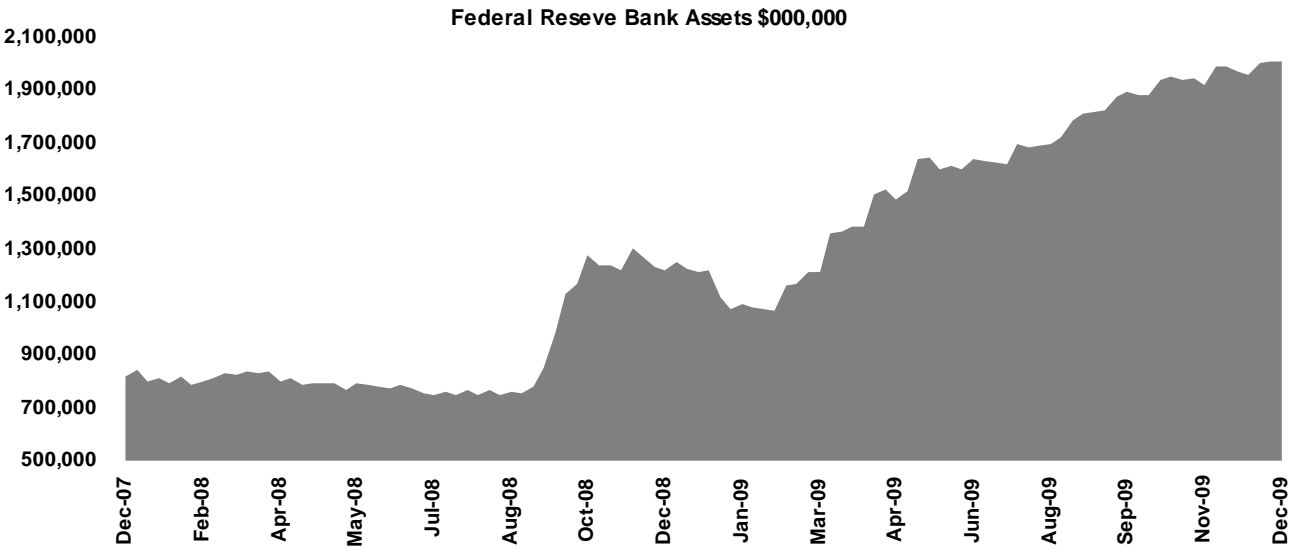


Bernanke "Exit" Strategy and His Penchant for Transparency Is Reassuring For the Markets

In a statement for the House Financial Services Committee earlier this month, Chairman Bernanke laid out, with a reasonable degree of specificity, his "exit" strategy for the Fed. This exit strategy is designed to gradually shrink the Fed's balance sheet and reduce the large quantity of banking reserves/liquidity in the system as part of a comprehensive monetary policy shift to a tightening stance, which presumably the Fed will undertake at some point in the future. Although the Fed's plan does not contain any major surprises, the Chairman's statement should nonetheless be reassuring to a skeptical market, which had viewed the Fed's unprecedented liquidity initiatives over the past 18 months as sowing the seeds of inflation.

Fed Liquidity Injections = Overstepping Authority?

There is little doubt that in 2008 and 2009, the Fed needed to take bold, imaginative steps to deal with the financial crisis, stabilize the markets and avert a catastrophe. As a consequence, the Fed more than doubled the size of its balance sheet as it bought securities, used repos, and generally financed assets and loans while providing much needed liquidity to the market. The Fed was forced to undertake all these initiatives in order to ensure the US financial system continued to function.



Despite facing an unprecedented set of potentially dire circumstances and subsequently making decisions it thought were appropriate and in the best interests of the country, the Fed has come under withering criticism. Some analysts continue to deride the Fed's bailout efforts as over-reaching, overly aggressive and inevitably inflationary. They feel the Fed overstepped its bounds and became involved in the economy in a way that compromises its independence and objectivity. Further, critics suggest that it will be difficult, if not impossible, for the Fed to quickly reverse course and "undo" all of this liquidity creation before we begin to see prices rise as all of this liquidity heats up inflation. The fear is the realization of the inflation hawk maxim; "too much money chasing too few goods."

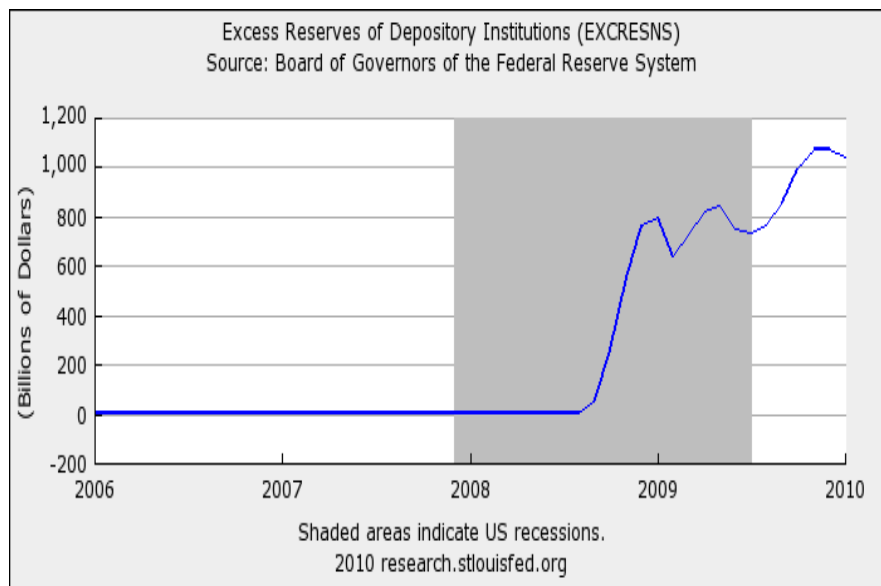
Certainly, with 20/20 hindsight some issues may have been handled differently and perhaps some decisions would have had other outcomes. However, we believe the Fed acted properly, given what was known at the time.

In this report we review the “new” tools the Fed now has at its disposal to manage monetary policy. The Fed is acutely aware that over time it must reduce the size of its balance sheet in an orderly manner that does not disrupt the markets and/or lead to unintended changes in the money supply or financial system liquidity.

“New” Fed Tools

Interest on Reserves

Excess reserves at the Fed have ballooned to over \$1 trillion. As the chart at the left shows; banks have always minimized excess reserves because it is idle cash earning no interest. However, today’s excess reserves are largely the liquidity the Fed has pumped into the economy. As the Fed bought securities from financial institutions, the banks simply deposited the cash proceeds from the sale back into the Federal



Reserve where it still sits idle but is now earning a deposit rate of 0.25%.

It should be noted that these excess reserves are problematic from a macroeconomic perspective. Excess reserves are “idle” funds banks have on deposit. Presumably, the reason the funds are idle is because banks can find no better use for them at the present time. Ideally, the Fed would like to see at least some of these funds find their way into loans, which would help propel the economic recovery. Consequently, these excess reserves represent potential loans which are not being made.

It is apparent that if the economy is going to stage a sustained recovery, growth in the volume of bank lending is essential.

Interest on Reserves II

The Fed has announced it will use its new authority to pay interest on these reserves as a way to regulate the flow of liquid funds into and out of the Federal Reserve Bank and in effect into and out of the money supply. For example, the Fed would increase the rate it pays on these overnight reserves as a way to attract funds when it wants the money supply to contract. The greater the amount of excess reserves, the less liquidity there is outside of the Fed. Conversely, when the Fed wanted to pursue a stimulative policy, it would reduce the rate paid on these deposits as a way to push liquidity out into the system. However, it should also be noted that the current low rate on these reserves, 0.25%, has not discouraged banks from increasing them. Although the Fed will undoubtedly use this interest on reserves as a part of future monetary policy, it is apparent that it may need to do more than simply adjust this reserve deposit rate.

Term Deposit Facilities

The Fed will also establish a term deposit facility in which it would hold an auction for deposits. These term deposits would be analogous to certificates of deposit. Presumably the institutions holding excess reserves would be inclined to participate since the rate for the term deposits would be greater than the overnight excess reserve rate. These term deposits would not be part of an institution’s reserve calculation but simply a short term investment with no credit risk counterparty.

The Fed is also considering inviting non-primary dealers to participate in the auction for these term deposits. Presumably these new invitees would be money market funds. The Fed is confident that the managers of these funds would welcome the opportunity to participate in the auctions and hold Federal Reserve backed CDs.

Repurchase Agreements

Although the Fed routinely uses repurchase agreements as part of normal open market operations, it intends to expand its use of repos in the future. The Fed has recently been testing the system it would use to provide these repos to the market. The key with these repos is the size of the transactions. Given the huge amount of securities on the Fed's balance sheet, these repos will need to be relatively large.

In a repo transaction, the Fed will sell securities to an institution/counterparty with an agreement to buy the securities back at a future date at a specified price. The counterparty has access to the securities for a limited period of time in exchange for cash. By doing this in sufficient volume the Fed can reduce banking system reserves by hundreds of billions of dollars very quickly.

Selling Assets/Securities

Another tactic that the Fed will be using is to simply sell securities it currently owns. Such actions would drain reserves from the system, shrink the size of the Fed's balance sheet and reduce the money supply. Recently, Chairman Bernanke clearly indicated that the Fed would not sell any of its assets or securities in the *"near term, (until) after policy tightening has gotten underway and the economy is clearly in a sustainable recovery."*

Some fear that when the Fed begins to liquidate securities it is holding, primarily mortgage backed securities and US Agency debt, this supply will drive the yields on these instruments higher. Certainly this is a legitimate concern, but from the Fed's perspective, the sale of these assets would be having the desired effect. For example, a sale of securities implies the Fed wants to reduce the amount of liquidity/reserves held by banks and others. This reduction in liquidity will presumably be part of a shift in monetary policy to a tightening stance. Since one of the intended outcomes associated with a monetary tightening is a rise in interest rates; a sale of securities by the Fed will help the Fed to achieve its objectives.

Transparency

Ever since his appointment to the Chairmanship, Bernanke has been irrevocably committed to the concept of transparency at the Federal Reserve. Among other things, Fed transparency is intended to reduce some of the "mystery" behind FOMC decisions. Bernanke feels very strongly that monetary policy is more effectively administered when the Fed clearly communicates its objectives so that markets are aware of what the Fed intends to do under various circumstances. Certainly, politics are a consideration in the Fed embracing transparency. Presumably, additional transparency will reduce demands for "audits" of monetary policy that the Fed so strongly opposes.

"The Federal Reserve is already one of the most transparent and accountable central banks in the world, providing voluminous information and explanation concerning all of its activities. However, I believe that we should be prepared to do even more, to become even more transparent."

This approach to transparency is best illustrated in the minutes of the FOMC meetings which very candidly reflect how the FOMC members view the current economic/financial environment, and what the reasons are for their decisions. Transparency will also spell the demise of one of the market's formerly favorite pastimes – "fed watching." Now, when the markets want to know what the Fed intends to do, simply perusing the FOMC minutes and/or listening to statements by the Chairman are all that is needed. A corollary to this new way of "reading" the Fed is that sometimes the Fed itself is unsure about the future direction of the economy, inflation, etc. and is not certain what changes in policy it should/will initiate to deal with the developing situation. But presumably, the Fed will reveal this uncertainty or hesitation via FOMC statements and speeches.

Discount Rate Example

A good example of this transparency is the recent 50 basis point increase in the discount rate by the Fed a few weeks ago on Friday February 19th. Some of the financial press used the phrase “markets surprised” in their headlines about the change. However, the Chairman clearly spelled out his intentions 10 days previously on February 10th in his written statement for the House Financial Services Committee;

“Also, before long, we expect to consider a modest increase in the spread between the discount rate and the target federal funds rate. These changes.....should be viewed as further normalization of the Federal Reserve's lending facilities..... should not be interpreted as signaling any change in the outlook for monetary policy.”

The fixed income markets should take comfort in the fact that Bernanke communicated to the markets that the discount rate was going to rise, but this does not mean a shift in monetary policy.

Greenspan Legacy

The obvious contrast to the Bernanke full transparency commitment is the approach that characterized former Fed Chairman Alan Greenspan's tenure as head of the Fed. Greenspan was accused, often unfairly, of purposefully obfuscating the Fed's intentions. It is well known that he tightly controlled the flow of information and opinions coming out of the Fed and as a result, he was generally the focal point for the markets for insight or information related to the Fed. Thus far, Bernanke has studiously adopted a style which promotes far more communication with the public and to some extent gives various Fed members greater leeway when expressing their opinions in speeches.

Inflation Targeting

Another aspect to this transparency is that the Fed is now considering periodic announcements regarding specific inflation targets. Until now the Fed has referred to its own inflation targets as general, almost informal, guidelines. The new targeting would be much more specific, intended as a way to communicate monetary policy intentions to the public. These “new” targets would give the markets a sense of the Fed's threshold level for prices before changes in monetary policy might occur. All of this is intended to make the Fed more transparent and allow the public to know what the Fed's may do.

Reducing Uncertainty

Perhaps the biggest beneficiary of the Fed's transparency will be businesses and consumers. For example, if transparency reduces uncertainty and the markets are not “surprised” by the Fed, then businesses will feel more confident when making decisions about future business investments. Similarly, if consumers can feel reasonably confident that the Fed will not abruptly change rates or shift policy, then they too will have more confidence in their spending/investment decisions.

Transparency should also help reduce fixed income market volatility. Again, if there is general consensus about what the Fed intends to do, it may not “pay” to be a contrarian.

CONSLUSIONS

- Despite the Fed's best efforts, charting a course for monetary policy will remain an inexact science. However, increasing the number of the tools the Fed has at its disposal will probably make the transmission of monetary policy much more effective.
- Further, Bernanke's demonstrable commitment to transparency will go a long way towards reducing unnecessary uncertainty and volatility in the markets.
- It remains to be seen if the new, more robust arsenal now at the Fed's disposal will enable it to have a more direct influence over the economy.

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