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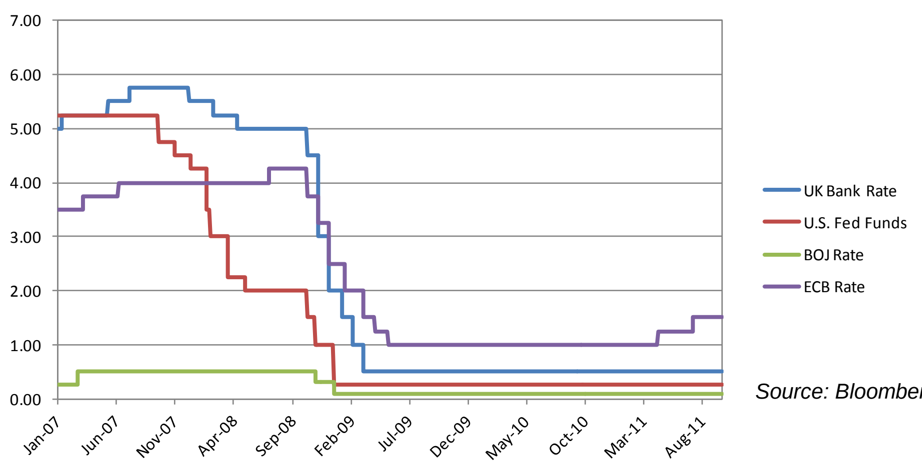
MARKET Commentary

Pushing on a String

October 2011

The global economy continues to strain under the weight of world-wide debt deleveraging. Central banks have maintained accommodative monetary policy hoping to stimulate growth. The Federal Open Market Committee (FOMC) led by Chairman Bernanke, a student of the Great Depression, has exhausted conventional policy and taken unconventional steps such as increasing interest on excess reserves, expanding the Fed's balance sheet and instituting a myriad of liquidity and funding programs to stimulate the economy. These extraordinary actions have drawn increased political scrutiny and much public debate and have had a questionable impact on the overall economy. With $1.6 trillion in excess reserves parked at the Fed, and the Federal Funds Rate at zero until mid-2013, the Fed may be pushing on a string as the follow-through to the economy remains muted. Consequently, as economic growth proves anemic, unemployment remains stubbornly high and inflation is contained within the Fed's acceptable range, we examine what the Fed has accomplished and what it can do further.

Figure 1: **Central Bank Rates (%)**



Source: Bloomberg

The Fed Acts Unconventionally

The Fed initially undertook unprecedented action in an effort to unlock frozen credit markets, but quickly transitioned to accommodative policy to stimulate economic growth. The first round of quantitative easing (QE1) – purchasing assets with money created by the central bank – was announced in late November 2008. At first, the Fed declared it would purchase $500 billion in agency mortgage-backed securities as well as $100 billion of agency debt (Fannie Mae, Freddie Mac, and FHLB). Those amounts were increased by $750 billion and $75 billion respectively as the Fed strove to inject liquidity into the system. At the conclusion of QE1 in March 2010, the Fed – along with other coordinated efforts by the FDIC, Treasury and U.S. government – helped spur a bid for risky assets where the S&P 500 rallied 40%, investment grade CDS declined 155 bps, and 10 year Treasury yields rose 71 bps.

US Treasuries

As of 30-Sept

Benchmark	Yield
3 Month	0.02%
6 Month	0.05%
1 Year	0.10%
2 Year	0.24%
5 Year	0.95%
10 Year	1.92%
30 Year	2.91%

Bank of America/Merrill Lynch Indexes

31-Aug to 30-Sept

Index	Return
1-3 Yr Gov/Corp ≥ A	0.36%
1-3 Yr Municipals	0.40%
1-3 Yr Agencies	0.33%
0-3 Month UST	0.00%
S&P 500	-1.13%

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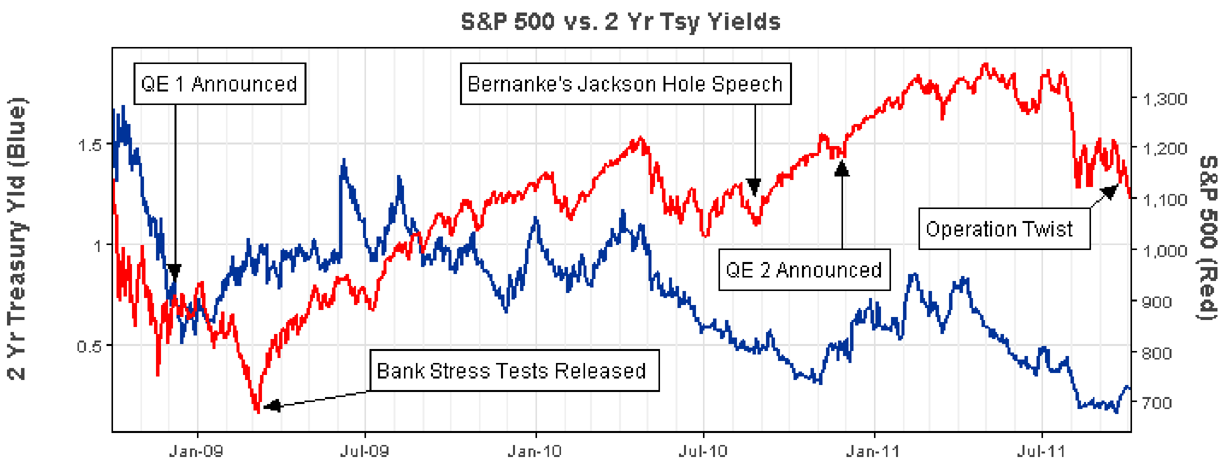
Source: British Bankers' Association, Federal Reserve, FDIC, US Treasury, Bloomberg, Barclays, Financial Times, JP Morgan, The Economist, S&P and Center on Budget and Policy Priorities

Unfortunately, the impact on the economy was short-lived. The FOMC, worried that the economy was too weak to bear tighter monetary policy through balance sheet contraction, announced in August 2010 that it would maintain its balance sheet size by reinvesting proceeds from its portfolio back into Treasury securities in an effort to keep rates low and spur demand for credit and investment. The Fed was trying to offset massive contractionary forces with policy actions that previously had minimal impact. However, Chairman Bernanke remained committed to act even if the intended monetary stimulus failed to pass through to the general economy. The Fed would not err on the side of caution.

Consequently, two years after commencing QE1, the Fed embarked on another round of quantitative easing (QE2) by announcing it would buy $600 billion in U.S. Treasury securities through June 2011. Market participants, encouraged by the Fed's bold action, again embraced risk – the S&P 500 rallied 26% from the Chairman's Jackson Hole speech to the end of this second round of quantitative easing while investment grade CDS declined 20 bps and 10 year Treasury yields increased 51 bps. Clearly, as it did earlier, expanding the balance sheet helped propel riskier asset prices higher. However, ballooning the balance sheet from a pre-crisis level of $700 billion to almost $3 trillion brought increased political pressures, public skepticism and opposition from within the Fed itself. The Fed was now on the defensive and in an attempt to tamp down criticism began publically discussing how it would extract liquidity from the system. Markets, having drawn confidence from the Fed's actions, seemed to question whether the economy needed further easing at all.

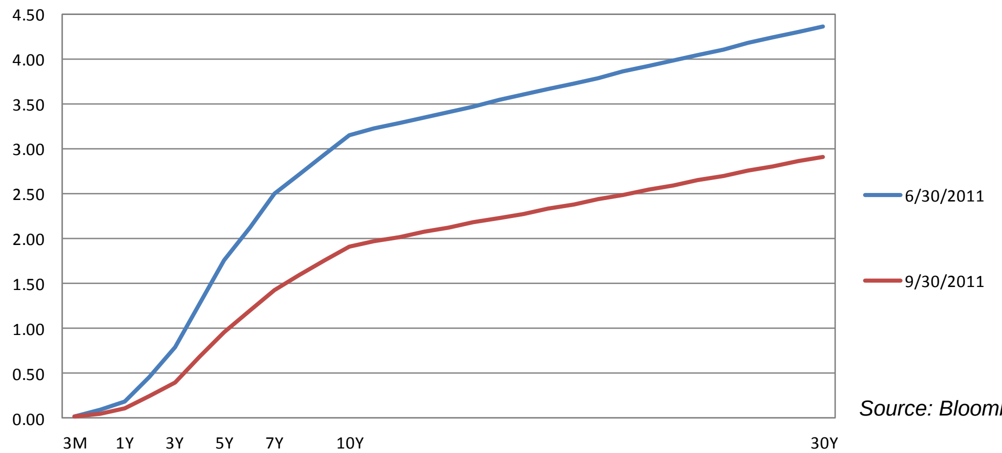
Figure 2: Easing Timeline (S&P 500 vs. 2 Yr Treasury Yields)



Source: BarclaysLive

Unfortunately, easy monetary policy did not translate into the economic growth anticipated by surging asset prices, especially in an economy recovering from a debt binge facilitated, ironically, by the easy Fed policy of the Greenspan era. In the U.S., economic growth weakened appreciably and unemployment remained stubbornly high. Fiscal ineptitude and an ever-tightening regulatory burden certainly did not help matters. The debt ceiling debacle ended with the U.S. losing its AAA rating from S&P. Overseas, the European Union continued to dawdle, allowing the sovereign debt crisis to worsen. With the economic outlook weakening, the Fed recently announced Operation Twist with the goal of lowering longer interest rates and providing continued support to the mortgage market. Reluctant to increase its balance sheet, the Fed will sell short Treasuries and purchase longer-maturity Treasuries. Chairman Bernanke estimates this action to be the equivalent of a 50 bps cut in Fed Funds. Unlike previous instances, the market demand for risky assets has soured – equity markets have dropped into bear territory, corporate bond offerings have plunged to their lowest levels since the failure of Lehman Brothers as investment grade spreads have widened, and Treasuries have rallied (see Figure 3) to record low yields. Had investors expected Operation Twist to boost economic growth, they would have purchased equities and sold bonds.

Figure 3: **U.S. Treasury Yield Curve**



Source: Bloomberg

Further Action to Come

In recent testimony to Congress, the Chairman has made it clear that the central bank "is prepared to take further action" to "promote a stronger economic recovery in a context of price stability". At its most recent meeting, the FOMC admitted that "there are significant downside risks to the economic outlook". With a massive amount of excess reserves parked at the Fed and fed funds at zero until mid-2013, the Fed may be running out of options. The Fed needs banks as lenders and creditworthy borrowers to turn those reserves into loans and potential economic activity, but this transmission mechanism is broken. Loan demand from qualified borrowers remains tepid. It's simply going to take time to cope with the fallout from the housing bust and financial crisis.

We believe another round of quantitative easing (expanding the Fed's balance sheet) is unlikely unless inflation were to fall considerably and the economy were to roll back into a recession. The Fed could lower the Interest on Excess Reserves (IOER), although this seems less likely given the modest impact it is expected to have. More plausibly, the Fed could set target yields for certain Treasury maturities, raise its unofficial inflation target or commit to hold rates lower for longer. On the extreme, given authority and funding from Congress, the Fed could buy risky assets – a move we see as highly unlikely at this time. Unfortunately, conventional monetary policy has been exhausted and the Fed is in uncharted territory as it tries to aid a struggling economy through unconventional policy actions.

Clearwater Portfolios

We continue to expect subpar growth in the U.S. and remain extremely wary of the European situation. We are skeptical of the funding models and high ratings endowed on many European banks and have been cautious domestically as U.S. banks continue to adjust to a post Dodd-Frank world. (This was illustrated most recently by Moody's downgrade of Bank of America and Wells Fargo in order to reflect lower government support.) We like senior tranches of high quality asset-backed securities and find value in agency mortgage-backed securities. Both asset classes have low exposure to Europe and have proven resilient in times of economic weakness. Furthermore (as we wrote last month), with the Fed on hold, extending 2-3 years into high-grade credit offers an attractive yield pickup without sacrificing liquidity. High quality industrials, like General Mills and Caterpillar, also remain high on our list.

Fall is typically a tumultuous time in the markets and we expect the ride to be bumpy heading into year end.

Please feel free to contact the desk with any questions or concerns.

Form ADV Part II

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