Implications of the Fed's Exit Strategy

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The Biggest Challenge Facing Investors is the Fed's Exit

The U.S. government, during the heat of the financial crisis one year ago, established a plethora of different programs to provide support to the capital markets. As the credit markets seized up, the unprecedented actions of the Federal Reserve and the U.S. Treasury helped to transfer a significant amount of leverage from the private sector to the public sector. In the process, the government created an orderly process to retire insolvent banks, purchase mortgage backed securities in an effort to lower mortgage rates, and provide a backstop to money market funds. In order to finance these programs, the Fed's balance sheet ballooned by over $1.4 trillion dollars.

At this point in time, we believe the single largest issue facing investors and the capital markets over the next year is the Fed's ability to withdraw its massive support and intervention without disrupting the economy or the capital markets. In fact, the Fed has already started to reduce systematically its support to the financial system.

This article discusses the current steps the Federal Reserve is taking to reduce its support of the capital markets. In the process, we summarize many of the more significant programs and discuss the potential for the Fed's use of reverse repurchase agreements to drain liquidity from the financial system. Finally, we explore the risks of inflation and the consequences of the Fed leaving the huge stimulus initiative in the financial system too long.

The Fed is in the Process of Withdrawing its Stimulus

Each of the programs initiated by the government has a predetermined expiration date that can be extended at the discretion of the government. In September, the Federal Reserve announced that its Money Market Mutual Fund Guarantee Program had expired. After the Reserve Primary Fund broke the coveted $1 Net Asset Value, this program, which was elective, was established to allow money market funds a government backstop. The program was funded through a $50 billion injection from the U.S. Treasury's Exchange Stabilization Fund and ultimately earned the government over $1.2 billion in participation fees.

The Fed has announced that it will reduce the Term Securities Lending Facility to $50 billion from $75 billion. In its September progress report, the Federal Reserve indicated that borrowing at the TSLF has stopped as a result of improving conditions in the money markets. There have been no borrowings at the Primary Dealer Credit Facility since mid-May. Also, the Term Auction Facility will shrink to $50 billion from the once lofty level of $900 billion.

The Federal Deposit Insurance Corporation (FDIC), in October of 2008, established the Temporary Liquidity Guarantee Program (TLGP) to help stabilize the financial system and to facilitate bank lending. Through the Debt Guarantee Program of the TLGP, qualifying banks could issue debt with a government guarantee which allowed banks to access the capital markets at a time when markets were frozen. Ultimately, $346 billion of debt was issued under this program which is expected to expire on schedule on October 31, 2009. In addition, the Federal Reserve will allow the Money Market Investor Funding Facility to expire on October 30th as planned.

One of the pillars of the Federal Reserve's support for the capital markets is its $1.0 trillion commitment to purchase mortgage backed securities in the open market. The program, which the Fed had originally indicated could expire in October, has been extended through the first quarter of 2010. In extending their purchases, the Fed is attempting to keep interest rates low for homebuyers.

The Fed is in the Process of Withdrawing its Stimulus

In response to the financial crisis and panic of 2008, The Federal Reserve established several new programs that provide lending support, liquidity and help to stabilize our financial system. These programs are listed below with a brief description.

1. Capital Purchase Program: Provides capital to qualified financial institutions of all sizes by purchasing senior preferred equity or subordinated debentures. This program is currently closed to banks above $500 million in assets.

2. Supervisory Capital Assessment Program: The Fed, OCC and FDIC designed a "stress test" which it applied to the 19 largest U.S. Bank Holding Companies to insure adequate capital under extreme economic assumptions.

3. Term Asset Backed Securities Loan Facility: This facility lends up to $200 billion to holders pledging AAA rated credit card, student loan and small business loan ABS as collateral.

4. Legacy Public-Private Investment Program: Announced in February of 2009, the PPIP program is designed to transition illiquid and difficult to price securities from banks to pre-qualified investment managers. The Treasury will match the capital raised from private investors.

5. Term Securities Lending Facility: Provides the exchange of investment grade securities held by broker dealers and banks for Federal Reserve holdings of U.S. Treasury securities.

6. TSLF Options Program: Gives primary dealers the option to draw on special short dated TSLF Auctions.

7. AIG: The Treasury provided exceptional financial assistance to AIG in order to insure its solvency and contain its asset and counter party problems.

8. Targeted Investment Program: US treasury purchased $20 billion in preferred stock from Citigroup and $20 billion in preferred stock from Bank of America. These investments were incremental to CPP investments in these institutions.

9. Asset- Backed Commercial Paper Money Market Mutual Fund Facility: Provides loans to banks and other depository institutions so they can purchase asset-backed commercial paper from money market mutual funds requiring liquidity.

10. Commercial Paper Funding Facility: Through a special purpose vehicle managed by the Federal Reserve Bank of New York-, this facility purchases three-month unsecured and asset-backed commercial paper directly from eligible issuers.

11. Money Market Investor Funding Facility: This facility provides up to $540 billion in cash liquidity to money market funds by purchasing assets directly out of money market funds.

12. Term Asset Backed Securities Loan Facility: This facility lends up to $200 billion to holders pledging AAA rated credit card, student loan and small business loan ABS as collateral.

13. GSE Securities: Program in which the Fed will purchase up to $100 billion in GSE direct obligations from primary dealers and $500 billion in qualifying mortgage backed securities in the open market.

The biggest piece of the government intervention was the Troubled Asset Relief Program (TARP). The $700 billion program was split into two parts and the first $350 billion of the TARP money was injected into the major banks through preferred stocks. With the exception of Bank of America and Citigroup, the largest recipients of the government's gift of capital have repaid their debts. According to our calculations, the profits collected from eight of the biggest banks that have fully repaid their obligations come to roughly $4 billion, or a 15 % annual return.

The government still faces potentially huge long-term losses from: its bailouts of the insurance giant American International Group, the mortgage finance companies Fannie Mae and Freddie Mac, the CIT Group, and the automakers General Motors and Chrysler. The Treasury Department could also take a hit from its guarantees on billions of dollars of toxic mortgages.

We expect the primary strategy the government will pursue in exiting its role of primary capital provider and backstop is to let the programs that it established expire. So far, seventeen of the nineteen largest banks have repaid their TARP capital.

Tightening Monetary Policy and Quantitative Easing

Today, as the economy shows signs of recovery and banks have shored up capital, we expect the profitable and traditional lending of bank reserves will ultimately return. This lending of reserves helps to accelerate the velocity of money which further stimulates economic growth and ultimately results in inflationary pressures. The Fed expects that this increased lending will result in a reduced use of their short term lending facilities. The Fed reported use of its short term credit facilities has declined from $1.5 trillion in December of 2008 to less than $600 billion today, thereby effectively shrinking the Fed's balance sheet.

One tool the Fed has to tighten monetary policy is to pay interest on reserve balances held with the Federal Reserve. This power, which has existed with the European Central Bank for some time, was granted to the Fed last fall and can be used to incentivize banks to lend out reserves or get paid to maintain balances with the Fed. The Fed currently pays 0.25% for balances held. When the time comes to tighten monetary policy, that rate could be increased as the Fed Funds target rate is increased. The theory there is that banks will not lend funds in the money market at a rate lower than the rate they can earn risk free by maintaining reserves at the Fed. This should also discourage excessive growth in credit since banks will not want to lend out reserves at rates below what they can earn at the Fed.

The Fed also has the ability to drain excess liquidity from the system as a means to tighten monetary policy. This could be accomplished through massive reverse repurchase agreement transactions with financial institutions which would allow the Fed to sell securities from its portfolio for cash on a short term financing basis. The Fed could also use its recent authority to pay interest on reserves by paying term interest rates. This would effectively lock up reserve balances at the Fed at a better rate than banks would earn in the money market. In addition, the Fed could reduce reserves by selling a portion of its portfolio of securities into the market. Each of these initiatives would accomplish additional tightening in monetary policy by raising short term interest rates and limiting the growth of money and credit.

While we believe the Fed has the tools and the wherewithal to tighten monetary policy when the time comes, we expect the balance sheet of the Fed will remain bloated for some time. The consequences of a larger Federal Reserve balance sheet, including the inflationary pressures and additional interest burden, concern us.

The Federal Reserve Explores the Use of Reverse Repurchase Agreements to Drain Liquidity

As part of the process to withdraw the unprecedented amount of liquidity that was injected into the financial system over the past two years, the Federal Reserve has started talks with bond dealers about using reverse repurchase agreements to drain some of the $1 trillion they pumped into the economy. A reverse repurchase agreement essentially involves the Fed lending securities to its 18 primary dealers for a specific period, receiving cash and temporarily decreasing the amount of money available in the banking system.

The central bank's challenge is to decrease the cash without stunting the economy's recovery before it sparks inflation. Fed Chairman Bernanke confirmed in a Wall Street Journal opinion article last July that reverse repos are one tool to accomplish that goal without raising interest rates. We expect the Fed to launch a pilot program by the first quarter of 2010 as a means of getting the market involved in the process of borrowing securities from the Federal Reserve.

Is Inflation or Deflation on the Horizon?

The question we wrestle with is: after all settles down and we discover that our financial system is solvent, do we end up with inflation or deflation when the Fed has reinflated the economy? The U.S. policy of funding our massive deficits through global sales of treasury and agency securities has perpetuated an inflationary cycle that has helped to drive consumption and asset values higher at the same time. As a society, we have lived beyond our means with a lower rate of savings and the comfort that countries like China and India can produce goods and services cheaper than we can domestically (which has helped increase productivity and masked inflationary pressures). Just how long the disinflationary cycle continues and foreign countries are willing to continue to purchase our debt is critical in answering the question of inflation or deflation.

With the growth in the size and sophistication of our capital markets and the securities and instruments that are traded, the risk of inflation in the US has shifted from price inflation of the 1970s to the asset inflation of the 1990's and 2000's. Inflation is the persistent expansion of money and credit at a rate which substantially exceeds the growth requirements of the economy. As a result of excessively easy monetary policy, prices rise. The rise in CPI in the 1970's to 14% is one example. Yet, the pervasive expansion of credit during the past 15 years has led to increases in the prices of homes, buildings, securities, and private corporations beyond previous measures. These are described as "asset bubbles" and are just as dangerous to our economy as price inflation.

A normal economic cycle would allow for the contraction of credit and a resulting decline in asset values. With unemployment at 9.5% and capacity utilization at 67%, we have slack resources in our economy that would under normal circumstances help to suppress inflation pressures. However, the speed and magnitude of the recent government bailout of our financial system effectively transferred the leverage in the system from the private sector to the public sector. We didn't reduce the bubble; we transferred it over to the government which is allowing the leverage in the system to remain intact and the reflation of our economy, and the resulting asset bubble, to persist. It is the excessive leverage in the capital markets, which is supported by huge deficits and the expected growth of government debt, which concerns us today. We expect these government deficits will put upward pressure on interest rates which could undermine the fragile state of the residential and commercial real estate markets.

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