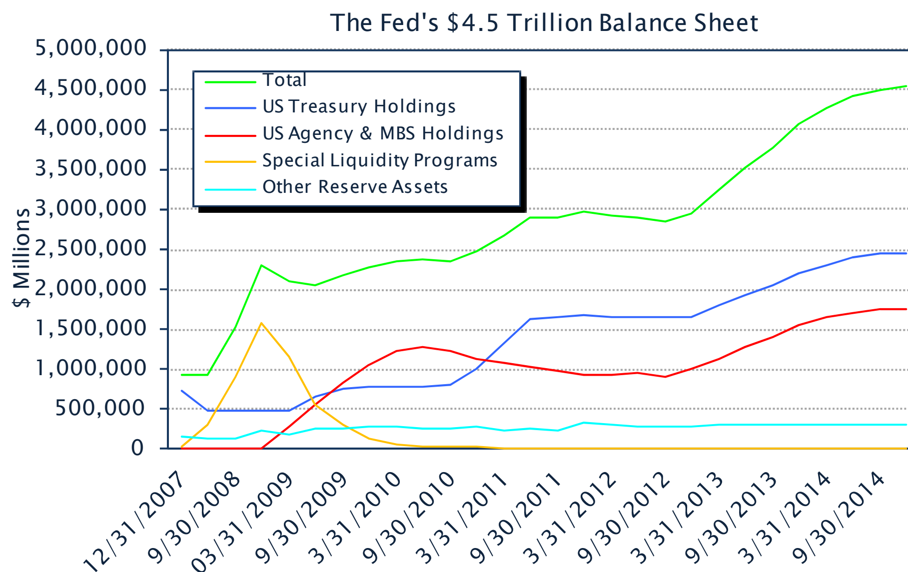
NOVEMBER 2014

# INVESTMENT UPDATE

This month, the Federal Reserve will stop doing something it has been doing for the past 20 months or so: Adding to the trillions of dollars of Treasury securities and US Agency-issued mortgage-backed securities (MBS) it holds in its portfolio. And yet, the Fed will still be buying billions of dollars of Treasuries and Agencies each month for the foreseeable future.

Say what? They're buying but not buying?

Yes, the Fed will end its large-scale asset purchase plan this month, a program that has been in place since the start of 2013. It has been tapering its buying of Treasuries and MBS, in $10 billion increments, since January 2014 from approximately $85 billion per month. Of course, this was the third phase of the Fed's quantitative easing program, a program which traces its beginnings to the dark autumn days of 2008, when the collapse of Lehman Brothers threatened to bring down the world's financial system. As the chart on this page shows, the purchasing of government-issued bonds, designed to keep longer-term interest rates low in order to stimulate the economy, has ballooned the Federal Reserve's balance sheet to more than 4.5 *trillion* dollars, a nearly five-fold increase since before the crisis.



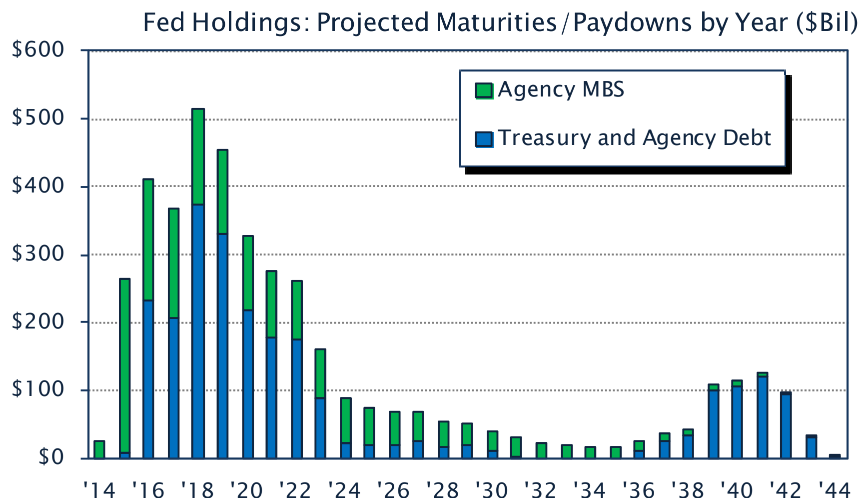

The end of the program does not mean that the Fed is ready to allow its balance sheet to shrink from its current gargantuan proportions. The sheer size and type of bonds in the portfolio means that it generates massive cash flow, both from maturing bonds and coupon income, but also from monthly principal paydowns and prepayments from MBS. Left alone, the Fed's holdings (average duration, for you bond geeks: 6.5 years) will pay down and mature fairly quickly; as the chart on the next page shows, under a "standard" model of prepayments for the coming years, the Fed's current portfolio of Treasuries, Agency debt and Agency MBS will pay down by more than half by 2020, and 75% will have paid off within 10 years. Keep in mind that this chart includes only the principal value of the Fed's maturing holdings—it does not include the billions in additional cash flow from coupon income that the portfolio is scheduled to generate in coming years, money that, as of now, will also be reinvested.

Allowing the portfolio to pay down and shrink would mean that "the market" would have to digest all the maturing holdings the Fed now holds as well as any new supply of Treasuries and MBS issued in coming years, instead of the Fed sucking up a huge chunk of it, as it has been. In the case of the MBS holdings, now that the Fed holds approximately 1/3 of the outstanding Agency MBS market, the average monthly principal paydowns are so large that reinvesting is equivalent, in most months, to the entire net new supply of MBS issued by the Agencies; November is shaping up to be such a month, with just $22 billion in estimated new Agency MBS, net of paydowns. And while a surge in home buying would mean more MBS supply for investors to pick from, that doesn't appear to be in the cards any time soon. As a result, the Giant Sucking Sound from the Fed will continue until further notice, despite "the end" of the QE program.

So while the Fed's balance sheet is likely to remain at current levels, at least for the time being, the European Central Bank (ECB) is trying to ramp theirs up. With European economic growth at a virtual standstill, and many member economies

flirting with the awful prospect of deflation, the ECB is finally realizing that it has messed up. In stark contrast to the Fed, which has expanded its balance sheet by more than $1 trillion over the past 18 months, the ECB has shrunk its by €1 trillion ($1.25 trillion). Currently, if the ECB wants to have the same amount of assets relative to GDP as the Fed, it will have to purchase an additional €2.5 trillion ($3.1 trillion) of bonds, far below its stated target of €1 trillion in purchases. Given that ECB members' economies are far weaker than ours implies that even €2.5 trillion might not provide a sufficient degree of stimulus.

On the face of it, the ECB appears to be fumbling the ball. That's understandable, as its job is much harder than the Fed's; there are 18 different countries in the Eurozone, with varying degrees of economic health and resources, a wide range of political obstacles, and separate and unequal bond markets. Even simple decisions are made difficult due to the politics involved—consider the seemingly-straightforward decision of which bonds to buy—for the Fed it was easy: buy US Treasuries and government-issued MBS. But critics will point out that the ECB is playing favorites if it buys French government bonds and not Italian or Spanish bonds. Buying government bonds based on the countries' GDP is a possibility, but that won't address the differing levels of economic health—and stimulus needs—among the member countries. As a result the ECB has shelved the idea of government bond purchases (for now) and is targeting purchases totaling €1 trillion of "covered" (collateralized, in US parlance) corporate bonds and asset-backed securities instead. But here again, there may not be enough of these bonds with sufficient liquidity and size to meet the program's needs.




It seems pretty clear that the ECB will have to broaden the list of acceptable securities for purchase, including purchasing government-issued debt of member countries. The political details are messy, but if they can be worked out, ECB government bond purchases can be very effective at targeting those economies most needing a monetary shot in the arm. There has also been some talk of the ECB expanding its range of assets to be purchased to include bank debt and uncovered/uncollateralized corporate bonds. As you may recall, the Fed decided against direct purchases of non-Government debt (although it took in certain assets as collateral for loans in the "special liquidity programs" that were put in place in the early days of the financial crisis) for fear of, once again, playing favorites. The ECB is up against the same political and policy roadblocks, plus the additional constraint of the relatively small (approximately €1.5 trillion) and lopsided (French issuers represent 44%) nature of the Euro corporate bond market. A good compromise (but one requiring a lot more time and political maneuvering to make happen) would be to purchase bank loans/bonds, since the lion's share of corporate borrowing in Europe is still done through banks. This would require the ECB to take on credit risk, which they are understandably reluctant to do, given "moral hazard" objections in the wake of the financial crisis. But buying bank loans has an additional benefit, as it would inject liquidity and capital into the European banking system, which is sorely needed.

The main objective, both here in the US and in Europe, is to avoid the "Japanese experience" of the last 20+ years, where an aging population and a poorly-run banking system created an excess of saving, a lack of spending, near-zero economic growth, a dalliance with deflation and—as a result—interest rates that begin with a "zero." While the cost has been high—and the jury has still not rendered a final verdict—it must be said that the Federal Reserve has been far more effective than its foreign counterparts in spurring domestic economic growth.

Meanwhile, the ECB and the Bank of Japan need to put together programs that will prevent their economies from falling into deflationary spirals by providing liquidity and spurring risk-taking by companies and investors. As we've seen, this is a significant challenge given the lack of fiscal stimulus available to most of these economies, nearly all of whom continue to face structural deficit issues in the coming years and decades. But that is the reality facing all modern, "developed" economies: With austerity programs the New Normal, policymakers must stimulate growth without the aid of federal spending programs. As a result, ballooning central bank balance sheets are sure to become a global phenomenon.