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Thursday, 19 March 2009

Flash Notes

US: The Fed Shocks and Markets Rejoice

- The Federal Open Market Committee (FOMC), while maintaining the target fed funds rate between 0% and 0.25% "for an extended period", delivered two market-moving policy announcements at the conclusion of the March 17-18 meeting:

    - The first is the decision to purchase $300 billion worth of longer-term Treasury securities, primarily along the 2-year to 10-year spectrum (predominantly on the nominal curve and to a lesser extent the TIPS curve), over the next six months, with two to three auctions per week on average (the first auction expected late next week).

    - The second announcement pertains to increasing the extent of agency debt (to $200 billion from the current size of $100 billion) and agency MBS (to $1.25 trillion from the existing $500 billion) purchases by an additional $850 billion this year. In total, the Open Market Desk will purchase an additional $1.15 trillion worth of longer-term securities (US Treasury, agency debt and MBS).

- Of the two announcements, the former (Treasury debt purchases) probably induced a more noticeable knee-jerk reaction in markets simply because the majority of the Committee voted against it at the last meeting in January (with the exception of Lacker's dissent), and NY Fed President Dudley also downplayed the idea roughly two weeks ago. While longer-term Treasury yields did downshift decisively on Wednesday--and likely to be artificially held down for now--the evidence in favor of a more sustained market impact is probably less conclusive. Indeed, the literature on this topic implies that only when central bank and Treasury actions are synchronized, the net market reaction could be more enduring; however, when the central bank and Treasury are on opposite sides of the curve, like in the current episode (i.e., with additional Treasury debt issuance implying upward pressure on yields, while Fed buying implying some downward pressure on yields), the net impact might be less apparent over time. A likely result, however, is that the longer-end of the Treasury curve could be exposed to greater unnecessary volatility (typically, the shorter-end of the curve tends to be more volatile than the longer-end of the curve).

- While the enlargement of the agency (debt and MBS) purchase program by the Committee was not entirely unexpected, the sheer magnitude of the agency program together with the size and complexity of the Term Asset-Backed Securities Loan Facility (TALF) would surely raise additional concerns surrounding the management of the Fed's bloated balance sheet in due time. Firstly, it is important to emphasize that although the Fed's purchase of Treasury and agency securities and the TALF program would further stretch its balance sheet, all else equal, the two different asset categories tend to offer different implications for the management of reserves (i.e., the liabilities portion of the Fed's balance sheet). And over time, when the Fed decides to shrink its balance sheet, the risks of greater market volatility, with some degree of market disruption probably inevitable, could become evident.

- In light of the aforementioned considerations, why did the Committee choose to surprise markets? There are at least two plausible explanations, in my judgment. The first rationale is that there is increasing risks that the growth and inflation outlook could be more dire. The tone of the accompanying March statement, however, seems to underscore the Committee's perception that the downturn could be broadening but not necessarily deepening. While the phraseology of the first two paragraphs of the statement suggests less certainty on the timing of the economic recovery, the Committee omits the "downside risks" reference to the outlook. Therefore, the overall tone does not conclusively imply a more ominous outlook. The second explanation, which appears to carry more weight, is that given the recent tentative stabilization in market confidence, the Committee might view this as an opportunity to further reinforce the positive momentum in markets. Certainly, the conclusion of the financial stress test of the largest banks (by the end of April latest) could potentially require additional capital needs and a more favorable market environment (given the allowance to raise private capital for the initial six months). Similarly, the "Public-Private Investment Fund" (with the involvement of the Treasury, Fed, FDIC and private participants) presumably would also garner more support if market conditions are less adverse in the near-term. Hence, positive policy jolts from the Fed to improve market confidence should help foster the ongoing government initiatives.

- Finally, the latter portion of the March statement, which removes the reference that it will "…assess whether expansions or modifications to lending facilities would serve to further support credit markets…", implies that the Fed has probably laid down most, if not all, of the available policy options at this time, albeit leaving additional leeway to enlarge and/or extend the existing programs if needed. If so, the intensity of the policy debates over time would increasingly surround exit strategies and Congressional approvals to assist an orderly shrinkage of the Fed's balance sheet.

Note: A copy of the March post-meeting statement can be obtained from http://www.federalreserve.gov/newsevents/press/monetary/20090318a.htm