narrow range. The U.S. debt-rating agency, Standard & Poor's, has changed its outlook on the AAA-rating of U.K. government-to negative. This is likely to impose a modicum of discipline in Britain's fiscal management. However, this development will force the BOE to pursue a more accommodative monetary policy. Weakness in Eastern Europe, Italy, Greece, Ireland and Spain will continue to put upward pressure on the fiscal deficits of the members of the European Union. However, the relative monetary restraint of the ECB will limit the downside risk from fiscal expansion of members of the European Union. We also expect Japan to continue to attempt to spend its way out of recession. There is much similarity among fiscal policies of the G-20 countries. However, we expect the United States and Japan to more readily and easily resort to the use of subsequent fiscal spending packages. There is the political impulse in Congress to create a second stimulus package that would more directly address stubborn unemployment. While we are unsure of the likelihood for the passage of a subsequent fiscal package, we would expect further rebate programs like the "cash for clunkers" program and a possible extension and broadening of the tax credit for all homebuyers.

Fiscal bailouts and supports, which include FDIC loss-sharing arrangements, asset-guarantees and the Temporary Liquidity Guarantee Program (TLGP); mortgage lending by the government sponsored entities, the effective government assumption of the outstanding debt of Fannie Mae and Freddie Mac and the TARP exceed the monetary stimulus provided by the Fed and fiscal stimulus provided by any of the other G-20 countries. These programs add to the accommodation of the current fiscal and monetary policies.

Fiscal policy appears to be much more effective at contributing to current economic growth than monetary policy. Although the risks of the current fiscal policies are that they provide little more than one-time benefits to the economy and do not encourage capital-investment and risk-taking, unlike cuts in marginal tax-rates, they appear to have contributed to the improvement in second-quarter GDP. With more than 85% of the Obama stimulus package yet to be spent, the economy should continue to benefit from these appropriations. However, there is little evidence that monetary policy is contributing to economic growth. Consumer credit contracted by 3.6% and 5.2% in the first and second quarters of 2009, respectively. The banking system continues to tighten lending standards. In addition, the amount of excess reserves at the central bank exceeds required reserves by a wide margin. As of week ended August 12th, required reserves totaled $64 billion, while excess reserves totaled $708 billion. This demonstrates that monetary policy is not effective at increasing the amount of credit in the financial system. While there are substantial risks to the economy from higher interest-rates from rising inflation and expanding budget deficits, the most immediate risk is a weaker dollar that is the result of the substantially more accommodative domestic monetary and fiscal policies of the U.S. Congress and the Federal Reserve than foreign counterparts. With The White House and the Congress showing little willingness to curtail spending, the Fed must take the first step to contract the size of the monetary base, as the magnitude of this accommodation runs the risk of weakening the dollar and igniting much higher price inflation that will damage economic activity. The Fed's quantitative easing has pushed crude-oil prices above $74/barrel, from a low of $33/bbl in March 2009. The monetary policy of the Bernanke Fed, which pushed crude-oil prices above $147/barrel in July 2008, remains in-place. As the domestic and global economies continue to improve, the ultra-accommodative Fed monetary policy is likely to push crude oil and other commodities well-above $74/bbl, which will risk a significant slowdown in global economic activity and depreciation of housing and financial assets.

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