SISR Strategic International Securities Research Inc.
An Independent Research Firm

Political Economic Review:
The Federal Reserve

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SISR Political Economic Notes

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FOMC Decision to Purchase Treasuries, Agency Mortgage Backed Securities, and Launch TALF – Rates Remain Unchanged

I. <u>Introduction</u>

This afternoon the FOMC committee made major news at their FOMC committee meeting by:

1. <u>Maintaining the target range</u> for the federal funds rate at 0 to 1/4%.
2. <u>To support mortgage lending and the housing markets</u>, the Committee this year will direct the purchase up and additional 750 Billion of agency mortgage-backed securities bring the total to $1.25 Trillion.
3. Will <u>increase its purchase of other agency debt</u> by $100B to a total of $200B.
4. Will <u>direct the purchase of $300B of longer term Treasury Securities</u> over the next 6 months.
5. <u>TALF was launched</u> to extend credit to extend credit to households, student loans, credit cards, small businesses and the real estate market.

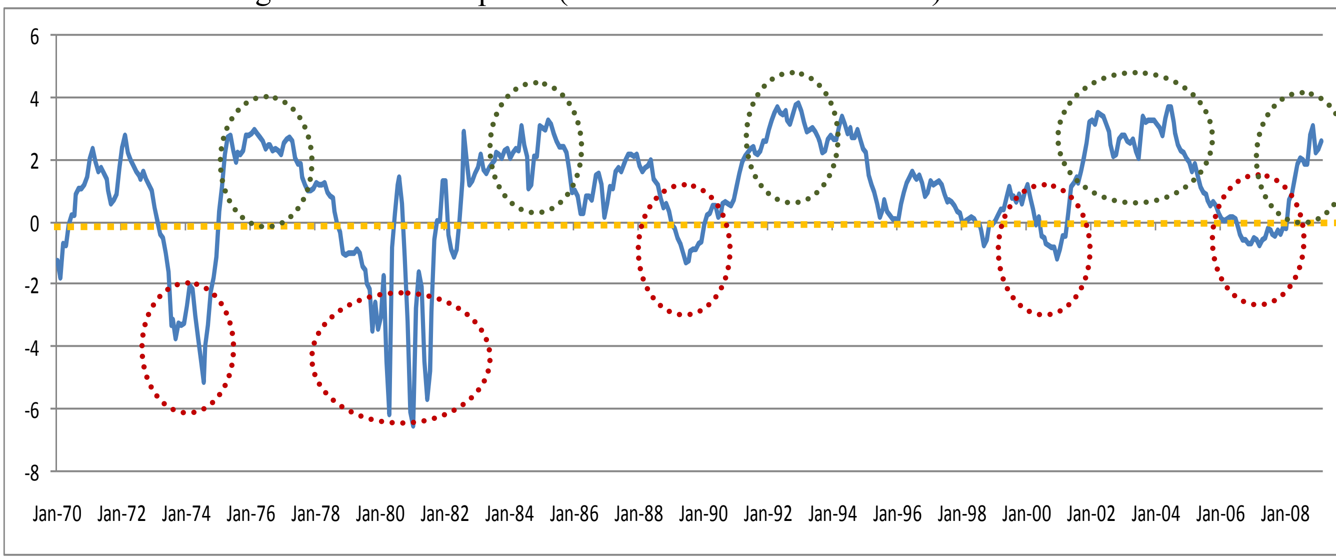
II. <u>Implications of FOMC ACTION of March 18, 2009</u>

1. <u>Maintaining the Target Fed Funds Rate</u>

By keeping the fed funds rate low this has been one of the mechanisms by which the Federal Reserve has enabled the banks to become profitable. We have argued extensively over the past few weeks about the importance during a recession of keeping the FFBond rate over 2%.

In February and March of 2008 we argued that one of the central conditions for economy to emerge from a recession was what we identified as Principle #2: That the FFBond relationship needs to be clearly in the positive by 1.5% or greater for an extended period for the financial institutions to be expected to recover, and in each recession this relationship went negative prior to the recession. With the announcement of expected profitability by Citigroup (C), Bank of America (BAC) and JP Morgan (JPM) last week, the fruit of those efforts by the Federal Reserve have become apparent.

Figure I: FFBond Spread (10 Year note less Fed Funds) 1970 to 2009



Source: Federal Reserve, SISR

With the expected profitability of these three referenced major banks, the markets soared last week and were up nearly 10% for the week. Viewing the Figure above we find that each time in the FFBond ratio went below the zero line for several months a recession was not far behind. This occurred as can be see in 1974, 1979-80, 1990, 2000, and yes 2007 (the red circles). Similarly, in each period of recovery the FFBond ratio exceeded 2% during the recovery (Green circles) including 2008-9. This pattern works like clockwork, and it is clearly in play today, and the likely reason that the Federal Reserve has decided to maintain the Fed Funds rate at 0 to 0.25%.

2. To Provide an Additional $750B to the Agency Mortgage-Backed Securities

This brings the total of purchases of agency backed mortgages to a $1.25T. This program was announced several months ago where the Treasury would purchases Fannie and Freddie mortgage backed securities enabling the mortgage rates to come down by creating more demand for these assets while lowering the interest rate on mortgages.

3. The Purchase of $100B of other Agency Dept

The FOMC provided for an additional $100B to the existing program of $100B for the purchase of agency debt this year. This would include student loans from Sallie Mae, Small Business Administration (SBA) and other government agencies. This program was also previously announced but the level of support for this program has now been doubled.

4. <u>Purchase of Long Term Securities</u>

<u>The component of the press release that made the most news and was of the greatest interest to the markets was that the Federal Reserve would purchase $300B in long term Treasury Securities over the next six months.</u> The net effect of this action would be to increase the demand for these longer term Treasury Securities which in turn would lower interest rates. <u>The immediate reaction was for the long term bonds to drop significantly. The 5 year went from a yield at the close yesterday of 2.00 to 1.54, the 10 year went from 3.02 to 2.51, and the 30 year went from 3.83 to 3.57.</u>

The purchase will have the effect of increasing liquidity into the system, but with money supply already growing at 18% annualized for the past 4 months, many have been asking what will be the long term effect on interest rates, if inflation is to occur from all this added liquidity. The obvious answer is that we are at war and hope to live till tomorrow and will worry about next year when we are there assuming we live to see the day. Bernanke was quite clear about this point in his testimony to the Senate several weeks ago to this exact question. He was emphatic that he thought that as the economy gained strength he would be able to reel in money growth in an effective way so that the economy neither heads into a serious inflationary condition, nor does growth stall.

The Bank of England is pursuing this same policy which has the effect of also increasing money supply in the U.K. The EU is working on various stimulus packages. We at this point feel confident that these regions including Japan will be as successful as the U.S. in raining in excess liquidity when it becomes appropriate to do so.

We are less confident, however, in the ability of China to do so and other developing countries that also have been attempting to use various stimulus programs. In fact one of the reasons that the U.S. did not experience inflation from 2003 to 2007 when oil was increasing at a rather rapid rate, was the import deflation from China had muted the impact of oil while China was increasing their money supply at rates in excess 15% to help their growing economy. The money system unlike the 1960 to 1980 when Friedman elaborated his theories, are now impacted more by international flows than domestic flows. Bernanke has written extensively as a Professor on this point, and we can only hope he is successful in cajoling all necessary parties. We have been warning about this concern for some time now, and can only hope that international cooperation will win out over provincial gains.

There is a second troubling aspect of this action, however, in that with the long bond yields falling this significantly has reduced the FFBond rate, which has been helpful for bank profitability during this trying period. By reducing yields significantly we have in effect reduced the spread by the amount of the decline in yield from 2.75% down to 2.25%in a single day. We expect that this step was necessary for the Federal Reserve to continue providing liquidity to the system, in light of the fact that they could not reduce the Fed Fund as a way to increase money supply.

At this juncture we really cannot make an intelligent assessment about where all the fallout will be and how successful ultimately all these maneuvers will be, nor do we believe that this affliction is limited to SISR only. However, what we can say with 100% certainty is that the Federal Reserve has created significant employment for the next two generations of upcoming PhD candidates in economics. To this we can add that the dismal science will not go the way of the Edsel for at least the next few generations. We wish Chairman Bernanke wonderful health and to the extent that he decides to head back to academia when he completes his work at the Federal Reserve, we would expect that he will be reading dissertations on these actions well into his 90's.

5. Launching of the TALF Program

The FOMC announced that they would launching the Term Asset-Backed Securities Loan Facility (TALF) with the intention of extending credit to households and small businesses and other asset classes including mortgages.

TALF I The TALF program was originally set up on November 25, 2008 within the Federal Reserve with 200 B in assets with the mandate to: "lend up to $200 billion on a non-recourse basis to holders of certain AAA-rated backed by newly and recently originated consumer and small business loans. The FRBNY will lend an amount equal to the market value of the ABS less a haircut and will be secured at all times by the ABS."

TALF II was expanded on February 10 to 1 Trillion dollars, and "could broaden the eligible collateral to encompass other types of newly issued AAA-rated asset backed securities, such as commercial mortgage backed securities, private-label residential mortgage-backed securities, and other asset backed securities…The Board's objective in expanding the TALF would be to provide additional assistance to financial markets and institutions in meeting the credit needs of households and businesses and thus to support overall economic growth in the current period of severe financial strains." The TALF programs we believe are the first steps in creating a market and creating a basis of value for these troubled assets, while enabling the banks to use some of those assets as capital for lending purposes.

Today the FOMC announced that they were beginning to take applications for this program and it was in the process of being launched imminently. We believe that this program in conjunction with the public-private Investment Fund: will be the vehicle for moving these toxic assets off the balance sheets of banks and with private funds in conjunction with government capital backing once a market can be made and a value placed on them. The TALF will help create a market value and the Public Private Investment Fund will purchase these troubled assets that are currently frozen and have a limited market i.e. level 3 assets on the balance sheets of banks.

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