

Investment Update



April 2010

Finding the Door

Every old time cowboy and gumshoe knew that the preferred seat in a room was the one facing the door. Even today, when entering a theater or sitting on a plane, it is good practice to know where the exits are.

While the possible options for the Fed's so-called "exit strategy" are many, we think that the reality is fairly straight forward. Long before someone yells "fire," it pays to know in which direction you should run. So today, before the tinder dries, the match is struck and smoke fills the air, Fire Marshall Bernanke is inspecting the premises to ensure that all exit signs are illuminated, paths are clear and stairs are sound. Preparedness

drills prior to an actual crisis help mitigate damage. The Fed is testing mechanisms that rarely or never have been implemented before. Akin to landing a plane on the Hudson River, the Fed hopes that it never has to attempt such a maneuver, but recognizes that practice greatly increases the odds of success should such a course prove necessary.

In trying to discern the Fed's course of action, one must differentiate between the Fed's actions in the area of credit policy versus monetary policy. During the financial crisis, the Fed lowered the federal funds rate to zero to help meet liquidity demand and spur recovery. The Fed likely has heeded Japan's lesson: moving to a zero interest rate alone was not enough. As a result, the Fed adopted a wide array of emergency measures to help offset the collapse in the private credit markets.

Now that the credit markets have returned to a more normal level and positive GDP growth arguably can be sustained, the Fed has determined that these credit support programs should be reduced or eliminated. In February, the Fed closed four emergency backstop lending programs. It also hiked the discount rate charged to banks on direct loans, describing the move as a "normalization of the Federal Reserve's lending facilities." By the end of March, after becoming

satisfied that credit spreads had declined to more appropriate levels, the Fed ended its mortgage-back securities purchase program. To help the Fed, the Treasury Department reinstated its Supplementary Financing Program, which was originally enacted to drain excess liquidity from money markets but had been suspended in 2009. All of these measures are small steps towards credit normalization. In speeches, Chairman Bernanke and other Fed governors have taken great pains to convince market participants that these actions relate to liquidity and credit and are unrelated to monetary policy.

Historically, monetary policy, that is, the supply, availability and cost of money, has been the Fed's primary tool for attaining its dual mandate of maximum

sustainable employment and price or inflation control. Monetary policy has a powerful impact on both the direction and rate of economic growth, albeit with considerable lag time. Having an expansionary monetary policy for too long can increase the chance of an overheated economy, inflation and excess use of leverage and speculation. Tightening the economy too soon can jeopardize a nascent recovery. Investors have recently lived through the former, therefore are understandably nervous about the latter.

The Fed, however, has clarified that, while it is encouraged by recent economic trends, it continues to see many of the risks we have highlighted in recent Updates. These include high unemployment levels, capacity utilization issues, and low manufacturing and exports. These factors should restrain near-term inflation. State and local government spending, unlike federal spending, will be constrained. Credit availability is restrained for consumers and has been largely unavailable to small companies. Consumer debt levels, while improved, remain high. Shrinking wages and consumer wealth, policy uncertainty and rising tax burdens are causing consumers to save more. To us, and we think to the Fed, these factors argue for a more subdued and uneven recovery than typical. To some, they suggest the possibility of a double dip recession. While we do not expect this to happen, these concerns will likely keep the Fed from aggressively raising rates until late 2010 at the earliest. We think that the Fed will weigh history's lesson on premature

tightening more heavily than the intermediate-term risk of higher inflation. In his February 10, 2010 testimony to the House Committee on Financial Services, Chairman Bernanke used the phrase, “at the appropriate time,” on three occasions, implying that he thinks now is not the time.

While steps toward normalization and, ultimately, a less accommodative monetary policy seem appropriate given market response to date, it will be interesting to see if the Fed will be able to continue in this direction. The rate of money supply (M2) is still positive, but declined, as seen in the chart.

If the money supply plunges from its current low levels or if short-term interest rates set by the market, such as LIBOR, rise too much, the Fed might be forced

Slowing Growth in Money Supply Year-Over-Year Percent Change in M2



to resume its purchase of mortgage securities and again suspend its liquidity absorption program.

Two Little Words

Are the markets in the clear regarding more Fed action? Possibly not. In studying the rate-hike cycle’s impact on equity markets, ISI Research found that, during the 1994 cycle, the language change from “considerable period,” which was code for Greenspan’s low-rate period (beginning in August 2003), to “patient in removing policy accommodation” produced an inflection point in both stocks and U.S. currency, even though the first rate hike still was five months away.

The watchwords that describe the current low rate policy are “extended period.” At least one Fed governor used the words “some time” to describe the likely duration of the current policy stance, though he later stated that he was not signaling

any change in view. Several of the economic improvements noted above are necessary preconditions for an eventual reduction in the current, extremely accommodative, monetary stance. We think that the Fed also will want to see clear improvement in credit growth rates and employment gains. We believe that unemployment likely has bottomed and upcoming data reports will reflect modest improvement. As such, a language shift will be the first step in moving toward a more neutral policy stance, and it likely will happen fairly soon. Movement to a more aggressive monetary stance still appears further off.

A handwritten signature in black ink, appearing to read "Chris Sheldon". The signature is fluid and cursive, with a long horizontal stroke at the end.

Christopher Sheldon
Director of Investment Strategy