The Fed's Exit Strategy – What's Next?

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The Current Role of the Fed

Over the past 18 months, the Fed has taken a much larger role in our capital markets and moved well beyond manipulating short term interest rates in order to effect a change in the potential for economic growth and price stability. The list of initiatives by the Fed has been long and encompassing. Since early 2008, the Fed has helped to merge Bear Stearns with JP Morgan Chase, set up no less than 14 capital market assistance programs designed to pump liquidity into the capital markets, helped merge Merrill Lynch and Bank of America, and assisted in the conversion of Morgan Stanley, Goldman Sachs and American Express into bank holding companies.

Since the onset of the financial crisis, the Federal Reserve has moved decisively to lower short term interest rates to zero and pump liquidity into domestic capital markets, which had ground to a halt as bank lending ceased. In doing so, the Fed greatly expanded the size of its balance sheet. All of these actions have helped to soften the impact of the financial crisis on the economy. The Fed's quick response also helped to revive the public credit markets as spreads in both investment grade and high yield securities have tightened considerably through 2009.

By definition, our economy is leveraged. For example, banks make loans to companies based on capital levels and companies, in turn, extend credit to buyers based on their ability to access credit. When credit is less available or "squeezed" companies are forced to shrink their operations. By November of 2008, the credit squeeze was so dramatic that the government set up several direct lending programs to support the flow of credit. We expect that these accommodative programs will exist for an extended period of time. We believe that some of these initiatives, such as the money market insurance program, may become permanent fixtures on the landscape of programs supporting our domestic capital markets. Yet, in spite of these massive initiatives to add liquidity, parts of our credit markets are very tight. One quick survey of corporations around the country will reveal that bank credit has been cut back significantly.

At some point, as economic growth returns, we expect that monetary policy will necessarily tighten in order to stave off the potential risks of inflation. The Fed faces a significant challenge of raising short term interest rates while reducing the programs that are serving as "life support" for our capital markets.

The Inevitable Tightening of Monetary Policy

At some point, we don't know when, the Fed will need to tighten monetary policy. As the economy shows signs of recovery and banks have shored up capital, we expect the profitable and traditional lending of bank reserves will 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 concern us.

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.

In spite of the slack resources in our economy, we are concerned about the risk of inflation – particularly asset inflation. 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 on 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 excessive 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 9.4% and capacity utilization at 67%, we clearly 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 completely 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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