MARKET Commentary

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Changing of the Guard

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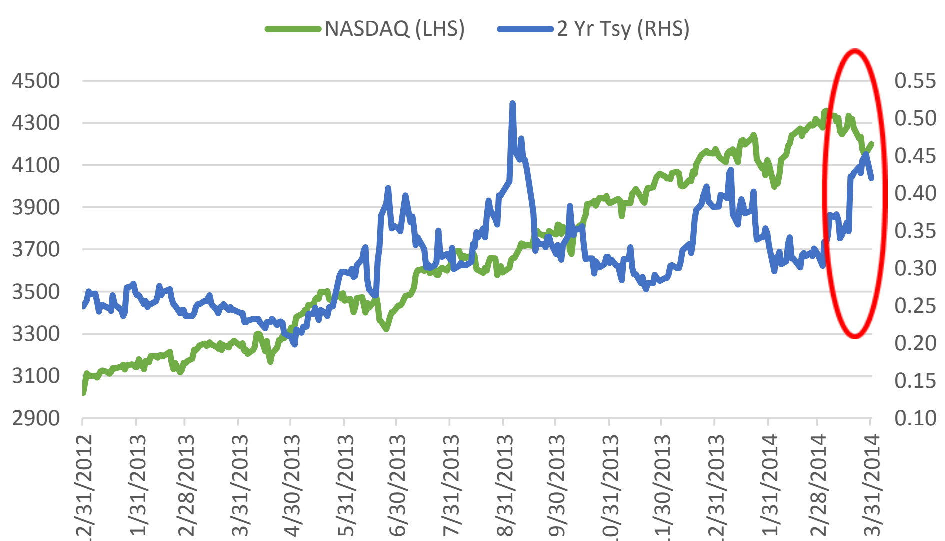
The Bernanke era came to a quiet close early in the year. The Chairman, who had overseen a massive expansion of the central bank's authority and balance sheet, presided over his last policy-making meeting in January. The timing came at an opportune moment as the underlying economic activity seems to have reached a level that is supportive of less accommodative monetary policy. The Federal Open Market Committee (FOMC) now takes on a more delicate task as policymakers attempt to reduce accommodative policy, while effectively communicating policy decisions without derailing the modest recovery. In this commentary, we outline what is next for the Federal Reserve, discuss the upcoming earnings season, and briefly revisit money market reform.

FOMC 2.0

The relative calm that followed Bernanke's departure was broken by what many are considering a "rookie mistake" by new Fed Chair Janet Yellen during her first news conference post-FOMC meeting in March. The FOMC statement read "it likely will be appropriate to maintain the current target range for the federal funds rate for a considerable time after the asset purchase program ends." Yellen was asked to clarify what the Fed meant by "a considerable time". Rather than offering an opaque explanation, she said "it probably means something on the order of around six months or that type of thing." That measure would put the first rate hike in March of 2015 rather than mid-to-late 2015 as many had expected. Yellen's timeline caught markets flat-footed and pushed bond yields higher (to price in an earlier-than-expected Fed Funds hike) and took a bit of air out of the equity markets (See Figure 1).

Figure 1: 2-Year Treasury Yield & NASDAQ Index



Source: Bloomberg

US Treasuries

As of 31-Mar

Benchmark	Yield
3 Month	0.03%
6 Month	0.06%
1 Year	0.11%
2 Year	0.42%
5 Year	1.72%
10 Year	2.72%
30 Year	3.56%

Bank of America/Merrill Lynch Indexes

28-Feb to 31-Mar

Index	Return
1-3 Yr Gov/Corp ≥ A	-0.10%
1-3 Yr Municipals	-0.16%
1-3 Yr Agencies	-0.09%
0-3 Month UST	0.01%
S&P 500	0.84%

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Source: British Bankers' Association, Federal Reserve, US Treasury, Bloomberg, Barclays, BofA/ML, S&P and Wall Street Journal

In subsequent public appearances, Fed officials, including Yellen, were quick to reinforce that Fed policy has not changed. The recently released minutes from the meeting reinforce that stance.

The Federal Reserve is in the very early stages of normalizing policy. It is gradually **reducing purchases of U.S. Treasuries and Agency MBS**. We expect the Fed will continue to reduce purchases by $10 billion at each meeting unless there is a significant economic disruption. Therefore, purchases would cease this fall. At that point, the Fed's balance sheet is estimated to total approximately $4.5 trillion, according to JP Morgan.

The next step would be to **halt reinvestment of principal payments of maturing Treasury and mortgage-backed securities**. With a newly shrinking balance sheet, the Fed would next **initiate reserve-draining operations and control overnight interest rates primarily via the Overnight Reverse Repo Program**. Finally, the Fed would be free to raise its policy target rate provided economic conditions warrant such a move. Even then, policy would be anything but normal, given the still very bloated balance sheet that is likely to shrink passively via maturities and mortgage pay downs.

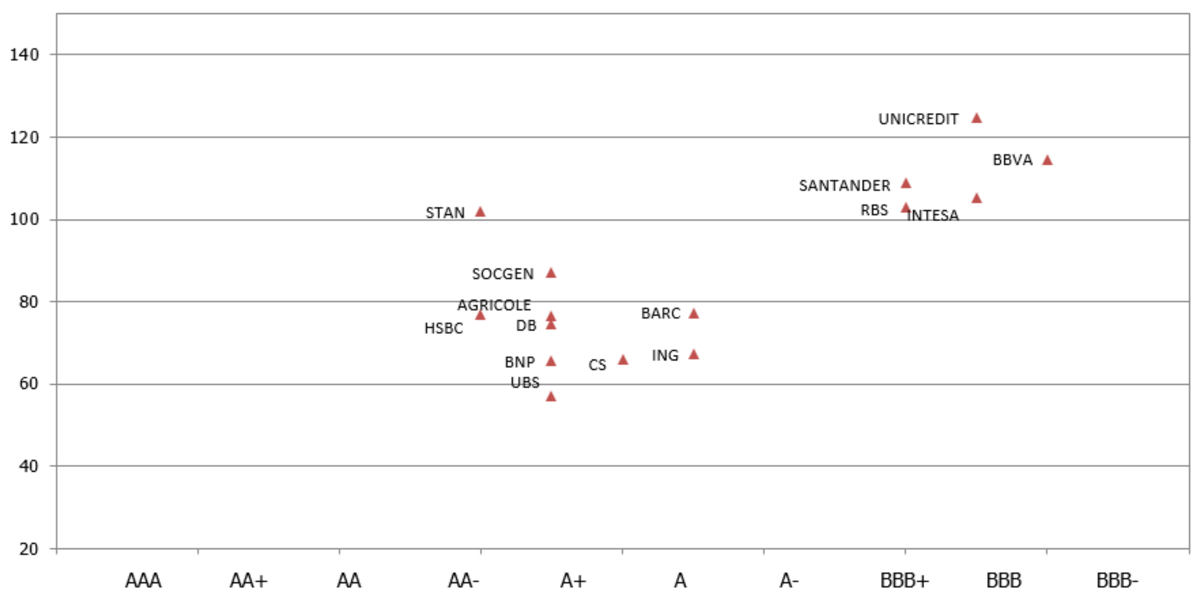
Considering the moderate pace of recovery and Fed policy that will err on the side of caution, expect this process to be gradual. We do not forecast Fed Funds hikes until the latter half of 2015. We expect Treasury yields to be sensitive to economic data prints that deviate from expectations as well as exhibiting heightened sensitivity to perceived policy shifts at the Fed. Forward guidance will be the primary monetary policy tool now that quantitative easing is ebbing. With inflation low, the impact will be felt most by the belly of the curve, 3-10 year maturities.

Quarterly Expectations

Earnings season kicked off last week with Alcoa beating analysts' expectations. Deutsche Bank estimates that because first quarter earnings forecasts were cut so sharply, roughly two-thirds of the S&P 500 should beat guidance. While earnings beats may be supportive of equity valuations, the impact on credit spreads will be more modest. The balance sheets of the issuers we follow remain resilient although shareholder-friendly and M&A activity is on the rise. Domestic banks have rebuilt their balance sheets to comply with a more stringent regulatory environment.

Overseas, Europe is setting the foundation for its new central banking authority which should be in place later this fall. Eurozone banks will be stress tested this summer and recapitalize as needed.

Figure 2: Current European Bank CDS & Ratings



Source: Bloomberg

EU policymakers are finalizing troubled bank recovery and resolution rules. Consequently, the ratings agencies will assess the new resolution tools and revise European bank ratings (affirm existing or downgrade) in the next month or so. This uncertainty comes at a time when money market fund investment in European banks has surged to a two-year high at 31% of assets, according to Moody's.

Money Market Reform Update

The Securities and Exchange Commission (SEC) has been wrestling with money market reform for the past year. SEC staff recently released data analysis and academic literature related to the reform effort and opened a comment period until April 23rd. As we discussed last fall, it is likely that Government and Treasury Funds will be excluded from further reforms. Additionally, Retail Funds may be exempt as well given prior research has shown that institutional investors tend to be the ones that redeem and force fire sales in times of stress. Recall, the SEC has proposed:

- *Floating Net Asset Value (NAV)* – Prime institutional, including tax-exempt, money market funds would be required to transact at a floating, market-based net asset value rather than maintain a $1.00 stable share price.
- *Redemption Limits* – Money market funds would continue to transact at a stable share price but would use liquidity fees (a 2% fee on redemptions) or redemption gates (a temporary suspension of redemptions) when a fund's liquidity falls below a certain level.
- The SEC could adopt either alternative or a combination of the two.

A final set of rules should be released by summer. Implementation of the final rule will likely take one to two years. To read the SEC research, please visit the following link – SEC Staff Analysis.

Looking Forward

The initial step to normal monetary policy has begun. The economic recovery remains modest ensuring a deliberate exit from the accommodative policy of the last several years. Front-end yields will remain anchored by Fed Funds while short-to-intermediate yields will be buffeted by economic data and Fedspeak. The yield curve remains steep, especially beyond one year, offering protection from future rate increases.

Fannie Mae and Freddie Mac have now returned all of the $187 billion bailout to the U.S. government. This has emboldened activist shareholders and enlivened the debate about resolving their conservatorship status. We don't expect Congress to act this year and when reform comes to pass existing debt will likely be covered by an explicit government guarantee. However, given the uncertainty, we see little value in short Agencies that often trade on top of or through similar maturity Treasuries.

Geopolitical risk is lurking as the situation in the Ukraine deteriorates. Markets have largely overlooked this as a major concern. While we don't view an escalation as having a large impact on U.S. markets, if risk aversion does surface we would look to take advantage of wider credit spreads and add exposure where prudent.

We will be presenting at AFP events in Minneapolis (April 29th) and Chicago (May 8th). If you're in the area, please attend our session or stop by to say, "Hello."

Please contact the desk with questions or to discuss investment opportunities and how to best navigate today's investment environment.

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