INVESTMENT IMPLICATIONS OF AN “ACTIVIST” FEDERAL RESERVE

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INVESTMENT STRATEGY GROUP
**Introduction: The Role of the Federal Reserve**

The Federal Reserve System (the Fed) is the central bank of the United States. It was founded by Congress in 1913 to provide the nation with a safer, more flexible, and more stable monetary and financial system.

A major role of the Fed is conducting the nation’s monetary policy in pursuit of maximum employment, stable prices, and moderate long-term interest rates. The term “monetary policy” refers to what the Fed does to influence the amount of money, credit, and level of interest rates in the U.S. economy. By implementing effective monetary policy, the Fed can maintain stable prices—thereby supporting conditions for long-term economic growth and maximum employment.

In addition, the Fed supervises banking institutions, protects consumers’ credit rights, maintains the stability of the financial system, contains systemic risks that may arise in financial markets, and provides financial services to depository institutions and governments—including playing a major role in operating the nation’s payments system.

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**The Fed’s Aggressive Response to the Financial Crisis**

Prior to the crisis, the Fed implemented monetary policy by controlling short-term borrowing rates via the “target federal funds rate.” It raised short-term rates to slow economic activity, and lowered them to stimulate activity. Longer-term rates would typically move in sympathy. In response to the crisis, the Fed dropped the target federal funds rate from 5 1/4% to effectively 0%, which was an extraordinarily rapid monetary policy easing. Figure 1 illustrates the yield curve (Treasury yields vs. maturity date) and the Fed’s interest rate operations.

In response to the financial crisis of 2008, the Fed embarked on an unprecedented expansion of its monetary policy. Meanwhile, the U.S. recovery has been gaining ground and leading markets to think about the end of the Fed’s ultra-easy monetary policy.

This paper reviews the response to the crisis by the Fed, and identifies potential concerns as the Fed ultimately returns to its traditional monetary policy.

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**Figure 1: U.S. Treasury Yield Curves and The Fed’s Influence**

(Source: Janney ISG, Bloomberg)
In addition to reducing short-term rates, the Fed implemented a number of programs designed to support the liquidity of financial institutions and foster improved conditions in financial markets. While many of the crisis-related programs have expired or been closed, the Fed continues to take actions to fulfill its objectives for monetary policy: maximum employment and price stability.

“Quantitative Easing” (QE)
Over recent years, many of these actions have involved substantial purchases of longer-term securities aimed at putting downward pressure on longer-term interest rates and easing overall financial conditions. These purchases are widely known as “Quantitative Easing” or “QE”. Through QE, the Fed purchases assets with money it creates in the form of bank reserves. The Fed is currently expanding its balance sheet (a financial statement that summarizes assets, liabilities, and equity of an entity) by purchasing mortgage-backed securities at a pace of $40 billion per month, and longer-term Treasury securities at a pace of $45 billion per month. The Fed pays the banks it is buying securities from in the form of bank reserves held at the Fed (a Fed liability). QE has resulted in the Fed’s balance sheet expanding from a pre-crisis $800 billion to a current $3.9 trillion and a significant increase in excess banking system reserves.

These purchases have also absorbed a tremendous amount of supply that would otherwise make it into the open market—resulting in higher Treasury and mortgage security prices and, consequently, lower yields (bond yields move inversely with prices). This has helped stimulate the economy and has also supported many other asset prices, including home prices and stocks as discussed below.

Importance of Avoiding Deflation: This Fed activism since the financial crisis has enabled inflation to remain at a low, stable level. Figure 2 shows the deflationary shock that accompanied the financial crisis. In an economy with substantial consumer debt levels, avoiding deflation was extremely important. Deflation was a major problem in the Great Depression and in Japan over the last few decades.

With deflation, consumers delay purchases thinking they will get lower prices in the future, while real debt levels (debt adjusted for inflation) increase—making it harder to pay them off. Example: Mortgage debt does not get adjusted down as home prices and wages fall with deflation. This makes it very hard for consumers to pay down debt or “de-lever”—a process the U.S. consumer has been able to accomplish as a result of avoiding deflation. Similar analogies can be drawn for government debt.

Fed Activism has Supported Many Asset Prices: The aggressive Fed action has fostered a recovery in the housing market—a major contributor to economic growth—and it has had a major influence on the pricing of many other asset classes, including stocks and numerous global assets. The potential return on stocks and many global assets has looked more appealing relative to extremely low returns available in the U.S. bond market. Figure 3 shows consumer net worth, which is now making new all-time highs as a result of avoiding deflation, improving housing conditions, and rising stock prices.
Concerns over the Fed’s Exit Strategy

The ability of the Fed to exit this “easy money” policy, and the impact it will have on global financial assets, is a major topic within the investment community. The Fed operates with a very blunt instrument—interest rates—and there are always unintended consequences as a result of its actions. Monetary policy also works with a lag, and the Fed must use forecasts and projections that are imprecise. Meanwhile, the potential for error has been magnified by the many unconventional measures taken by the Fed.

We discuss the potential impact of the Fed’s exit from this unprecedented action in the following sections.

The Importance of the Fed’s Balance Sheet: The Fed holds the mortgage and Treasury securities it is buying as assets on its balance sheet. Offsetting these assets are liabilities in the form of banking system reserves that depository institutions (major U.S. banks) hold with the Fed. These banking system reserves are the raw fuel for money and credit creation in the economy, and are currently at very high levels. As confidence and the economy improve, these reserves could ultimately end up in the real economy as business and consumer loans. This increased economic activity could cause inflationary pressures to build unless controlled properly.

Fortunately, the Fed believes it has the ability to control these excess reserves. Most importantly, in October 2008, Congress gave the Federal Reserve authority to pay interest on banks’ reserve balances. By increasing the interest rate on reserves, the Fed will be able to put significant upward pressure on all short-term interest rates, as banks will not lend at rates significantly below what they can earn by holding reserves at the Fed. The Fed will have the ability to fine-tune the spread between what banks can earn on their risk-free deposits at the Fed, and what they can earn on other types of riskier loans and investments. This should also cause longer-term interest rates (the entire yield curve) to shift higher.

The implication is that the Fed can increase market interest rates and slow the pace of bank lending and money creation, without changing the

What is Inflation?

Inflation is defined as a rise in the general price level for goods and services (falling purchasing power)—the Fed targets 2% inflation and pays closest attention to the GDP price deflator, a broader measure of inflation than the consumer-driven CPI.

Inflation can be caused by: 1) an increase in the money supply, which can cause demand for goods and services to increase (demand-pull inflation) or 2) an increase in production costs, such as rapidly rising wages or raw material prices (cost-push inflation). There is currently significant slack in labor markets and capacity utilization, while the global slowdown has significantly reduced raw material price pressures. All of this points to a lack of cost-push inflation in the current environment.

This leaves the dramatic increase in excess bank reserves as a source of inflation concern. The bond-buying (or quantitative easing) by the Fed results in money entering the economy via increased reserves in the banking system (i.e., deposits of commercial banks at the central bank). This gives depository institutions the ability to make new loans. Currently, there is not strong demand for loans in the economy. If loan demand were to pick up, and if the banks lent their excess reserves freely, this could result in demand-pull inflation. This is the major concern of many market participants that are against the Fed’s “Easy Money” policy.
quantity of reserves. As Fed economists put it: “... the rate of interest paid on reserves now acts as a valve, reducing the pressure that the Fed purchases [of securities] might place on banks to increase lending and thereby spur money growth... the reserves are put in a sort of reservoir, relieving a flow that could ultimately generate higher inflation.”

**Historical Examples:** There are historical examples that suggest the Fed’s plan will work. A Fed study looked at the historical record and operating procedures for eight central banks. Five of them (the ECB, the Bank of Japan, the Bank of England, the Bank of Canada, and Norges Bank) are currently operating a ‘floor system’ in which banks are left with substantial excess holdings of central bank balances, and the short-term market interest rate is allowed to trade at a level close to the floor. The study finds multiple examples over the past 10 years of policy tightening that was not accompanied by draining excess reserves. The interest rate paid on reserves served as an effective floor, as market rates were guided higher. The Fed concludes that “...interest paid on excess reserve balances...can be used by a central bank to tighten monetary policy and reduce reliance on supporting operations to drain balances.”

The historical examples are not all directly comparable with the Fed’s position, but they at least provide some confidence that the Fed’s plan to raise rates without significantly draining reserves will probably be effective.

**The key to controlling the excess bank reserves and the Fed’s balance sheet will be accurate forecasts for economic growth and inflation. Considering that monetary policy acts with a lag and that economic forecasts are inherently uncertain, the timing of increasing interest rates is critical in order to avoid an inflation problem or stall the economic recovery through unnecessarily tight credit conditions.**

**The “Mini Stress Test” of Late May through Mid-September—the Start of Tapering**

In May, with many assets at multi-year highs, the Fed began to discuss its plan to gradually end (taper) its large scale asset purchases. Tapering would likely begin in late 2013 and end in the middle of 2014. This news caused a global volatility shock that uncovered some potential financial fragility.

**Returning to a Normal-Size Balance Sheet**

The Fed plans to eventually return to a balance sheet that is normal in size and is comprised mostly of Treasury securities. Despite the massive increase in scale and duration of its securities holdings, right-sizing the balance sheet can still occur largely via run-off (bonds maturing), rather than through asset sale.

Historically, the Fed has held about 1/3 of its assets in the form of T-bills (securities with a maturity of one year or less). Prior to the financial crisis, more than 50% of its Treasury holdings matured within one year. Fed activity has significantly increased the average maturity of the Fed’s Treasury holdings. Even if the Fed were to stop buying assets tomorrow, its holdings of Treasury securities would not even begin to run off until the end of 2015.

Still, the pace at which the Fed’s portfolio would shrink merely as a result of passive run-off is probably underappreciated. The average maturity of its Treasury holdings is about 10 years. The amount of mortgage debt on the Fed’s balance sheet will be cut in half in about five years, even if the Fed does not seek to actively sell them.

In the case where the Fed does not sell assets, but relies simply on passive run-off, it will probably take 6½ years after QE ends for the excess reserves to be completely absorbed (mid-2020). However, the Fed would still own a significant amount of mortgage debt at that time. As such, it may still not consider its balance sheet to have returned to ‘normal’.
The shock impacted many asset classes, especially those closely correlated with interest rates, as monetary policy expectations reset. The impact was especially strong on U.S. longer-term Treasury rates and mortgage rates—the main targets of the Fed’s ultra-easy policy. Emerging market equity and debt markets were also strongly impacted, along with many other interest-rate-sensitive asset classes. Figure 4 summarizes the market movement of major asset classes from mid-May through mid-September.

Tapering is not Tightening…
Tapering involves the reduction of the Fed’s current large-scale asset purchases (thus reducing Quantitative Easing). The Fed is currently buying $85 billion per month in Treasury and mortgage securities. It intends to reduce these purchases over several months, until it is no longer making purchases. This should not be confused with traditional monetary tightening, which would involve raising short-term interest rates. We do not anticipate the Fed raising short-term interest rates until long after it has completed its QE program. Most projections do not show the Fed raising short-term rates until 2015 or even 2016.

The 10-year Treasury moved from a yield of 1.93% to 2.88%, while 30-year mortgage rates went from 3.89% to 4.86% over this time period. This caused a noticeable slowdown in the housing market—a significant part of the economy that the Fed has been actively trying to improve, and one that is critical to a self-sustaining economic recovery.

Impact on Bond Surrogates: Asset classes that benefitted as income alternatives to bonds suffered a significant sell-off over this period. These “bond surrogates” include Real Estate Investment Trusts (REITs), Master Limited Partnerships (MLPs), Consumer Staples, Utilities, and Telecom stocks.

The Janney Investment Strategy Group (ISG) believes that the sell-off in REITs has produced solid value for this asset class, especially as occupancy and rental rates increase with an improving economy. ISG remains favorable toward MLPs, which are major benefactors of the energy renaissance occurring in the U.S.

ISG expects Consumer Staples, Utilities, and Telecom sectors to underperform the more cyclic sectors, once the Fed feels the economy is in a self-sustaining recovery.

Figure 4: Major Asset Class Returns from May 15th through September 13th

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>10-year Treasury</td>
<td>-7.2</td>
</tr>
<tr>
<td>REITs</td>
<td>-13.4</td>
</tr>
<tr>
<td>EM Bonds</td>
<td>-11.6</td>
</tr>
<tr>
<td>Telecom</td>
<td>-8.9</td>
</tr>
<tr>
<td>Utilities</td>
<td>-6.6</td>
</tr>
<tr>
<td>EM Equities</td>
<td>-4.3</td>
</tr>
<tr>
<td>MLPs</td>
<td>-4.0</td>
</tr>
<tr>
<td>Consumer Staples</td>
<td>-2.9</td>
</tr>
<tr>
<td>Financials</td>
<td>2.3</td>
</tr>
<tr>
<td>S&amp;P 500 Index</td>
<td>2.4</td>
</tr>
<tr>
<td>Technology</td>
<td>3.9</td>
</tr>
<tr>
<td>Consumer Discretionary</td>
<td>4.8</td>
</tr>
<tr>
<td>Industrial Sector</td>
<td>6.0</td>
</tr>
</tbody>
</table>

(Source: Janney ISG, Bloomberg)
ISG expects undervalued Industrials, Technology, and Financials to outperform once tapering begins. A normalized interest rate environment will also benefit the profit models of financial institutions that borrow at short-term rates and make loans at longer-term rates.

**Impact on Emerging Markets:** During the May-to-September period, emerging markets (EM) faced sustained capital outflows for the first time since the Lehman Brothers collapse in September 2008. EM assets are beneficiaries of easy global monetary conditions that will change with Fed tapering. Evidence of slower EM growth is also mounting, and many of these countries are in need of structural economic reforms. ISG currently holds underweight positions in most EM countries, with China being the exception.

**A Key Risk to the Fed’s Exit Strategy:** A key risk to the Fed’s exit is the potential for long-term interest rates to overshoot and create tighter credit conditions and slower economic growth than intended. The Fed is actively targeting its communication toward this concern, and is communicating that short-term rates will stay low long after QE ends—probably into 2015 or 2016.

**Other Risks:** Many high-yield bond issuers have been able to obtain easy financing that may not exist under tighter monetary conditions. There has also been yield-seeking behavior among pension funds and insurers, and an extension in portfolio duration (owning more long-term bonds for higher yields). If long-term interest rates overshoot, significant portfolio losses and forced asset sales could occur.

**Summary**

The Fed’s actions have enabled a slow economic recovery to develop, with signs of a self-sustaining recovery on the horizon. As the Fed ultimately exits its easy monetary policy, there is the potential for unintended consequences to occur. We are closely monitoring the economic data and asset classes to ensure that client portfolios are properly positioned for the constantly changing investment landscape.

For additional information, contact your Janney Financial Advisor

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