Investment Perspective

The Fed Extends its Purchase Program September 22, 2011



Yesterday, the Federal Reserve announced its newest initiative to spur economic growth by investing a portion of its massive portfolio in US Treasury securities with maturities between six and thirty years. Up until this point the Federal Reserve has initiated two asset purchase programs since 2009 totaling \$2.4 trillion. Each program was designed to lower short term interest rates in order to stimulate economic growth in an environment clouded by health care reform, financial regulatory reform and partisan infighting in Congress. On the heels of the downgrade of the credit rating of the US Treasury debt to AA+, interest rates are at the lowest levels in history. Now, the Fed is stepping in to further manipulate the capital markets in an effort to lower long term interest rates even further, and flatten the yield curve to further stimulate economic growth.

We believe that it is important to recognize that we have entered another chapter in a huge central bank experiment that has never been tested before. The fundamentals that apply to security valuation matter less as central bank manipulation overshadows unconstrained free market forces. The Federal Reserve has taken its balance sheet from \$914 billion to \$2.4 trillion in the past three years in an effort to provide capital market stability and stimulate economic growth in the absence of private credit expansion. Clearly, the Fed sees trouble in the economy and Fed Chairman Bernanke is not inclined to let market forces work independently. First, we'll explain the Fed's latest initiative. Then we'll attempt to provide some context for the actions of the Federal Reserve and why current monetary policy is ineffective.

The Federal Reserve - "Operation Twist"

By our estimates, the Federal Reserve currently owns \$2.1 trillion in US Treasury and mortgage-backed securities. Through the Fed's two asset purchase programs, known as *quantitative easing*, banks were able to sell securities which met certain maturity requirements to the Fed and free up capital to redeploy in other investments. In turn, the Federal Reserve accumulated a securities portfolio with the ultimate goal to lower short term interest rates. The result is an orchestrated transfer of debt from the private sector to the government sector.

The Fed has pushed the Federal Funds Rate, generally described as the rate in which banks lend to one another, from 5% in 2008 down to 0.25% today. Given the structural problems in the capital markets and the economy, traditional monetary policy initiatives which include adjusting the money supply and short term interest rates have proven ineffective in spurring economic activity. As a result, our central bank initiated the quantitative easing programs to step in where traditional monetary policy was ineffective. However, the Fed has determined that it should do more to adjust the *term structure* of interest rates. In addition to lowering short term interest rates, the Fed is now attempting to lower long term interest rates including yields on ten year and thirty year US Treasury securities by selling short dated securities as well as reinvesting the coupon payments, prepayments, and maturities in longer dated US Treasury securities.

The result of the Fed's newest initiative will be to reduce the slope of the yield curve – the difference between yields on short US Treasury notes and long dated US Treasury bonds. As students of the capital markets, we believe the yield curve is still the best predictor of economic activity. However, in the absence of meaningful policy initiatives to create jobs and real incentives for the banks to expand credit, the Fed is attempting to push long term interest rates lower to allow cheaper financing for those who can take advantage of it.

We believe that we have entered into a new monetary regime where our central bank directly manipulates interest rates through open market purchases. These are not temporary programs; we believe that the Federal Reserve's asset purchase programs will exist for a prolonged period of time and that any thought of a Fed exit plan is naïve. We are concerned that the unintended consequences of the Fed's initiatives will result in more harm on the economy and financial system. These concerns include insurance companies' inability to profitably fund certain insurance products, retiree's inability to earn enough interest income on their savings to maintain their life style and fixed income mutual funds inability to earn a total return that exceeds their investment expenses. And, while we acknowledge that that the Fed's initial response to the financial crisis was necessary and largely successful, moving further down the path of manipulated lower interest rates without fixing the structural problems in the economy which are prohibiting capital formation, credit expansion and business investment will only make it harder to wean ourselves back to free market policies.

Monetary Policy and the Financial System

The financial system is the system that allows the transfer of money between savers and borrowers. Banks are an integral part of the financial system. The Federal Reserve relies on the banking system in order to execute monetary policy. Through various mechanisms including adjusting required reserves, manipulating the Fed Funds rate and altering the monetary supply, the Federal Reserve utilizes the banking system to expand or tighten monetary policy thereby stimulating or slowing economic growth. Today, that system is broken. The result is that the Federal Reserve has to revert to large asset purchase programs to alter interest rates and credit expansion is impaired.

The function of banks in the financial system is to extend credit. At this point in an economic recovery, we would expect banks to increase their loan portfolios by lending to consumers and small businesses which in turn would boost profits for the banks and create jobs in the economy. However, loan growth has been impaired as credit expansion remains muted. It took 200 years for the banking system to amass \$400 billion in consumer loans. It only took eight years to double consumer loans to \$800 billion and an additional thirteen years to triple the loans to consumers to \$2.4 trillion. The banking system has provided so much credit over the past two decades that the market for private credit is saturated. As a result, demand for further loan growth is extremely low.

In the absence of private credit expansion, the Federal Reserve has taken the initiative and stepped in to provide the market function by attempting to manipulate the market level of interest rates. However, we do not believe the Fed's program will increase the expansion of credit. Until we move through the cumbersome process of regulatory reform resulting from the Dodd-Frank Act, banks have really no incentive to increase their loan portfolios. Without the efficient expansion of credit, there is little incentive for risk taking and business development. As a result, corporations are hoarding cash and consumers are shoring up their balance sheets. *Until we deal with the structural problems embedded in the economy and provide more efficient means for credit expansion than our current banking system allows, we will remain in a period of slow economic growth and persistently high unemployment.*

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